

## The Crisis' Silver Lining: Impact Accounting Penetrates the Mainstream

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**M**alcolm Durham, a San Jose, California, native and former Marine, is a successful real estate entrepreneur. Since the recession, he has been purchasing distressed mortgages across the country on the secondary mortgage market from banks eager to be rid of them. While striving to achieve extraordinary financial returns, he also works with homeowners to establish new terms they can afford, proactively striving to reduce the need to evict families. Despite the hassle and declining property value for him and the neighbors that typically ensues from eviction, Durham sympathizes with the disruption that eviction brings for homeowners and their families. "I'm not a social entrepreneur," he told me. "I'm a regular businessman, but I can tell what I'm doing is having an impact on the lives of the people I'm helping."

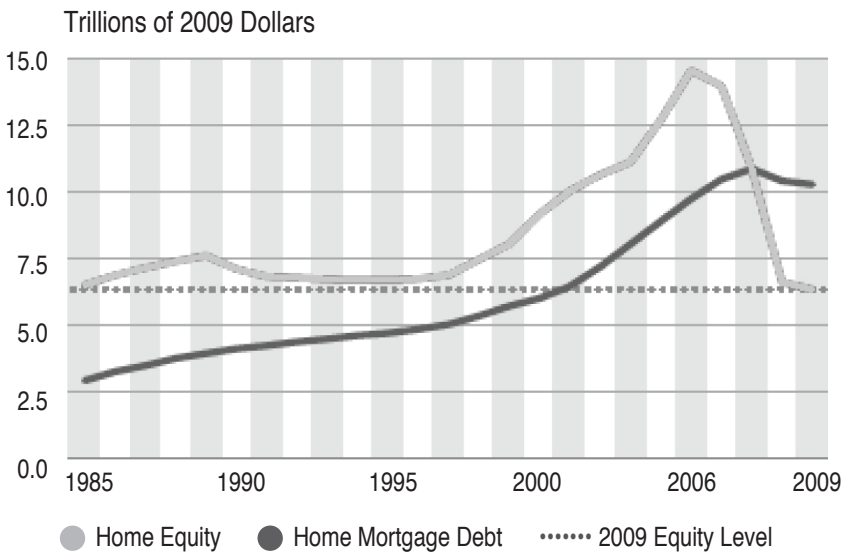
The impact on families and communities that Durham is having is valuable, both inherently, and in terms of its effects on Durham's financial returns. This value should somehow be measured and added to the bottom line. Yet as investors and mortgage holders are currently working out millions of distressed mortgages, many solutions result in manageable new terms for homeowners, but all too often the lives of the distressed homeowners are severely disrupted because affordable terms are not found, even when lenders face far higher costs from evictions. When considering just the short-term cash outlays, banks laden with distressed mortgage assets frequently though inaccurately determine that it is cheaper to not mitigate the economic and psychic costs to the homeowner and the related declines in property value. After all, the bank's urgent priority is getting these devalued assets off the books so everything can move forward. However, financial value, and value in other terms to humans, are intertwined, and there is enough potential financial and social value in doing the extra work that some entrepreneurs, like Durham, are not only paying attention to homeowner outcomes and providing technical assistance, but they are also measuring both the financial and social impact of their efforts—as well as the costs to homeowners and taxpayers of doing nothing. Their objective is to quantify this value so that it is a more explicit part of the overall value proposition of the mortgage, and sell the mortgage to those who recognize this value.

The banking crisis has laid bare something that is often hard to quantify: the social value from homeownership that accrues to people and their communities. According to Building Resilient Regions at the University of California, Berkeley, foreclosures uproot children from their schools when families must move, vacant buildings contribute to an uptick in crime in neighborhoods with high foreclosure rates, and parents suffer the emotional strain of losing the biggest asset they own, not to mention a poor credit score that will shadow them. Even neighbors are affected. Homes within one-eighth of a mile of a foreclosure has been estimated

to lose between .05 and 2 percent of their value.<sup>1</sup> Finally, the individual executing the transaction suffers from being the one who literally puts a family out of their home. Yet these aspects of potential value are systematically discounted by conventional accounting systems.

