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How does business ethics pay?

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How Does Business Ethics Pay?

An exploratory look at the ways through which
doing business ethically is being translated
into corporate financial performance.

By

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How Does Business Ethics Pay?

Contents

1. Executive Summary

2. Methodology used in the Research

3. The Two Key Stakeholders

(a) Employees

- Labour turnover
- Attraction and retention of staff
- Employment Tribunal application analyses
- Rating agency data

(b) Customers

- Customer Retention
- Britain's Most Admired Companies
- Customer complaints

4. Cost of Capital

- Choice of measurements
- Interest rate differentials
- Volatility

5. Cost of Insurance

6. Corporate Top Management

7. Summary of the Main Conclusions

Appendices

Literature Review

Executive summary of *Does Business Ethics Pay?*

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1. Executive Summary

In 2002/3 the Institute of Business Ethics (IBE) undertook research that showed that for large UK companies having an ethics policy (a code) operating for at least five years, correlated with above average financial performance based on four measures of value. The performance of a control cohort of similar companies without an explicit ethics policy – no code – was used for comparison. This was published by IBE in April 2003 under the title *Does Business Ethics Pay?* [See Appendix 2].

The present pilot study investigates what, if any, are the distinguishing features of the governance operation of companies with explicit ethics policies compared to those without such a policy. [It should be viewed as a progress report]

In order to try and recognise differences of policy and approach, we focused on three areas:

1. *Employees and Human Resource Policies*

We would expect that the companies with ethics codes would be more effective in engaging with their employees, provide a good working environment and have an ethics culture that ensures that unethical behaviour is easily identified and dealt with. There is evidence that staff prefer working for such organisations and that good quality staff are attracted and retained. Consequently, we would expect labour turnover to be lower and for companies to have less costs associated with union disputes and employment litigation. The paper explores these hypotheses using data in the public domain.

2. *Reputation and the Customer*

The literature suggests that reputation is a key factor from both an employee and customer perspective. Economies on marketing expenditure may be expected when customers select firms or brands that they trust. Companies with a good reputation may also expect customer loyalty resulting in a more stable or increase in turnover over time. This study has not attempted to show the link between reputation and financial performance but has relied on the evidence from other studies in this area. It has however, considered whether companies with codes of ethics do actually enjoy a better reputation than those which are not explicit about business ethics.

3. *Cost of Capital and Insurance*

It is suggested that a company with an effective ethics management culture will be perceived by investors to be of lower risk than a company without one. As a result of this reduction in perceived risk, it has been suggested that companies will pay less for capital raised and this will result in a direct impact on profitability. We have considered the cost of capital of our 41 sample companies using credit ratings as a proxy for cost of capital and have determined the pricing differential between those companies with codes of ethics (24) and those without (17).

In order to explore these three areas, and one other related to the selection of top management, a number of data sources largely in the public domain were identified and our hypothesis tested. So far some appear to be valid while others need more refinement. *Prima facie*, the cost of capital appears to be significantly cheaper for those having an explicit ethics policy over an extended period.

2. Methodology used in the Research

Initially it was proposed that four pairs of UK companies from different industry sectors should be selected for comparison. This was found to be too small to obtain valid results and it was decided to use the 41 companies used in the original study by Webley and More (2003): *'Does Business Ethics Pay?'* (DBEP?). These were taken the FTSE 250 list of companies using data covering 1997-2001. The wider list ensured that any findings would be of more validity than the original 'pairs' approach.

The companies were divided into two cohorts: those with codes (24) and those without codes (17). The management and governance characteristics of each cohort were examined based on areas of research identified in the DBEP? Study and others garnered from an extensive literature search.

Using the larger sample had the added benefit that it would eliminate the need for selected companies to be similar in size, activity, geographic spread etc. as averages can be calculated for each of the cohorts.

As in the earlier study, it was decided that the companies would not be named and all data would be given in aggregated form. For the present exploratory study, the companies were not approached directly and all information used can be found in the public domain or were measures supplied by ratings agencies that were derived from an analysis of publicly available information. Should the study be continued, it would be necessary for data to be obtained from the companies in the sample on matters such as labour turnover.

The literature survey identified some methodologies that had been used in (mainly) US studies which examined the business case for having an explicit policy or a policy related to business ethics such as corporate social responsibility and environmental policies. Of particular relevance were the methods followed in two books by Collins (1994) & (2001) and an article by Berman and Wicks *et al.* (1999). The following Chart sets out the five areas of interest upon which we focussed and the sources of the evidence we considered.

Area of Interest	Data Considered
Employees	Labour Turnover Statistics Employment Tribunal Statistics Core Ratings Risk Assessment SERM employee risk ratings
Customer and Reputation	Britain's Most Admired Companies MORI reputation information
Cost of Capital	S&P Ratings Pricing differentials – Barclays Bank Loan and interest payment information – Company Annual Reports Moody's Ratings
Cost of Insurance	Insurance pricing Directors and Officers' prosecutions
Origin of Top Management	CEO origin information in Company Reports

3. The Two Key Stakeholders

The article which framed our thinking in this area was the Berman and Wicks paper '*Does Stakeholder orientation matter? The relationship between stakeholder management models and firm financial performance*'. Using exclusively US data, it shows that relationships with employees and customers are strongly positively correlated with financial performance. The proxies used for **employees** were: union relations, employee involvement in decision-making, cash profit sharing and fines received. The proxies used for **customers** were product safety and quality. Using similar methodology the available UK data was used as follows:

Employees

The issues considered were labour turnover, attraction and retention of staff, employment tribunal information and ratings agency data.

