The Business Case for Corporate Citizenship

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Introduction

Corporate citizenship is about companies taking into account their complete impact on society and the environment, not just their impact on the economy. It is about business assuming responsibilities that go well beyond the scope of simple commercial relationships.

One major company states in its annual report that corporate citizenship is both “a moral responsibility and an economic necessity.” This paper examines the latter part of this statement: To what extent is there a business case for increased corporate citizenship?

The Business Case

Good corporate citizenship can provide business benefits in eight areas:

- Reputation management
- Risk profile and risk management
- Employee recruitment, motivation, and retention
- Investor relations and access to capital
- Learning and innovation
- Competitiveness and market positioning
- Operational efficiency
- Licence to operate

This paper discusses each of these areas, identifying ways that increased corporate citizenship can improve business performance and providing real-life examples of companies that have invested in or ignored key aspects of corporate citizenship.

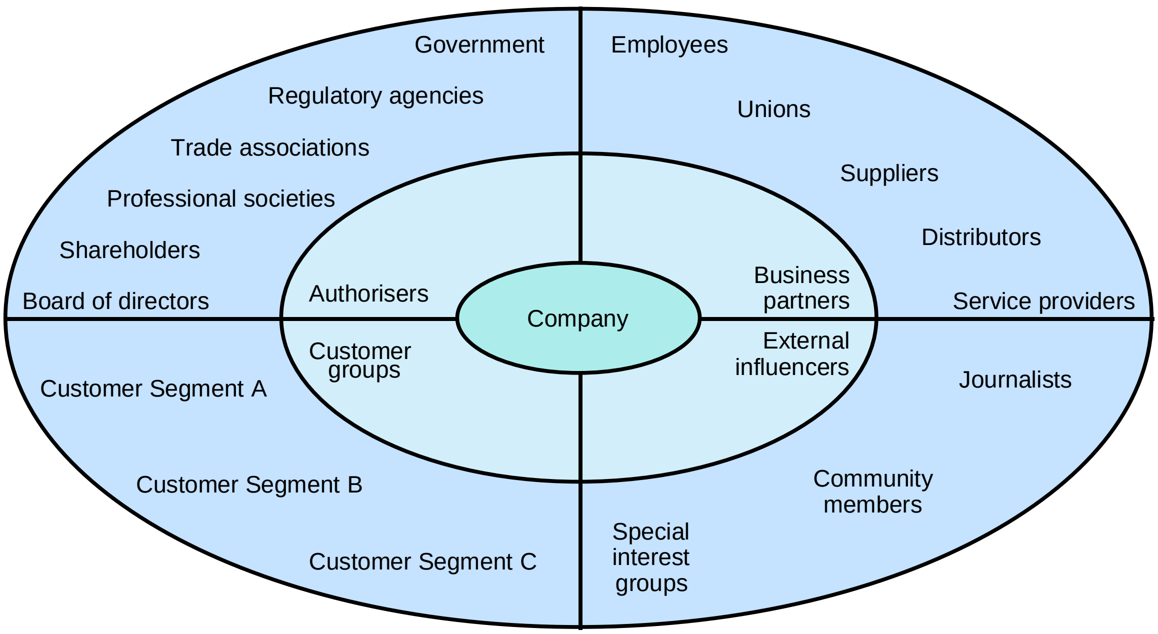
Reputation Management

Reputation is critical to corporate success, topping the intangible asset list of most CEOs.[1] Research by a major consultancy found that the proportion of a company’s value derived from intangible assets rose from 17 percent in 1981 to 71 percent in 1998.[2]

Reputations are built and maintained by a firm’s relative success in fulfilling the expectations of multiple stakeholders.[3] Companies have a range of stakeholders (Exhibit 1) and understanding their expectations is crucial to managing risks to the business and maintaining a positive reputation.

Various studies have demonstrated a link between reputation and financial performance. A study of companies over an 11-year period by two Harvard professors concluded that "stakeholder-balanced" companies show four times the sales growth and eight times the employment growth of companies that focus solely on shareholders. An analysis of "America's Most Admired Companies," as listed in *Fortune* magazine, found that a good corporate reputation increases the length of time that a firm spends earning above-average financial returns and decreases the length of time that a firm spends earning below-average financial returns.[4]

Exhibit 1: Corporate Stakeholders



Adapted from Dowling 2001

The higher the profile of a company or brand, the greater the scrutiny of its activities and the higher the potential for it to become a target for pressure group action. A number of big-name clothing brands have suffered considerable reputational damage from allegations about exploitative labour practices in their subcontractor factories. When the CEO of one of the world's best-known brands realised that his company name had become synonymous with slave wages, overtime and arbitrary abuse[5], he took concerted action to improve conditions in the supplier factories and now has 70 staff members working on corporate responsibility issues.

Likewise, some well-known wood-product retailers found themselves pilloried as rainforest destroyers when they admitted not knowing the source of their timber. By comparison, those wood-product retailers that have taken the impact of their purchasing power seriously and instigated systems to ensure that their timber comes from sustainable forests have gained considerable kudos.[6]

Risk Profile and Management

Increasingly, companies have to be aware of, and respond to, a widening range of risks. For instance, the London Stock Exchange recently informed its listed companies that they must implement the Turnbull Committee's recommendation to address "environmental, reputation and business probity issues" when considering internal controls.