The result of this is becoming apparent: price and value have been divorced. The unaccounted-for facets of value to buyers that are inherent in goods have too often been stripped out of those goods by financial accounting that is blind to the human costs and benefits, and by capital markets that fail to recognize this value. Buyers are left with only a shell of the good at the original price (before the discovery that it is not so valuable after all, and the ensuing fall in price). As a result, buyers, investors, and the public are at risk.

*Figure 1. Real Home Equity has Returned to its 1985 Level and Stands Below Mortgage Debt for the First Time on Record*



Note: Values are adjusted for inflation by the CPI-U for All Items.

Source: Federal Reserve Board, Flow of Funds

<sup>1</sup> Todd Swanstrom research via Building Resilient Regions, The Institute of Governmental Studies at the University of California, Berkeley; see <http://brr.berkeley.edu/2011/08/how-metro-regions-can-prepare-for-housing-markets-of-the-future>.

## Accounting Badly Needs an Update

In the case of mortgages, the moment this divorce occurred can be pinpointed with astonishing precision in 2005 (see figure 1).<sup>2</sup> But while mortgages are the most vivid example, the same phenomenon plagues many other products laden with externalized hidden costs. These range from personal computers (whose suppliers sometimes resort to unsafe or inhumane manufacturing conditions to deliver lower prices<sup>3</sup>) to conventional strawberries (grown in fields sprayed with carcinogenic pesticides<sup>4</sup>).

So, in our world in which the buyer and seller often never meet one another and goods are produced at a great distance from where they are consumed, how to strengthen the connection between price and value to ensure that buyers and society aren't getting (intentionally or unintentionally) scammed? The answer is simple if not easy: by accounting for the benefits generated by products or investments to people and communities alongside the financial benefits generated for shareholders, and by making this information equally transparent.

This is already happening, and the practice is being catalyzed rapidly by crises such as that in the mortgage industry.

The demand for measuring social as well as environmental impact is going mainstream. When the California Public Employees Retirement System (CalPERS), the largest public pension fund in the United States, established an environmental technology private equity investment initiative, its board knew that "if you don't measure it, you can't manage it." The board established a mechanism to track the net environmental benefits of each investment made. From 2008 to 2010, the board tracked some \$600 million invested in more than 200 companies through its private equity partners. When combined with the investments of other investors in the same set of companies, \$9 billion in assets were measured for environmental impact, perhaps the largest effort in history to measure net environmental impact among privately held companies.

A number of Fortune 500 corporations have internally piloted social return on investment (SROI) accounting principles within the past two years, although to my knowledge they have not publicized their efforts. The same corporations have not been quite so circumspect about their interest outside the United States. The "Big Four" accounting firms PWC and KPMG have sponsored and participated in projects and conferences designed to promote accounting for SROI, such as Social Evaluator (Netherlands)<sup>5</sup> and the SROI Conference (Australia).<sup>6</sup>

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2 Harvard Joint Center for Housing Studies, "State of the Nation's Housing 2010 (Cambridge, MA: Harvard University, 2010), downloadable at [www.jchs.harvard.edu/son/index.htm](http://www.jchs.harvard.edu/son/index.htm).

3 These conditions have in some cases cost lives. See the MSNBC story, here: [http://www.msnbc.msn.com/id/37510167/ns/business-us\\_business/t/why-apple-nervous-about-foxconn/](http://www.msnbc.msn.com/id/37510167/ns/business-us_business/t/why-apple-nervous-about-foxconn/).

4 Environmental Protection Agency, Pesticides: Topical and Chemical Fact Sheet" (Washington, DC: EPA, March 17, 2011), available at [http://www.epa.gov/pesticides/factsheets/iodomethane\\_fs.htm](http://www.epa.gov/pesticides/factsheets/iodomethane_fs.htm).

5 Social Evaluator "News Update 20/01/2010" at <http://www.socialevaluator.eu/Newsevents.aspx>.

6 [http://www.csi.edu.au/event/Social\\_Impact\\_Measurement\\_Conference.aspx](http://www.csi.edu.au/event/Social_Impact_Measurement_Conference.aspx).

