Best Practices in Context-Based Sustainability[1]

Center for Sustainable Organizations
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Context-Based Sustainability (CBS) is a specific approach to measuring, managing, assessing and reporting the sustainability performance of organizations and other human social systems that is arguably no different, in principle, than the way in which the management of financial performance has always been done.

Managing financial performance, that is, has always been about managing the impacts of organizations on a particular type of capital – economic – for the benefit or well-being of a defined category of stakeholders: shareholders. The mainstream practice of capitalism, that is, has always been *monocapitalistic* in form.

In what we and many others now refer to as Triple Bottom Line (TBL) accounting, the same thing can be done relative to managing the impacts of organizations on not just one capital, but all of them; and for the benefit of all stakeholders. This in turn we can think of as *multicapitalism*. Multicapitalism is, in fact, the basis of TBL performance accounting and the CBS form it takes today.

Briefly described below are several key principles and best practices that should be adhered to when practicing CBS, the application of which makes it possible to operationalize TBL accounting in systematic and rigorous ways.

Stakeholder Well-Being

The purpose of performance management and accounting is to guide and assess the activities of an organization or group in such a way as to help ensure the well-being of its stakeholders. Stakeholder well-being, that is, is a core principle of management, the achievement of which necessarily entails the safeguarding of both human and non-human well-being. Indeed, any actions that can have the effect of diminishing human or non-human well-being can either directly or indirectly affect the well-being of those whose interests are more directly served by an organization (i.e., its stakeholders), if only through the negative reputational effects of selfish or negative behaviors, or worse. Shareholders are certainly not the only stakeholder group whose well-being managers should be concerned with.

[1] McElroy, M. (2008) *Social Footprints: Measuring the Social Sustainability of Organizations*: https://www.sustainableorganizations.org/McElroy-DISSERTATION.pdf

Materiality

The scope of performance management and accounting should be confined to only those areas of impact that correspond to duties and obligations owed by an organization to its stakeholders. Since this will vary by organization, the need to perform materiality determinations is of paramount importance in CBS. Performance assessments, that is, should never be done using predetermined/one-size-fits-all sets of metrics or indicators as if all organizations are alike. Indeed, they are *not* alike, and so the indicators we use to assess their performance should, themselves, be uniquely defined, even if it is the case that multiple organizations will very often have a need to utilize the same, or substantially similar, metrics for common areas of interest (e.g., for greenhouse gas emissions, water use, employee wages, product safety, etc.).

To be meaninmgful, materiality determinations must take account of the following key factors: *Capital Impacts, Stakeholder Well-Being*, and *Duties and Obligations.*

- ***Capital Impacts***

Performance management and accounting should specifically concern itself with the impacts of organizations on the quality and sufficiency of vital capitals, since it is vital capitals that their stakeholders rely on for their well-being. This includes, of course, the capitals upon which organizations are, by design, supposed to produce or enhance for the narrow benefit of shareholders, but also the capitals upon which organizations may have other direct or incidental impacts as a consequence of their activities (e.g., the functioning of the Earth's climate system, a type of natural capital), which one or more constituencies directly rely on for their well-being.

The capital construct is especially useful here for five other reasons:

1. It helps us to differentiate between the effects of organizations' activities on resource *stocks* and *flows*, according to which a capital stock can be distinguished from the beneficial flows of goods or services it produces (e.g., the Earth's climate system is a stock, not to be confused with the flow of ecosystem services it provides in terms of temperature regulation and climate control);
2. It provides us with a non-arbitrary basis for differentiating between social, economic and environmental areas of impact (i.e., the Triple Bottom Line), by which we are able to correlate impacts on specific capitals with the respective bottom lines they pertain to, all in a way that makes quantitative Triple Bottom Line performance measurement and reporting both possible and meaningful;
3. It provides us with an empirical variable we can use to make such quantitative assessments: namely, the *carrying capacities of capitals*, a measure of the capacity of specific capitals to satisfy basic human and non-human needs. The sustainability of an organization's activities, therefore, boils down to what the effects of its activities are on

the carrying capacities of vital capitals, as such capacities may be needed to ensure stakeholder well-being;