Labour Turnover data

Hypothesis:

Labour turnover in companies with codes of ethics will be lower than in companies without codes of ethics. The following costs are associated with labour turnover:

- Leaving Costs – payroll and personnel administration of leaver
- Replacement Costs – recruitment, interview time, placement fees
- Transition Costs – training costs, 'unproductive' time whilst learning, induction
- Indirect Costs – loss in customer service / satisfaction

These costs will have a direct impact on profitability.

Evidence:

We have been unable to find a source of labour turnover statistics for individual for the relevant period. This is one area that would be worth exploring further in a more detailed companies study in this area. However, estimates of the costs associated with labour turnover have been found as follows.

Data Based on the Chartered Institute of Personnel and Development (CIPD) Labour Turnover Surveys:

$$\text{Labour Turnover} = \frac{\text{Number of leavers in a set period}}{\text{Average no. employed in that period}} \times 100$$

(Leavers include those going from the organisation by way of voluntary or involuntary severance, redundancies and retirements, but do not include internal transfers.)

Average labour UK turnover: 1997-2000

Type of employee	1997	1998	1999	2000
Full-time	16.64%	17.64	16.3	20.9
Part-time	29.15%	29.15	21.5	29.6
All employees	19.82%	19.82	18.3	26.6

CIPD information is also broken down by occupational group, industry and organisation size.

Average Number of weeks taken to fill a vacancy

Occupational Group	1997	1998	1999	2000
Managers / administratives	12.15	12.91	12.1	13.5
Professional	13.25	14.05	13.8	13.9
Assoc. Prof., technical and scientific	12.31	12.83	11.9	13.0
Clerical and Secretarial	6.53	6.78	6.7	6.8
Sales	9.17	10.32	9.7	10.6
Personal service	6.81	7.73	6.9	7.3
Craft and skilled manual	7.11	7.85	7.5	7.5
Operative and assembly manual	4.67	4.55	4.5	4.7
Routine unskilled manual	4.61	4.9	4.7	4.9
Other	7.71	8.11	7.3	8.3
Average			10.5 weeks	11.1 weeks

Estimated Labour Turnover Costs (£s per person)

Occupational Group	1997	1998	1999	2000
Managers / administratives	£4560	£4939	£4762	£6086
Professional	4669	4621	5206	5813
Assoc. Prof., technical and scientific	3598	3623	3999	4591
Clerical and Secretarial	1681	1733	1906	2215
Sales	3316	4669	3917	4179
Personal service	1894	1491	1961	1589
Craft and skilled manual	1377	1526	1648	1736
Operative and assembly manual	947	1158	1350	1225
Routine unskilled manual	773	845	1127	895
Other	1881	1385	1839	1779
Average			£3546	£3933

In 2000 respondents to the CIPD survey were asked how labour turnover affected their organisation's performance. The results are as follows:

Effect of Turnover	%
Serious negative effect	12.7
Minor negative effect	55.55
No effect	26.9
Positive effect	4.8

Individual company labour turnover data is not readily available, but the above figures could be used to calculate the direct cost to each company for each period of a vacancy.

b) Attraction and Retention of Staff

The Industrial Society's (now known as The Work Foundation) survey of 255 UK professionals in Oct. 2000 indicates that there is increasing pressure on companies to become 'employers of choice' as a way to recruit and retain best talent (Draper 2000). 82% of people surveyed said they would not work for an organisation whose values they did not believe in. 59% said that they chose the company they work for because they believe in what it does and what it stands for. Further, 85% of the UK population agree that knowing that the company they work for is engaged in activities that help improve society would /does increase their loyalty to their company. The attraction and retention of quality staff would be expected to be reflected in high productivity and subsequently profitability but no quantitative data was found to verify this assertion.

c) *Employment Tribunal Application Analysis*

Hypothesis:

Companies with codes of ethics will manage their relationships with their internal stakeholders (employees) more effectively. This will result in good working practices, employee satisfaction and lower costs associated with employee disputes.

Evidence:

The initial evidence from the records of the Employment Tribunals does not appear to support this proposition. The data collected indicates that over the four year sample period, the average proportion of applications made to employment tribunals was higher for those companies with codes than for those without codes. The data also suggests that the proportion of applications increased over the four year for those companies with codes and decreased for those without codes.