The development of an accounting discipline that captures social or environmental impact for both for-profit and nonprofit entities is not confined to a handful in the private sector. The SROI Network, which began as an informal group of practitioners in the United States, Canada, and Europe, was incorporated in 2008 and today numbers more than 800 members in Europe, Asia, North America, and Africa. The members promote the development and adoption of a principles-based accounting method focused on social value creation. This accounting movement was catalyzed by the U.K. government's adoption of SROI in 2008 as a way to standardize efforts to better enable nonprofit organizations and businesses with a social purpose to account for the social value they create.<sup>7</sup>

When one party generates and accounts for that value, and when another party audits the efforts, a “dialectic between auditor and accountant” occurs that results in “an acceptable norm for how to value the impact,” according to a conversation I had with Jeremy Nicholls, economist, chartered public accountant, and director of the UK and International SROI Networks. This dialectic can be engineered, for example, by convening industry experts to design the best method or metrics, such as when the Aspen Network of Development Entrepreneurs' encouraged agreement on standard job-creation and other performance metrics among international sustainable development investors. The dialectic can also emerge from a standing corps of practitioners and auditors, such as SROI Network, equipped with principles that can be applied to assess social value. A third way the dialectic can arise is through in-person relationships that transcend the need for either formal reporting or verification, as individuals use their internal judgment to ascertain what the value is for them to a standard they find personally acceptable. This third approach, though the most ancient and still the most pervasive, is appropriate when only the auditor himself is at risk should his judgment prove incorrect. The future probably looks like a combination of all three.

If the business case for measuring social impact is to be firmly closed, more investments and companies must account for their impact, and document that they have done so. Five factors are causing this to happen and trends suggest that by as early as 2015, accounting for the human impacts of their mortgage investments even on the secondary market will be *de rigueur* for the major banks to stay competitive.

1. **Visibility.** The public at large is increasingly aware that the actions of a given business or industry drive specific costs (or benefits) born by the public and the natural environment. Whether it is concerns about cancer posed by the chemicals that companies put in the plastics we drink from and the water we drink; Type II diabetes spurred by the quantities of refined sugar in our staple foods and drinks; poverty-wage, forced or foreign labor used in the manufacture of our clothes or electronics; or the destruction of favorite forests or fisheries due to climate change, people are understanding that these and many other impacts are driven by industry practices. This knowledge creates resentment and friction that hinders

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7 See the Scottish Government website on SROI at <http://www.scotland.gov.uk/Topics/People/15300/SROI>; and Roxanne Clark, “SROI: Government and Third Sector Extend Reach of Measurement Tool,” *Philanthropy UK Quarterly*, no. 37 (June 2009), available at <http://www.philanthropyuk.org/quarterly/articles/sroi-government-and-third-sector-extend-reach-measurement-tool>.

companies' ability to sell and grow. Conversely, those companies that take account of and design their products and processes to mitigate or completely circumvent these problems experience increased goodwill. The banking sector in general, and the mortgage industry in particular, has discovered this most recently. There has been a steady erosion of goodwill toward big banks, signified by the November 5, 2011 "Bank Transfer Day," in which a grassroots campaign on Facebook led hundreds of thousands to close bank accounts and reopen them with competitor community banks and co-ops. Numerous startups are reinforcing the transparency and action loop, from Goodguide.com to B Lab to LaborVoices.com.

While the traditional solution to this problem that banks and other businesses have pursued is marketing campaigns to persuade consumers that they really aren't so bad, by highlighting a few anecdotal cases of good-doing combined with lottery-style chances to win prizes by becoming or staying customers, the widespread availability of social media combined with a more systematic social accounting framework for public evaluation of the costs and benefits of patronizing one business versus another makes it easier than ever for the public to promote best practices and to reveal cases of abuse, and more necessary for businesses to develop a more systematic approach to accounting for their overall value, including in terms of social and environmental impact. The advice to businesses seeking to manage their social media image is: be authentic because the public will call you out if you aren't. Brad Shaw, Home Depot's vice president for corporate communications and external affairs, says, "You can't control the conversation. You have to learn to be comfortable being uncomfortable," and be part of a genuine dialog with the customer.<sup>8</sup> In the past four years Facebook has grown from 50 million to 800 million active members worldwide; within just six months of its launch Google+ boasts 62 million users. Given the global public's newfound interconnectedness, its ability to see the consequences of specific businesses' actions, and to mobilize consumer behavior accordingly, is already huge and will only accelerate as people gain experience doing it in the next three years.