4. It helps us to avoid committing the mistake of interpreting and reporting performance in terms that illegitimately assume that negative performance in area (e.g., environmental) can be offset or compensated for by positive performance in another (e.g., social or economic). Indeed, it is capital theory that makes it clear that social or economic capitals are generally not substitutable for natural capitals. And without the aid of capital theory to inform us, we might be tempted to think otherwise, in which case our TBL performance accounting and reporting systems would misguide us;
5. Capital theory also helps us to understand that (a) some capitals are limited in their availability and cannot be replenished by humans at all (i.e., the natural capitals); while others are, in fact, human-made and can almost always be renewed, given the will and the resources required to do so. This basic insight also provides us with a basis for assigning monetary values to our impacts on vital capital capitals in cases where we choose to do so. Specifically, as the use of non-renewable natural capitals approaches their limits, their incremental costs should rise exponentially; and likewise, in cases where the ongoing reproduction of anthropogenic capitals falls short, the cost of such negligence should also increase exponentially the closer an organization or group gets to zero in its output.

All this and more comprise the instrumental value of using capital theory as a basis for modern-day TBL accounting.

- ***Stakeholder Well-Being***

We cannot speak of performance accounting without first raising the question of why we do it, or for whose benefit it should be done. Why, in other words, does the performance of an organization matter? It matters because the well-being of certain groups depends, at least in part, on what the effects of an organization's activities are and whether or not it survives because of it. Shareholders' equity, for example, is entrusted to an organization, which in turn is expected to produce a return from it (i.e., a gain in value) at a reasonable rate – and certainly not a loss.

Shareholders, that is, have a stake in the performance of an organization insofar as the effects of its activities can affect the quality or sufficiency of the capitals they rely on for their well-being (their economic capital). The same goes for impacts organizations have on other vital capitals, whether for the benefit of shareholders or not. Performance accounting, then, must be stakeholder-based in the sense that the needs and interests of all parties whose well-being can or should be affected by the activities of an organization, and not just one of them (shareholders), should be addressed in its scope.

Determining materiality, then, is the process we follow in order to identify whom an organization's stakeholders are and what the corresponding capitals are that it is either already having impact on, or should be having impact on, in ways that can affect their well-being.

Stakeholders, in turn, acquire their standing as such either as a result of the capitals an organization is having impact on (e.g., community members by virtue of the effects a manufacturer is having on local water resources) or because of agreements or contracts it has voluntarily entered into (e.g., agreements with employees, suppliers, and customers). All of this must be determined in order to do a proper job of defining the scope of a TBL/CBS-based performance management and accounting system.

- ***Duties and Obligations***

Once the identity of an organization's stakeholders and the types of capitals it is, or should be, having impact on have been determined, norms, standards or thresholds for what such impacts ought to be in order to be sustainable must be defined. These can be thought of as duties and obligations (D&Os) owed by an organization to its stakeholders, the substance of which in performance management and accounting can serve as *organization-specific standards of performance*.

The ethical basis of this principle is quite clear: organizations have no right to undermine or put the well-being of others at risk; and are otherwise accountable for their impacts on vital capitals as set forth in agreements they voluntarily enter into, not to mention as prescribed by law. All such D&Os therefore have a role to play in performance management and accounting, and in fact generally underlie the core *theory of performance* in Context-Based Sustainability (CBS) – that the most important measure of an organization's performance is the extent to which it adheres to its duties and obligations to have or manage its impacts on vital capitals in ways that can affect its stakeholders' well-being.

The fundamental theory of performance described here, then, is perhaps best understood as one that relies on sustainability as its regulative ideal, since it is the preservation of vital capitals for the sake of stakeholder well-being that is valued so highly in the CBS approach. Impacts that have the effect of diminishing, or that fail to continually create or preserve, vital capitals in accordance with D&Os owed to stakeholders are counted towards negative performance, precisely because they put the well-being of people who depend on them at risk.

Moreover, this same basic theory of performance is arguably the one that has otherwise prevailed in conventional financial accounting for centuries now (i.e., that the economic capital of shareholders must be preserved, if not expanded in size, in order for an organization's financial performance to qualify as positive). In CBS, we simply add social and environmental impacts to the mix and thereby complete the criteria according to which an organization's broader TBL performance can be assessed.

One final point on D&Os that should be made here is that voluntary, discretionary or non-obligatory areas of impact on vital capitals rarely qualify as material for inclusion in a performance management and accounting system. Philanthropy and charitable donations, for example, should not be comingled with other areas of impact for which D&Os to have impact are non-negotiable, so to speak.

