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Business and society

Adding corporate ethics to the bottom line

Thomas Donaldson examines the logic behind the growth of corporate ethics programmes and seeks evidence for their success or failure

Corporate ethics programmes were like hummingbirds in the 1950s. You didn't see one often and when you did it seemed too delicate to survive. Now, these curiosities have proved their sturdiness, flourishing and migrating steadily from their historical home in Europe and the US to Asia, Africa and Latin America. Most of the 500 largest corporations in the US now boast a code of ethics, and the proportion among a broader collection of US companies has risen to 80 per cent. Similarly, a recent study of FTSE 350 companies and non-quoted companies of equivalent size undertaken by the London Business School and Arthur Andersen showed that 78 per cent of the responding companies had a code of conduct, compared with 57 per cent three years ago.

In the 1950s, ethics programmes were the personal creations of charismatic leaders, such as General Johnson who fashioned Johnson & Johnson's Credo statement; today they are produced by a wide variety of organisations. They encompass not only written standards of conduct, but internal education schemes, formal agreements on industry standards, ethics offices, social accounting techniques and social projects.

The popularity of ethics programmes raises several questions. Do they deliver what they promise in making companies more ethical? Do they aid companies in achieving traditional performance measures such as return on investment or customer satisfaction? And, should companies institute new programmes, or perhaps change the ones they have?

The vogue for ethics programmes does not resolve the most common theoretical question asked of business ethics, namely, what counts as ethical? Even the socially screened investment movement that specialises in assessing stocks for ethical characteristics often seems confused. Consider the tendency of such funds to screen out the "sin" stocks of tobacco, alcohol and firearms. As a result, high-tech stocks, ones unlikely to produce sinning products, have become darlings of such funds. But while Microsoft, for example, will probably never produce wine and so almost always finds itself on the screened funds' lists, it has been found in violation of US anti-trust laws, a sin greater in some people's eyes than fermenting grapes.

Ethics programmes, however, offer a solution to the question of what is ethical by simply decreeing an answer. It makes little difference to Motorola whether other companies agree or disagree that its principle of "uncompromising integrity" prohibits even small payments in countries where bribery is common. Motorola is content to set the standard for itself.

Similarly, programmes created by industries or international organisations decree their own rules, although they often make use of existing standards as templates. The Organisation for Economic Co-operation and Development's (OECD) recent prohibitions on companies based in member countries from engaging in foreign bribery were developed through extensive discussion among participating countries, although they contain precepts seen earlier in the US Foreign Corrupt Practices Act.

> "Ethics schemes have spread, yet no evidence suggests this is the result of a fall in standards

Corporate ethics programmes have spread widely, yet no evidence suggests this growth is the result of a decline in standards. Studies indicate that between 25 and 60 per cent of employees in any given year admit to having seen ethical misbehaviour, depending upon the context in which the question is asked.

What, then, has driven the ethics boom? Likely factors include the stronger focus by the media on corporate conduct, increased government pressure and growing maturity of business institutions. Recently, media exposure of labour standards in Asia prompted a cascade of initiatives by companies such as Nike in the US and Puma in Germany.

Moreover, people have seen that companies reeling from media and legal pressures suffer heavy losses. Names in the financial services industry such as Prudential Group, Daiwa Bank, Salomon Brothers, and Kidder, Peabody are sobering reminders that these problems can damage both a company's brand and its financial prospects. According to Roy C. Smith and Ingo Walter, financial experts who have analysed these cases, Prudential Group's fraud at Prudential Securities and Prudential Insurance cost it $1.8bn in fines and settlements; Daiwa Bank's concealment of its trading losses cost it fines and the loss of its US licence; Salomon Brothers' government bond auction scandal cost it $500m in fines and settlements and $1bn in market capitalisation; and Kidder Peabody's insider trading scandals and falsification of government bond trades cost it its viability – it was sold by General Electric in 1994 and is now defunct.