2. *Technique.* A method to credibly and practically measure social impact—and one that could be taught in management programs alongside financial accounting—is needed. Because of the nearly infinite diversity of businesses and situations, this method should be based on a set of principles that can guide judgments in any context. In specific sectors or contexts, a consensus on the best particular metrics to use is also valuable. These solutions have come into existence in the past two decades, and within the past three years have seen increasingly rapid development and improvement. The Global Reporting Initiative (GRI) was founded in Boston in 1997 to create "an accountability mechanism to ensure companies were following the CERES Principles for responsible environmental conduct." It has since published three major updates to its guidelines on what and how to report relative to these principles, and has been adopted by more corporations than any other reporting approach to date. The Prince of Wales' Accounting for Sustainability (A4S) Project, instigated in 2004 "to develop

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8 Brad Shaw, "Five Social Media Lessons for Business," *Bloomberg Businessweek*, September 20, 2011 (<http://www.businessweek.com/management/five-social-media-lessons-for-business-09202011.html#>).

practical guidance and tools for embedding sustainability into decision-making and reporting processes,”<sup>9</sup> promotes its own sustainable accounting principles, and in 2010 teamed with the GRI to create the International Integrated Reporting Committee (IIRC), “to create a globally accepted framework for accounting for sustainability.”<sup>10</sup> Complementing these solutions primarily designed for publicly-listed companies are SROI and Social Accounting and Audit, as well as efforts to capture the collective intelligence about the best way to measure a given impact such as Impact Reporting and Investing Standards (IRIS), a clearinghouse for metrics initiated in 2008 which now contains both cross-sectoral and 8 sets of sector-specific metrics. Additionally a myriad of sector- and issue-specific measurement certifications complement these standardized principles, reporting systems and metrics, all of which make it far easier to credibly account for and audit environmental and social value than ever before.

3. *People power.* A methodology is useless if nobody knows how to use it, but we are witnessing an acceleration in the rate of adoption of accounting methodologies fueled by more coordinated training. It took approximately ten years for the GRI to grow to its current size of over 600 Organizational Stakeholders who fund its work; the SROI Network in just the past three years reached 800 paying members. Both groups offer trainings and train-the-trainer workshops to accelerate adoption of their approaches. A Social Impact Analysts’ Association recently formed to implement a set of principles among the nonprofit sector that are nearly identical to SROI Network principles. It too focuses on both methodology development and training. Also encouraging, dozens, if not hundreds, of graduate and undergraduate programs in environmental economics, business, and other disciplines have begun not only teaching courses on social entrepreneurship in the past decade, but more recently have also begun lecturing on impact management. Those who have received some degree of training are more able to evaluate the performance and marketing claims of businesses in any industry; based on just a count of trainings I have provided through SVT Group and those of groups we have worked with, I estimate that at minimum tens of thousands of people worldwide now have a basic framework for evaluating the environmental and social performance of business, and the numbers are growing rapidly.

4. *Technology.* To justify the business case for measuring impact, we must radically reduce its cost and complexity. Aside from sheer computing power, the internet and cellular technology among other innovations are making it far easier for people around the globe to help paint the picture of environmental and social impact in real time, to manage and communicate that picture, and to drive consumer behavior (Bank Transfer Day being but one recent example). In addition to the growth in social media cited above, in just the past four years the number of mobile phone subscribers worldwide has grown from 3.4 to 6.0 billion.<sup>11</sup> When

9 Prince of Wales Accounting for Sustainability Project mission statement (<http://www.accountingforsustainability.org/about-us>).