There is, however, an exception to the rule, which occurs in cases where an organization has publicly committed itself to the making of what would normally be regarded as voluntary or discretionary acts of beneficence. If such commitments are in fact made in ways that have the effect of recruiting investors, customers, new employees, trading partners, brand loyalty or political support of any kind, the areas of impact involved are no longer discretionary and become obligatory. This kind of thing is now starting to happen with increasing frequency amongst so-called purpose-driven organizations such as B Corps and others. For a guide on how this works under the law, readers are encouraged to familiarize themselves with the legal principle of *Promissory Estoppel*. It effectively applies to TBL accounting, as well.

Boundaries, Thresholds and Allocations

As explained above, the proper scope of an organization's performance management and accounting system should be determined by reference to: 1) the types of capitals it is either already having impact on or should be having impact on, or not, in specific ways, 2) the stakeholders whose interests and well-being are involved, and 3) the corresponding duties or obligations it owes to each of them (as groups) to manage its impacts accordingly. The results take the form of entity-specific responsibilities or standards of performance that can then be used as norms or targets for assessing the TBL performance of organizations.

This raises the question of how specifically to specify targets for what impacts on vital capitals should be, or not be, once they have been determined to be material. This can be particularly vexing in cases where the responsibility for preserving vital capitals is arguably shared by an organization with others, such as the shared responsibility to maintain natural capitals, like water, biodiversity, the climate system on Earth, etc. In all such cases, the normative impacts of an organization should be fair, just and proportionate – no more, no less.

The first determination that should be made, then, for specifying performance norms in material areas of impact is whether or not the responsibility for creating or maintaining the capitals involved is shared or exclusive. The responsibility for upholding a threshold of compensation for employees, for example (e.g., as in never paying employees less than a living wage), is exclusive to an organization; the responsibility for maintaining the sufficiency of a water supply in a community, by contrast, is shared with others in the community.

With all of this in mind, the process for specifying organization-specific standards of performance (norms) for impacts on vital capitals has three parts to it:

1. **Boundaries** – The first step is to determine what the overall boundaries of the vital capital are, so that whether the responsibility for maintaining it is shared or exclusive can be understood. The boundary of wages paid to employees, for example (a type of economic capital), is the payroll scope within an organization itself; the boundary of a supply of water, by contrast, is the geography in which it is found (e.g., a specific watershed).

2. **Thresholds** – Thresholds specify the extent of the stocks and flows of capitals within the boundaries of interest that must be maintained in order to ensure stakeholder well-being. The magnitudes of capital stocks and flows are sometimes also referred to as their *carrying capacities*, with such capacities being defined in terms of the levels of demand they can support. It is ultimately the carrying capacities of vital capitals that must be maintained at specific levels in order to ensure the well-being of stakeholders. The threshold for a living wage, for example, is the wage level itself that should be paid to all employees within an organization; the threshold for water, by contrast, is the extent of its renewable supply in a watershed that should not be exceeded by consumption.
3. **Allocations** – Once thresholds have been defined, the next question is the extent or degree to which an individual organization should be held responsible for its maintenance. The allocation or responsibility for paying a livable wage, for example, is exclusive to an employer; the allocation or responsibility for maintaining natural resources, by contrast, is typically shared with others, most notably those who also happen to inhabit the same geographic boundary of interest.

   Calculating fair, just and proportionate shares of the responsibility to maintain vital capitals in cases where the responsibility is in fact shared with others is typically done using scaling factors as proxies. The proportionate share of an organization's entitlement to use water resources, for example, might be made in accordance with what its proportionate contribution to GDP is in the same geographies (boundaries); or what its proportionate headcount in size is (workforce) relative to the background population of interest (i.e., within the watershed). Other proxies might include a reference to what an organization's proportionate share of production or output is in its sector.

   In order to be viable, any such proxy for making allocation determinations must be supported by: 1) readily available macro measures of the scaling factor being used in the bounded domain of interest (e.g., GDP or population in a watershed), and 2) readily available measures of the organization's own contributions to such measures (e.g., its contributions to GDP; its workforce size; or its output).

   Last, it should also be clear that whereas allocations in the case of impacts on natural capitals will be expressed in terms of not-to-exceed shares of available supply (consumption), allocations in the case of impacts on all other capitals should be expressed in terms of not-to-fall-below shares of the responsibility to produce them (production) – e.g., living wages, workplace safety, product safety, etc. To be sustainable, that is, an organization must live within its means (natural capital) and ensure the means to live (all other capitals) – fairly, justly and proportionately. Its metrics should be designed accordingly!

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For more information about Context-Based Sustainability, contact Mark W. McElroy, PhD, founder and Executive Director at the Center for Sustainable Organizations by email at mmcelroy@vermontel.net.