Often fines and court judgments take a back seat to the cost in damaged reputations. In the US, the 1994 legal dispute involving the Bankers Trust Company and its sale of derivatives cost it tens of millions in an out-of-court settlement. But more significant was the company's damaged reputation: in a matter of months, its share price halved. And while Royal Dutch/Shell avoided significant legal action for its alleged passivity during the trial and execution of Nigerian environmentalists, the effect on its reputation in the late 1990s was substantial.

Governments, too, have applied increasing pressure on companies, prompting new designs for ethics programmes. In 1991, US Federal Sentencing Guidelines offered companies

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Out in Africa: social outreach projects go beyond writing cheques – they build on a corporation's core competency to contribute to society

a dramatic incentive to develop formal schemes. The guidelines promise reduced penalties for companies found guilty of criminal conduct as long as they meet requirements for compliance and ethics programmes. In turn, compliance-oriented ethics programmes, usually with designated ethics officers, have boomed. Both the Ethics Officers Association and the Defense Industry Ethics Initiative have hundreds of members and share best practice for establishing ethics offices, hot lines, code design, web pages and training programmes. Most of the largest 200 companies in the US belong to one or both of these groups.

Finally, many experts argue that the ethics boom stems partly from the maturing of democratic capitalism. With Marxism dead, capitalism must nonetheless face the moral expectations of market participants. Consumers acknowledge the capacity of markets to generate wealth, but interpret the social contract between business and society as involving more than unmitigated profit-mongering.

The limits of law and regulation to cope with corporate ethics became obvious in the past century when consumers saw that regulation inevitably lags behind knowledge inside an industry. For example, governments were powerless to regulate successfully the use of asbestos because knowledge about its carcinogenic effects was held not by regulators outside the industry, but by employees inside it. By the time the law caught up, it was too late. Society expects companies to use their knowledge in a responsible way.

Most economists agree that externally imposed regulation can be invasive and inefficient. Companies, in turn, reason that if they can substitute moral persuasion for inefficient regulation, then they will benefit.

If the ethics programmes of 50 years ago resembled a rare bird, today they resemble a Brazilian aviary. They fall into three types:

- code and compliance;
- identity and values;
- social outreach.

Each programme has a different goal. Code and compliance programmes are the most common and focus on regulating the behaviour of employees. These formal documents specify employee behaviour in detail and are often written by lawyers. Such codes govern conflict of interest, accepting gifts, anti-competitive behaviour, entertaining customers and so on. Some industries have slowly developed highly specialised compliance programmes. For example, the financial services industry has raised compliance nearly on a par with other aspects of corporate management such as human resources, finance and marketing.

Employees are often asked to sign a document each year indicating that they have read and understood the code. Thus, if the code is broken, it becomes easier to identify and penalise offenders. Motives for such codes are usually starkly self-interested: companies hope to avoid legal and reputational harm by specifying and monitoring behaviour.

A variant of compliance programmes is the trend towards third-party sponsored codes. The ISO 9000 code (regulated in conjunction with The Council for Economic Priorities), the Japanese ESC 2000 Code, the Caux Roundtable Principles, the Sullivan Corporate Responsible Principles, OECD directives on foreign bribery and Kofi Annan's recent Global Compact from the United Nations are a few examples. Many such codes attempt to regulate labour standards in factories that supply global companies, as well as to specify standards for other aspects of behaviour.

Companies such as Mattel, Levi Strauss and Royal Dutch/Shell have developed their own codes. However, increasingly companies find it convenient, if not more efficient, to use third-party resources for monitoring. One example is the work done by the non-profit, anti-corruption group Transparency International. This group not only publishes yearly rankings of bribe-paying and bribe-taking countries, but has worked with corporations and governments to clean up institutions in host countries.

Identity and values programmes, which sometimes exist alongside compliance variants, differ starkly from their counterparts in tone and motivation. They usually draw inspiration from a list of the company's values that emphasises positive concepts such as integrity, respect for others, teamwork and service to stakeholders. Not unlike mission statements, values programmes aim to express what the corporation stands for, to specify an "identity". Royal Dutch/Shell's "principles" and Johnson & Johnson's Credo are examples. Most very large US corporations possess such programmes and companies in other countries are following suit.