Summary statistics are contained in the graph and table below:

		Applications as % of No. Employees	% with no applications
1997	Codes	0.10%	33%
	No Codes	0.15%*	59%
1998	Codes	0.09%	25%
	No Codes	0.09%	65%
1999	Codes	0.16%	25%
	No Codes	0.06%	71%
2000	Codes	0.19%	15%
	No Codes	0.07%	47%
Ave	Codes	0.14%	
	No Codes	0.09%	

*The 1997 data for companies without codes is high due to the high number of applications concerning two companies in the sample

However, the data was shown to be inadequate for the purposes of this study. For instance, they refer to all applications made in England and Wales only. As a number of companies in the sample have substantial operations in Scotland and N. Ireland consequently any employment tribunal applications will not be reflected in the data collected. Furthermore, some of the companies within the sample have large operations overseas and only a small head office presence in the UK. As a result, looking at Employment Tribunal statistics for England and Wales is an inadequate indicator of good employee relations.

The search was carried out in the Group name only. In cases where staff is employed through subsidiary companies with different names, this will not have been picked up in the employment tribunal search.

It is not known which cases were won or the level of compensation provided and consequently a direct connection with bottom line results is unable to be made.

e) *Rating Agency Data*

A number of rating agencies assess the policies, processes and performance of a company's human resources management. This is done primarily through qualitative analysis of publicly available information. The lack of quantitative data used in most ratings makes them a less certain source of data for the main purpose of this project. Nevertheless, they are useful as a source when other hard data is not available. One of the agencies selected was SERM.

SERM Ratings

When considering the SERM indicator for Human Resources, the average risk avoidance rating for companies with codes (in our sample) is 2.9 as opposed to an average rating of 1.7 for the companies without codes. A higher number shows lower risk. This implies that companies with codes have better stakeholder relations with employees than those without.

Behind each of their 'risk ratings' is a series of categories where companies are scored on a 1 to 10 basis. These scores are based on the answers to a range of questions (many qualitative). SERM also give each company an overall social and ethical rating. While it may be interesting to look at the ratings for each of the companies, it may not necessarily be an unbiased opinion. One of the things on which they rate companies is their ethical character. So it would be no surprise that the companies with codes of ethics were rated higher than those without!

Customers

Burnham *et al* (1999) in their US study used product safety/quality as their proxy for customer retention and subsequent effect on the financial performance of a company. Waddock (2000) used a similar approach.

a) Customer Retention

We tried to identify ways which indicate that customer retention is a key corporate strategy and to identify proxies for determining this. Our assumption was that companies with an explicit ethical policy should find it easier to retain customers than those without. If customer retention figures could be obtained for our sample companies, this hypothesis could be tested. There does not appear to be any publicly available information on this.

However, we found that corporate reputation / trust / perception appear to play significant roles in ensuring customers retention.

New York University's Reputation Institute use a reputation quotient to measure companies based on their findings that people regularly justify their feelings about companies on 20 attributes. These they grouped into six conceptual categories: Emotional Appeal, Vision & Leadership, Products & Services, Workplace Environment, Social Responsibility, and Financial Performance

Rosa Chun (2002) for instance, has shown that ethical character makes a difference in the way that customers (and other stakeholders) identify with the company (brand awareness). She argues that this connection is an 'emotional one' when it comes to stakeholders and is not all about business measurables. This type of work can justify the use of opinion based approaches to assess the impact of ethics but there will however be difficulties in showing how this feeds into the bottom line!

b) Britain's Most Admired Companies

Another approach to measuring corporate reputation is to look at the results of the survey work of Michael Brown of Nottingham University and his team in their regular measurement of Britain's Most Admired Companies (BMAC) which appears annually in *Management Today*. We compared the results for our sample of companies for 1997-2000 with his with the following results:

1997: 29% of companies without codes were identified as among Britain's most admired companies as opposed to 72% of companies with codes.

1998: 35% of companies without codes included in the list compare with 72% of companies with codes.

1999: 65% of companies without codes were included compared with 75% of companies with codes.

This suggests that companies with codes have working practices that are admired by others. We would expect this higher perceived reputation to have an impact on customer choices and consequently have an impact on bottom line profitability.

c) Customer Complaints

Another approach to measuring the impact of having an ethics policy on customers would be to compare the frequency of customer complaints as a proportion of total customers. This type of data is not in the public domain and would present a number of problems with comparisons between sectors. However, it is data worth collecting over time as it serves as one measure of customer satisfaction

4. Cost of Capital

Choice of Measurements:

Three measures were considered as proxies for cost of capital – bond prices, credit ratings and beta values. We decided not to follow up on beta values as their relevance to this study was questionable. This was principally due to the realisation that beta values reflect an outcome of a company's cost of capital rather than a determinant.

Both bond prices and credit ratings rely on information such as: past financial performance, underlying assets, expected cash flows and profitability, volatility of firms' assets, existing debt levels, maturity of debt etc. Consequently in any published analysis we would have to stress that our results are only indicative and further in-depth study would have to control for these factors. Specific issues with each are as follows:

- **Bond pricing** – as this usually relates to specific deals it is difficult to compare between companies. It takes into account maturity, interest rates, face value as well as company specific issues. Also it is likely that there will not be a bond issue for all companies in each of the relevant years.
- **Credit ratings** – while these are better from the point of view that they focus on the company rather than looking at a specific event, it does tend to concentrate on the likelihood of default rather than looking at the upside potential. However, credit ratings do take into account the benefits of high levels of corporate social responsibility and are an accurate way of assessing pricing differentials between companies. It appears that if a company's ethics / CSR performance is rated as poor then this may have a negative effect on credit ratings and bond pricing due to increased risk.