10 Ibid, press release on the IIRC’s launch, August 1, 2010.

11 Worldwide mobile phone subscriptions in 2007 were 3.37 billion and in 2011 were 5.98 billion. “Key ICT indicators for developed and developing countries and the world (totals and penetration rates),” International Telecommunications Union ([http://www.itu.int/ITU-D/ict/statistics/at\\_glance/KeyTelecom.html](http://www.itu.int/ITU-D/ict/statistics/at_glance/KeyTelecom.html)).

these technologies are combined with more standardized reporting of impact information, businesses that manage impact information will increasingly be able to use those practices to drive bottom line value.

5. *Investor demand.* One marquee institutional name like CalPERS is groundbreaking but insufficient to assure others that they aren't sticking their necks out too far when they follow suit. However it won't take many more of the top investors to jump in for the rest to follow, and whereas a few years ago their investment advisors discouraged it, more recently they have actually begun encouraging it. Recently two Harvard scholars published a study of a large sample of publicly traded U.S. firms over 16 years, investigating "the impact of corporate socially responsible (CSR) strategies on security analysts' recommendations." They found that "socially responsible firms received more favorable recommendations in recent years relative to earlier ones, documenting a changing perception of such strategies by the analysts."<sup>12</sup> This would certainly make sense given that 10 years ago the findings of 80 academic studies over the prior 30 years showed that the relationship between social enterprise activities and corporate financial performance was in the majority of cases (53 percent) positive, and in only 5 percent of studies was a negative impact on the bottom line recorded.<sup>13</sup> As author Umair Haque put it:

The folks that recommend to the world's investors whether to buy or sell your shares just upended their expectations about better and worse--and in which direction prosperity lies. Decode the message inside the logic, and they're issuing a manifesto worthy of an uprising. It says: Want to create shareholder value in the twenty-first century? Tough. Now, it depends first on not destroying real wealth--and better yet, on creating it. Continue to map that trajectory, and here's what you might conclude: we're heading toward a world of human exchange in which hard-nosed measures of a company's impact are as important to a company's vitality and viability as yesterday's weary conceits of 'profit.'

Entrepreneurs, who are the most gifted at sniffing out business opportunities just before everybody else, will help bring these five forces together. Dean Engle is an example. His firm, Park Tree Investments, has recognized that human relationships act as a means of accounting for social value. Park Tree has a customized mortgage management program for low- to moderate-income borrowers, in close partnership with financing entities and a network of innovative nonprofit organizations that provide in-person loan and financial counseling. Since 2005, the firm has acquired 1,300 distressed mortgages from banks in 37 states, and by providing personalized coaching to borrowers they have dramatically boosted portfolio performance while helping borrowers gain mastery over their overall debt. Park Tree works to

12 Quotes are from Georgios Serafeim's faculty profile page on the Harvard Business School website; see <http://drfd.hbs.edu/fit/public/facultyInfo.do?facInfo=pub&facId=15705>.

13 Interview of Harvard Business School Professor Joshua Margolis referencing his research on the topic, quoted in article by Umair Haque, "Business Isn't as Profitable as Betterness," FastCoExist; see <http://www.fastcoexist.com/1679052/business-isnt-as-profitable-as-betterness>.

provide borrowers the attention they need when they begin struggling with payments, both in terms of helping them understand how to better manage their financial obligations and, when necessary, restructuring the loans. When a borrower is late in a payment, he immediately receives a call, often from someone he already knows, who asks if there's a problem and how can they help.

Engle told me, "We have cracked the code on delivering on-location mortgage services. It's the relationships that matter. We are working with partners to scale relationships." In other words, he says, "To us, every borrower is a person." He plans to account for his firm's value not only in terms of portfolio financial performance but also in terms of avoided economic and emotional distress to the homeowners who might otherwise have defaulted.

Says Engle, "I want to be able to deliver not only as good or better financial returns to the financial institutions we work with, I want to be able to say they've had 4x the social ROI their competitor has had. Those things actually go together." He plans to establish metrics for the benefits to homeowners and may ultimately have an accredited SROI practitioner verify his reported social impact. His three-year goal? To sell Park Tree's services to Bank of America, Chase or Wells.

The big banks may not view such new impact-accounting entrepreneurs as much of a competitive threat. But the package of financial results driven by social value that these entrepreneurs can deliver will confer a clear competitive advantage on whichever bank implements it first; and when that happens the invisible hand will ensure the others quickly follow suit.

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