Nonetheless, many corporations launch values programmes only to see them wither. In contrast, companies that have been successful in maintaining schemes tend to renew them from time to time and managers use language from values statements to justify business decisions. The tone of values programmes is markedly different from compliance codes. They emphasise positive against negative concepts and self-motivation rather than external sanction. The phrasing tends to be in plain language and sometimes even emotional, in contrast to legalistic compliance codes.

Finally, "social outreach" programmes, the least common type, emphasise the company's role as a social citizen. Two trends dominate such programmes. The first is the "social accounting" movement with its roots in Europe and the second is the "competency-based" responsibility movement from Europe and the US. Social accounting programmes rest on the premise that companies should account for social activities in much

> Ethics programmes are successful when they are seen by employees as being about values

the same way as they account for their financial activities.

Recently a group of 300 global companies called the Global Reporting Initiative (GRI) began formulating standards to improve social reporting. European companies including BP and the social accounting pioneer Norsk Hydro of Norway, have adopted such programmes. To date, social accounting is a legal requirement only in France, where companies with over 300 employees are expected to produce a *bilan social*.

The second form of social outreach emphasises a corporation's core competency in its attempt to contribute to society. Increasingly, such programmes are adopted by companies which want to move beyond writing cheques for good causes.

One of the first to use a competency-based programme was US pharmaceutical company, Merck. Merck startled the world in 1980s when it moved to develop a drug, Mectizan, that would treat the tropical disease river blindness. Because potential users of the drug constituted some of the world's poorest people, no one, including Merck, expected the drug to make a profit. Merck also knew that developing such a drug would cost hundreds of millions of dollars. But relying upon its identity/values tradition of emphasising the health of the customer as the best means to achieve profit, Merck pushed ahead.

The result was remarkable. Merck reaped a public relations windfall and even more significant, the World Health Organisation last year announced that river blindness was on the short list of diseases officially eradicated. Following Merck's success, peer pressure on other pharmaceutical companies proved intense. Since then, Pfizer has announced a $60m project to eliminate the eye disease trachoma and SmithKline Beecham has agreed to give away its drug to cure lymphatic filariasis.

Competency-based initiatives have spread. Ericsson developed a project on magnetic pollution; with help from UNICEF, Procter & Gamble is developing Nutri-Delight, a new product that addresses malnutrition in poorer countries; and BP in 1998 agreed to give solar-powered refrigerators to doctors in Zambia for storing malaria vaccines. Danone sponsors employees in Hungary to work with local groups to raise health standards for children.

Such efforts are not without risk. Monsanto applied its scientific expertise in an initiative with the International Rice Institute, groups from Thailand and the Thai government to educate poor farmers about how to improve crop yields using scientifically engineered seeds and modern chemicals. But Monsanto has since been the target of vigorous criticism in the media, much of it alleging that Monsanto's technology is a hazard to the environment.

Ethics and profits

The motives behind the three kinds of ethics programmes vary markedly. A 1999 study by the Conference Board demonstrated that the reasons behind ethics codes are markedly different in different cultures. Codes dominated by considerations of bottom-line success turn out to be far more popular in the US than elsewhere. The study showed that 64 per cent of all US codes are dominated by self-interested or "instrumental" motives, while 60 per cent of European codes were dominated by "values" concerns.

Despite geographic differences, the Conference Board study demonstrated that increasing numbers of senior managers are involved. About 95 per cent of companies formulating ethics codes include contributions from the chief executive, in contrast to 80 per cent in 1987; and 78 per cent of company boards of directors in contrast to 21 per cent in 1987.

Do better corporate ethics fuel higher profits? This question has been studied for decades with no resolution. A 1999 academic study by Roman, Hayibor and Agle summarised 52 research projects devoted to corporate ethics and profit. At first sight, the results appear encouraging for corporate ethics programme defenders. The authors concluded that 33 studies showed a positive link between corporate ethics and profit, 14 showed no effect or were inconclusive and only five suggested a negative relationship. Nonetheless, the problems of grappling with the relationship between ethics and profit are huge. They include determining not only what "counts" as a more "ethical" company, but also excluding reputational effects that can follow financial success. It is difficult to know what to conclude. Even if better ethics is good business, the question of whether programmes make better ethics remains.