Issues related to using cost of capital as a mechanism:

Other Factors - Because of the large number of other factors that are given more weight than ethics, it would be difficult to deduce anything from it without isolating these factors. We could only really make a judgement if all other risk factors were the same. In reality, while business ethics is taken into account in determining cost of capital (mainly as it acts as a proxy for good management) it is only a tiny fraction of the overall equation.

Direction of Causality - In the risk assessment process, considerable weight is placed on past and expected financial performance. Consequently, it is important to remember that an alternative to the process considered (i.e. good ethics resulting in a reduced cost of capital leading to improved financial performance) is that it is possible that past financial performance will play a much bigger role in determining the future cost of capital.

S&P Credit Ratings as a Proxy for Cost of Capital

S&P credit ratings were obtained for 18 of the sample companies with codes and 5 of the companies without codes. The other companies had not been rated during the relevant period. From this data, average credit ratings for each year were calculated:

Average S&P Rating	Companies with Codes	Companies without Codes
1997	A+	BBB+
1998	A+	BBB
1999	A-	BBB+
2000	A	BBB+
Average	A+	BBB

Average interest rates were obtained from Barclays Bank for each of the credit grades and used to calculate the difference in cost of borrowing.

Pricing based on Spread to Gilts were as follows:

Rating	Pricing (%)
AAA	0.45
AAA-	0.55
AA+	0.65
AA	0.75
AA-	0.9
A+	1.05
A	1.22
A-	1.39
BBB+	1.56
BBB	1.73

Cost implications:

The difference in cost of borrowing between companies with codes and those companies in the sample without codes is 0.51%. It follows that an average company in the sample of those with an embedded ethics policy could expect that for borrowing of £1,000,000, there would be a cost reduction of £5100 compared with those in the sample without an overt ethics policy.

Interest Rate Differentials between Cohorts:

Company Report data shows that the actual interest rate differential between the two cohorts over the relevant period was 2.1%. The average borrowing for the companies was £1,976,000,000. This translates into an average difference in interest costs of £41,000,000.

Moody's Ratings:

Moody's hold information on 14 of the sample companies with codes and five of those without codes. Four of these five companies were also those rated by S&P and two of the companies had ratings for only one of the four years in this project. The results showed that the average rating for companies with codes is A1 as opposed to A3 for companies without codes. This supports the evidence derived from the S&P data.

Average Moody's Rating	Companies with Codes	Companies without Codes
1997	A3	A1*
1998	A1	A2
1999	A1	A3
2000	A1	A2
Average	A1	A3

*Note: Only 2 companies without codes were rated in 1997. This skews results upwards for this year.

Volatility:

We would expect companies with embedded business ethics / CSR performance to be less volatile in their performance due to their ability to manage shocks, risks, downturns effectively. This was demonstrated to be case by Webley and More (2002).

This is also one of the ideas behind the Feldman, Soyka and Ameer (1996) article, '*Does Improving a Firm's Environmental Management System and Environmental Performance Result in a Higher Stock Price?*' They showed that environmental improvements led to a substantial reduction in the *perceived* risk of a firm which leads in turn to a lower cost of capital. This suggests that as investors are likely to be willing to pay more for the firm's future cash flows, its stock price will rise and shareholder wealth will increase.

The authors' simulation shows, the magnitude of the share price increased from a 50% improvement in the firm's environmental management system matched by a 50% improvement in financial performance. It is generally accepted that capital markets operate more efficiently as the level and reliability of information available to investors increases. Corporations that provide relevant, detailed and reliable information on their environmental programmes and performance on a continuing basis are more likely to be rewarded with a perceived lower risk as compared to corporations that provide only qualitative information on a few aspects of their programme.

Having an effective ethical policy is likely to reduce perceived risk. However, measurement of an improvement in corporate ethical performance is more difficult than that of measuring the financial benefit of having a positive environment policy. Qualitative assessments of ethics management policies would perhaps have to suffice using ratings data referred to earlier. This pilot project did not pursue this avenue.

5. Cost of Insurance:

Hypothesis

Companies that demonstrate consistently good ethical policies will have a reduced cost of insurance due to the decrease in risk that insurers are taking to insure the relevant company.

Evidence:

In looking at the ways of measuring the cost of insurance, several issues were identified. Firstly, the level of insurance held by a company is not necessarily only a reflection of the risk involved. Companies may adjust the level of insurance premiums paid as a way of finessing financial results. In reality the amount of insurance purchased in any period tends to be arbitrary. Determining the price of corporate insurance is difficult as the information is not in the public domain. There is however one way of assessing this.

Ethical behaviour is usually reflected in the way the company is managed. It was therefore decided to focus on one type of insurance, namely Directors and Officers (D&O). Our key reference in this area is an article by Terzich (2003). He suggests that in a time when D&O premiums are increasing rapidly and the number of suits brought against directors and officers is also increasing, the human element of D&O insurance is becoming more significant. In other words, having an explicit ethics policy could be significant in minimising risk for an organisation. This article does not suggest that cost savings can be achieved through reduced premiums by having an ethics policy. However, we could draw the inference that good ethics result in cost savings because of the decrease in the number of D&O law suits brought against the company in the period under consideration.

Considering this, it was decided to investigate the possibility of finding information on the number of prosecutions against Directors and Officers brought against each of the 41 companies in our sample. It appears that the number of lawsuits in the UK is substantially less than that in the US due to the much higher cost of prosecution. As a result, most UK cases are settled out of court and while this has an effect on D&O insurance premiums, it does not provide the information required to assess the total numbers of prosecutions and hence as a way of determining cost.

Although this is a potentially fruitful area of investigation as it does seem to have an effect on financial performance, in practice the information is not readily available. Also, it is only really since 2001 that there have been a significant number of D&O prosecutions so comparing the frequency of prosecutions during the sample period may not be particularly meaningful.

It may be necessary in any future work to approach companies directly to obtain further information on the level of insurance premiums and their related costs

6. Corporate Top Management

The key literature references in this area are the books by J.C Collins (*Good to Great* and *Built to Last*). He suggests that the characters of CEOs in the best companies displayed a mixture of personal humility, professional will and a strong ethical outlook. Moreover, almost all of the CEOs rose from inside the company. While we have not tried to assess the ethical commitment of CEOs in the sample companies, we have examined whether, over the period 1977 -2000, they were internal or external appointments.

Hypothesis:

Companies with CEOs that have been nurtured from within the organisation are better managed and have a more effective and consistent ethics culture. Consequently, we would expect more of the 'with codes' sample to have CEOs that have been appointed from within than in the sample 'without codes'.

Evidence:

CEO appointments from 1997 to 2000 were considered for each of the sample companies. An initial analysis was made to determine whether each CEO had spent 10 years or more within the company prior to appointment as CEO (an internal appointment). This was then relaxed to determine if CEOs had spent five years or more within the company prior to appointment. The results were as follows:

Companies without codes: 7 out of the 17 companies* without codes (41%) had appointed CEOs who had spent 9 years or more within the company. When looked at on a five year basis, it was found that this rose to 10 of the 17 companies (59%).

Companies with codes: 14 out of the 23 companies* (61%) had CEOs who had spent 9 years or more within the company. When a five year cut off point was considered, it was found that 16 out of the 23 (70%) companies had made internal appointments. Because of a merger, one company was excluded from this analysis.

* The percentage in brackets covers the period of 5 years.

The figures support our hypothesis that companies with codes have a greater proportion of CEOs appointed from within the company than for companies without codes. The following Chart sets out the findings.

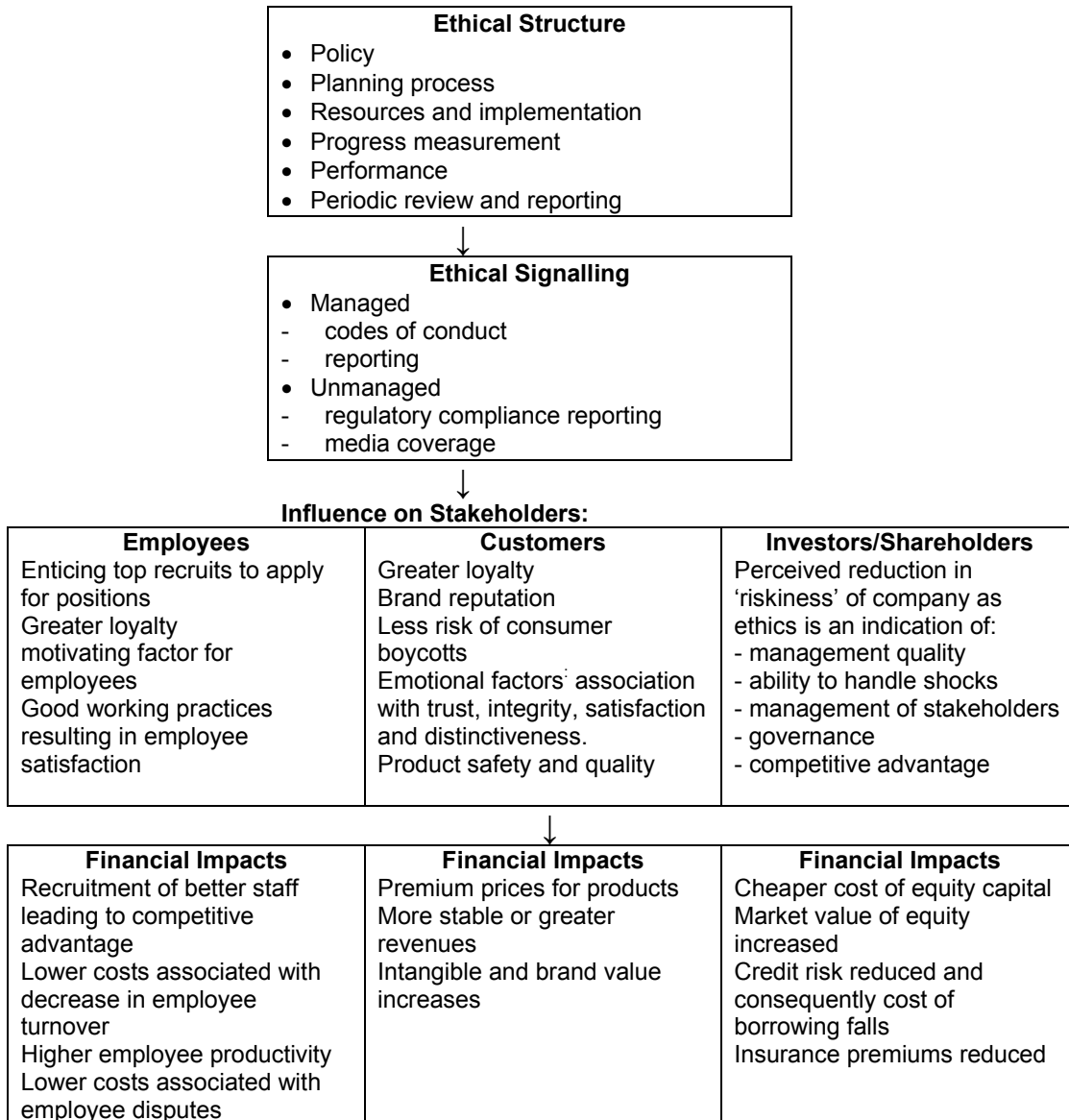
Summary of internal appointments:

	10 year cut off	5 year cut off
No Codes	7 out of 17 (41%)	10 out of 17 (59%)
With Codes	14 out of 23 (61%)	16 out of 23 (70%)

7. Summary of the Main Conclusions

The following Chart sets out a possible course of the relationship that a corporate ethics policy may take in effecting the financial performance of a company.

Summary Chart of the Relations of Ethics Policy on Financial Performance



The methodology explored in this pilot study indicates that it may well be worthwhile investigating further the ways that those companies with longer term explicit ethics policies are managed.

Limitations on the size of the sample and the time period involved make it risky to draw more than indicative conclusions from this pilot study. Certainly controls to assess the impact of external factors and tests of causation need to be pursued.

Interviews with all the sample companies would undoubtedly yield pertinent information. For instance, labour turnover data and insurance costs could be fairly easily translated into potential cost savings. Further exploration of survey data is another source of evidence about management practice and stakeholder perceptions. However, confidentiality and data protection put limits on how useful this approach could be.

We considered whether companies with codes of ethics in place for some years would enjoy a better reputation among its principal stakeholder: investors, employees and customers. To assess the impact that this has on financial performance, the ways through which reputation is translated into financial performance could well be fruitful.

It was in the cost of borrowing that our analyses showed a direct impact on the bottom line. Statistical testing and the isolation of external factors, would add to the credibility of this finding.

Finally, we found little agreement about how to measure ethical performance – and we wondered if companies with embedded ethical cultures have more effective governance structures and how does this impact on profitability?

Appendix 1

Literature Review – Why does Business Ethics pay?

Contributed by Andrea Werner, PhD. student at Brunel University, UK and research assistant at IBE

Relations between ethics and financial performance

The overall relationship between Corporate Responsibility (CR) and Corporate Financial Performance remains a central interest among business ethics researchers.

Although the research findings are not consistent (as they range from positive links to inconclusive evidence to negative links (cf. Griffin and Mahon 1997)) recent studies suggest more strongly a *positive* link between CR and CFP. For example, the meta-analysis study undertaken by Orlitzky *et al.* (2003), which combined 52 previous studies on the relationship between CR and CFP, concludes that “corporate virtue in the form of social responsibility is likely to pay off”. By using “publicly available information”¹ Verschoor and Murphy (2002) demonstrated “that firms that are simultaneously committed to social and environmental issues that are important to their stakeholders also have superior financial performance and superior reputations as well”. Similarly, Webley and More (2003) found, by using the presence of a code of ethics for five years or more as a proxy for ethical commitment, that UK companies that had a code financially outperformed companies that did not have one. Graves and Waddock (2000) investigated the companies that Collins and Porras (1994) had identified as “built-to-last” companies² with regards to their social performance.³ They found that ‘built-to-last’ companies consistently outperformed the control group companies.

Ways of linking corporate responsibility with financial performance

Researchers have also attempted to gain more insight into the mechanisms linking CR to CFP, in order to understand how a positive relationship between the two may have been achieved. For example, Orlitzky *et al.* (2003) suggest that CR appears to be more highly correlated with accounting-based measures of CFP rather than with market-based indicators and that CR reputation indices are more highly correlated with CFP than are other correlators. Moreover, their findings suggest a less strong link between environmental responsibility and CFP. Graves and

¹ I.e. the 2001 list of the Best Corporate Citizens (based on one financial indicator and six of KLD’s social indicators) and Business Week rankings etc.

² I.e. companies that attain outstanding long-term performance.

³ Using the KLD measures community relations, employee relations, treatment of the environment, product (as surrogate for customer relations) and diversity.

Waddock (2000) showed in their study that there was a strong link with regards to employee relations and diversity and the dimensions that provided the weakest evidence were “environment” and “community relations”.