> The forces that have propelled ethics programmes into being are showing no signs of abating

The 2000 National Business Ethics Survey in the US confirmed earlier studies showing that merely having a code of ethics does nothing to improve corporate ethics. Indeed, this most recent study confirmed the trend of earlier pessimistic studies in showing a slight positive correlation between merely having formal ethical standards and poorer ethics – in this instance poorer ethics being reflected in the percentage of employees who feel pressure to compromise ethics. The picture, however, is different for companies being restructured.

The study showed that when organisations are not in transition, the presence of ethics programme elements (such as formal standards, training and an advice line) is not statistically related to the pressure employees feel to compromise on ethical standards. But when organisations are in transition, pressure to lower ethical standards is significantly higher if formal initiatives are missing.

Evidence is accumulating that ethics programmes are more successful when they are seen by employees not as being about compliance, but about values. A 1999 study undertaken by academics Weaver and Trevino showed that when employees construed companies' ethics programmes as being oriented towards "values" rather than "compliance", they displayed far more commitment to the organisation, more willingness to deliver bad news and more willingness to seek advice.

Another study by the same authors strongly suggests that programmes fare better when they are "integrated" rather than "decoupled"; in other words ethics policies fare better when they are integrated with other corporate structures and policies, such as reward policies, and where people who occupy corporate structures are held accountable. In contrast, less successful "decoupled" ethical policies appear to conform to external expectations while making it easy to insulate much of the organisation from those expectations. Hence, companies that attempt to manage ethics without co-operation of senior managers and without adjusting structures and policies are less likely to succeed.

In line with this finding, a 1992 US study by the Institute of Chartered Financial Analysts of 5,000 people in the financial services industry showed that only 11 per cent of financial services managers who witnessed unethical behaviour reported their concerns. Clearly, financial services companies need more than a well-constructed compliance mechanism.

Studies support the connection between employee evaluation of their company's ethical behaviour and important indicators such as loyalty. The 2000 National Business Ethics Survey undertaken by the Ethics Resource Center in the US indicated that 43 per cent of employees who disagree that the head of their organisation "sets a good example of ethical business behaviour" also feel pressure to compromise ethics standards. But only 8 per cent of employees who agree that he or she sets a good example feel ethical pressure.

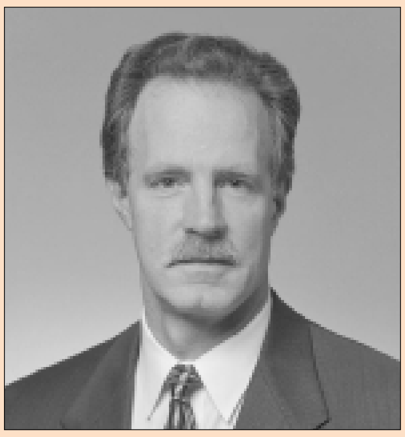
In a recent KPMG integrity survey, four out of five employees who felt that managers would uphold ethical standards said they would recommend their company to potential recruits; whereas only one in five employees who did not believe managers supported ethical standards would do so. The study also found that four out of five employees who felt management would uphold ethical standards also believed customers would recommend the company to others, while the figure halved for employees who did not have faith in managers' ethical standards.

Conclusion

First, we should get used to ethics programmes. The forces that propelled them into being show no signs of abating. Yet not all ethics programmes are created equal. Corporate ethics programmes can either fit with or conflict with the interests and aims of the corporations that create them.

Companies that wish to define their identity and communicate their values to employees, stockholders and customers, should adopt different programmes from ones who simply want to limit legal and public relations problems. Even in the latter case, however, evidence suggests that compliance programmes will be more successful when connected to positive values with which employees can empathise. For any ethics programmes, furthermore, the evidence is strong that merely having a formal code is not enough. Any such statement must be synchronised with the company's organisational structures, its culture and its leadership.

Finally, companies aiming for high standards of social citizenship, or aiding society by doing more than just giving money away, require a different kind of programme. Current trends for such programmes are towards social accounting systems and making creative social use of a company's core competencies.



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