Johnson (2003) and Berman *et al.* (1999) suggest that undertaking a *strategic* stakeholder approach will yield a positive correlation between CR and CFP.

Johnson's (2003) observations on the links between CR and CFP, which he categorises in a 5-level-CSR-continuum, provide moreover a useful starting point for understanding how specific mechanisms can work between the two. Johnson argues first, that “companies behaving in an illegal or irresponsible manner are hurt financially by such actions” and second, that strategic targeting of employee development and satisfaction together with customer service make a significance difference to financial performance. Furthermore, he suggests that a mere compliance with legal mandates fragmented social responsibility activities and advocating social change offer no fiscal advantage.

Robust empirical evidence for Johnson's first claim is found in Frooman's (1997) analysis of 27 event-studies of socially irresponsible and illicit behaviour as indicated through product recalls, lawsuits etc. Frooman found that irresponsible behaviour had a statistically significant effect on shareholder wealth. Rao and Hamilton (1996) arrived at a similar conclusion by looking at how published reports on unethical behaviour resulted in a lower than expected stock performance.^{4 5}

Johnson's second claim is backed up by a study undertaken by Berman *et al.* (1999), which looked at the top 100 Fortune 500 companies. They found that, among a number of CR measures, only employee orientation and product safety/quality directly affect financial performance.⁶

Treatment of employees

With regards to the employee dimension, there are a number of empirical studies that confirm a positive CR-CFP relationship.

Huselid (1995) showed that systems of High Performance Work Practices⁷ diminish employee turnover and increase productivity and corporate financial performance across a wide range of industries and firm sizes.

Simons and Hinkin (2001) found in their study on the hotel sector that excessive employee turnover is a costly phenomenon, which indicates that companies should try and retain their employees through enhanced pay, incentive systems and other measures that could increase employee satisfaction and thereby reduced recruiting and training costs.

De la Cruz Deniz-Deniz and De Saa-Perez (2003) tried to test empirically the existence of a significant and positive relationship between organisational results and a social responsiveness toward employees. They carried out a study in the Spanish savings bank sector and concluded that those banks that have institutionalised high-commitment practices toward employees have greater profitability.

Two studies focus on employees as well as their relationship to the wider CR of companies. Schmidt Albinger and Freeman (2000) found in their study, which they carried out among potential and actual job seekers, that companies with high levels of CR are more likely to attract job seekers with high levels of job choice, which in turn can enhance company performance. Klebe Treviño and Weaver (2001) investigated the employee perception of organisational justice and ethics program follow-through. Their findings indicate that when employees perceive general organisational justice and ethics program follow-through, there is less unethical behaviour (which harms the organisation) and a greater willingness to report problems (which may uncover potential harm).

⁴ Both studies are mentioned in Johnson's article.

⁵ Related to unethical behaviour or “white-collar crime”, Schnatterly (N.N.) carried out a study which looked at measures of how to prevent unethical corporate behaviour. She found, among other things, that clear policies and procedures and a comprehensive code of conduct (only partially statistically supported) prevent white-collar crime.

⁶ Interestingly enough, Berman *et al.* found that the three CR variables ‘community’, ‘diversity’, and the ‘natural environment’ failed to exhibit statistically significant relationships, which partly confirms, partly contradicts the findings of Graves and Waddock (2000).

⁷ Which was made up of the following factors: ‘employee skills and organisational structures’ and ‘employee motivation’

Treatment of customers

A frequently used proxy for customer orientation as a strategic priority is product quality and safety (e.g. Waddock 2000 using the KLD measure). An example of the importance of this particular CR dimension is given by Johnson (2003), who points to the fact that companies that won the (US American) Baldrige National Quality Award (2003) significantly outperformed the S&P 500.

Other stakeholders

Although employee and customer relations are identified as the most significant key stakeholder relationships by Berman *et al.*, other stakeholder relationships may show an important link to CFP as well. So, for example, Brownell and Reynolds (2002) carried out a survey among purchasers in the food-service sector and found that trust and communication were key elements in developing strong partnership between purchasers and suppliers. This is an important finding in that partnerships with suppliers in this sector have come to be viewed as contributing to long-term economic success.

Reputation and trust are two more intangible impacts through which ethical character can have an impact on the bottom line. Charles Fombrun suggests that a corporate reputation represents the net emotional reaction – good or bad, weak or strong – of customers, investors, employees and the general public to the company's name. He claims that the benefits of a good reputation are commanding premium prices for products; paying lower prices for purchases; enticing top recruits to apply for positions; experiencing greater loyalty from consumers and employees; having more stable revenues; facing fewer risks of crisis; and enjoying (greater) latitude by stakeholders.

Chun (2002) suggests that ethical character does make a difference in the way that stakeholders identify with the company (brand awareness). She argues that this connection is an emotional one when it comes to stakeholders and is not all about business measurables. She shows that there are clear links from ethical character to identification, satisfaction and perceived distinctiveness for both customers and employees. These findings can be seen justify the use of opinion based approaches to assess the impact of business ethics on companies.

The role of CEO

Another interesting observation is made by Collins (2001), who in his 'Good-to-Great' study sought to identify mechanisms which led companies that used to perform on an average level "to take the leap to greatness". He argued that the CEOs of those good-to-great companies displayed a paradoxical mix of personal humility and professional will, in other words, "these great CEOs seem[ed] to have in common an ethical outlook that accepts as rational a co-operation that harnesses self- and mutual-interests for larger benefits for all" (Molyneaux 2003). Moreover, almost all of the CEOs came from inside the company (Collins 2001, 10).

The effect of ethics on the cost of capital of a company is another proposed mechanism leading to improved financial performance. The extent to which ethics is integrated within the structure of a company will impact the level of risk perceived by investors. This risk is valued by financial markets and this will lead to a reduction in the cost of capital. Feldman, Soyka and Ameer (1996) consider how improvements in environmental management can lead to reduced risk to the firm. They propose that a lower cost of capital means that investors are willing to pay more for the firm's future cash flows, its stock price will rise and shareholder wealth will increase.

Feldman *et al.* also stresses the importance of strategic communications in the perception of risk. As the level and reliability of information available to investors increases, financial markets operate more effectively. Corporations that provide relevant, detailed and reliable info on their environmental processes and performance on an ongoing basis are more likely to be rewarded with a perceived lower risk. It would be reasonable to expect that this would also apply to ethics.

Other studies deal with the impact of company size on the levels of CR and CFP. Stanwick and Stanwick (1998), for example, found that "firms that *are larger in size*, have higher levels of profitability and lower levels of pollution emissions have higher levels of CR". Related to that issue is the question of sequence. For instance, Waddock and Graves (1997), argue based on their empirical findings that CR is found to be positively associated with prior

financial performance, supporting the theory that slack resource availability and CR are positively related.

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Appendix 2

Executive Summary of *Does Business Ethics Pay?*

By

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IBE, London 2002

'Does business ethics pay?' is a question that some would say is a wrong one. Behaving ethically, they argue, is what you do because it is the right thing to do.

Nevertheless, there is a continuing requirement for reliable indicators to measure the performance of corporations in the non-financial areas of a business and to link these to business success. Concepts such as integrity and fairness are, however, generally only measurable using indirect indicators.

This study was undertaken to explore some indicative measures of ethical commitment/corporate responsibility and then to compare them against financial performance measures over a period of four years. In this way, the research set out to investigate whether it can be shown that a commitment to business ethics does pay.

For this research, seven indicators were chosen – four of corporate financial performance [Market Value Added, Economic Value Added, Price Earnings Ratio and Return on Capital Employed] – and three of corporate responsibility [having a code of ethics, ratings for managing socio/ethical risks and being cited consistently in the annual list of Britain's Most Admired Companies].

The sample consisted of between 41 and 86 companies taken from the FTSE 350 for which full and comparable company data was available for the years 1997-2001. It was divided into two cohorts: those who have had codes of ethics/conduct/principles for five years or more and those who explicitly said they did not.

Findings

A review of similar research shows that the relationship between good financial performance and other indicators of corporate responsibility (environmental management, corporate social responsibility, sustainability etc.) is positive but not definitive. However, Verschoor's work in the US, on whose methodology this research is based, showed that there was superior Market Value Added in companies which referred to their ethics' programmes in the annual report, compared with those who did not.

Before testing the validity of Verhoor's conclusion for the UK, this study sought to find out whether or not the presence of an ethical code could be used as an indicator of genuine ethical commitment. Good practice for a sample of UK companies with and without a code was tested by looking at a) a rating for risk management and b) a peer evaluation which included, for example, competent management, financial soundness and quality of goods and services. A positive relationship was found. Having an accessible ethical code was then used to investigate the relationship between ethical commitment and financial performance over the four year period.

- ❖ Regarding financial performance, from three of the four measures of corporate value used in this study (EVA, MVA and P/E ratio) it was found that those companies in the sample with a code of ethics had, over the period 1997-2001, out performed a similar sized group who said they did not have a code.

- ❖ Companies with a code of ethics generated significantly more economic added value (EVA) and market added value (MVA) in the years 1997 – 2000, than those without codes.
- ❖ Companies with a code of ethics experienced far less P/E volatility over a four year period, than those without them. This suggests that they may be a more secure investment in the longer term. Other research has suggested that a stable P/E ratio tends to attract capital at below average cost; having a code may be said to be a significant indicator of consistent management.
- ❖ The indicator that showed a different result pattern to the others was Return on Capital Employed. No discernable difference was found in ROCE between those with or without a code for 1997-98. However, from 1999 to 2001 there was a clear (approximately 50%) increase in the average return of those with codes while those without a code fell during this period.
- ❖ The data also indicates that in the years 1997–2001, those with an explicit commitment to doing business ethically have produced profit/turnover ratios at 18% higher than those without a similar commitment (see note on profitability in Appendix 5).

The general conclusion from this study is that there is strong evidence to indicate that larger UK companies with codes of ethics, e.g. those who are explicit about business ethics, out perform in financial and other indicators those companies who say they do not have a code. Having a code of business ethics might, therefore, be said to be one hallmark of a well managed company.