Many companies already have robust environmental management systems and evidence shows that these systems can lead to direct benefits in terms of risk profile. For example, a survey of 300 large publicly listed companies in the United States found that investment in environmental management leads to a substantial reduction in the firm's perceived risk and an accompanying increase in its stock price of about five percent[7]. Another study concluded that companies with stringent environmental standards are more likely to be profitable than those with lower standards.[8]

Systematic management of social issues is much less widespread in the corporate world. To avoid risks to their reputation, businesses need to understand stakeholder concerns about both issues under their direct control, such as employment policies, and under their influence, such as the impact of their supply chains on the environment and society.

Employee Recruitment, Motivation, and Retention

The reputation of a company as a corporate citizen affects its attractiveness as a prospective employer. For example, a 1997 Walker Information Survey revealed that 42 percent of respondents took into account a company's ethics when deciding whether to accept a job.[9] In contrast, companies with tarnished reputations as corporate citizens can face significant recruitment problems. When a major oil company suffered damage to its reputation on environmental and social grounds, the CEO said repeatedly that the most negative impact—and the one that made him fear for the future of his company—was the fact that bright young graduates were no longer attracted to the company.

Investor Relations and Access to Capital

Traditionally, investors have been portrayed as having little interest in the non-financial aspects of business management. But as evidence of the link between good corporate citizenship and good financial performance mounts, few investors can afford to ignore this aspect of business behaviour.

In *Built to Last*, James C. Collins and Jerry I. Porras compared 18 companies that had been operating successfully for at least 50 years with 18 of their direct peers, all of which had been well known and relatively successful at certain points in their history. Collins and Porras found that a key characteristic in distinguishing the so-called "visionary" companies from their peers was having a core purpose beyond making money. Being clear about this purpose helped visionary companies achieve far greater long-term financial performance than their peers. One dollar invested in 1926 in a fund comprised of visionary companies would have grown to $6,356 by 1990, compared to $955 for a dollar invested in the comparison group.[9] Similarly, a two-year study of leading companies by the Performance Group found that improving environmental compliance and developing environmentally friendly products can enhance earnings per share, profitability, and the likelihood of winning contracts.

There is now a range of indices that rate corporate performance on environmental and social criteria and can be used to benchmark the performance of good corporate citizens against their peers. The Dow Jones Group Sustainability Index (DJGSI) consists of the top ten percent of companies in terms of sustainability performance, drawn from the 2,500 biggest companies in the Dow Jones Global Index (DJGI). And the recently launched FTSE4Good indices include companies that exhibit good policy, management, and performance with regard to human rights, stakeholder relationships, and environmental sustainability.

Backcasting the FTSE4Good and the DJGSI indices shows that these companies would have continually outperformed their conventional counterparts. For example, over a five-year period the DJGSI performed an average of 36.1 percent better than did the DJGI and energy companies in the DJGSI performed 45.3 percent better than did those on the DJGI.[10] These results reinforce the view that companies that take a strategic approach to corporate citizenship are likely to be well managed overall.

An increasing number of funds are now managed according to the principles of Socially Responsible Investment (SRI), with portfolio managers either screening out businesses that do not meet high environmental or social standards or using their influence to improve the ethical performance of these companies.

Starting from a small niche, demand for SRI portfolios has grown dramatically. Assets in professionally managed, socially screened investment portfolios rose by 36 percent between 1999 and 2001. And, despite the stock market slide that began in 1999, the total level of socially and environmentally responsible investing in the United States rose by eight percent from $2.16 trillion in 1999 to $2.34 trillion in 2001.[11] This means that about one of every eight dollars under professional management in the United States is in socially responsible investment. Although still small compared to the market for traditional investments, SRI is beginning to be seen as significant by key members of the investment community. A recent survey by “Business in the Community,” found that as many as one third of analysts now consider that environmental issues affect the value of their investments.

In 2000, investors adopting a shareholder advocacy approach to SRI targeted many companies to seek assurances that they would strengthen their corporate citizenship. In 2001, more than 251 resolutions were filed on social responsibility and the amount of money controlled by investors involved in shareholder advocacy totalled $906 billion. Examples of the kinds of success that result from this pressure are numerous. In 2001, as a result of a shareholder resolution, three major U.S. financial organisations were forced to amend their lending practices to eliminate abuse. In another case, a major global beverage company was asked to increase the amount of recycled plastic it used to make plastic beverage bottles.

Learning and Innovation

Corporate citizenship objectives can encourage creativity and innovation that leads to bottom-line benefits. For example, a major global science- and technology-based chemicals company teamed with an agricultural and industrial products firm in a joint venture to produce fibres entirely from renewable resources. The vice president and chief technology officer of one of the companies explained that his motivation for exploring this type of innovation was his desire to change the world for the better and in a way that had realistic and substantial business applications to encourage its widespread use**.**

This joint venture has led to the development of a new polymer made entirely from agricultural crops, with applications for packaging, fabrics, and furniture. The material uses 20-50 percent less fossil fuel and releases lower amounts of carbon dioxide than conventional alternatives. The product has been so successful that it has won numerous awards for environmental innovation and its sales are expected to triple within the next seven years.[12]

Competitiveness and Market Positioning

If you were a fly on the wall in the boardroom of any company, one question you would be sure to hear frequently is “Are we delivering what our customers want?” And customers clearly want companies to behave as good corporate citizens. In the United Kingdom, 92 percent of customers think that British companies should have a minimum standard of labour conditions for their developing-world suppliers and 41 percent say that corporate social responsibility is important in their purchasing.[13] These attitudes are replicated across the globe. The most comprehensive survey of consumer attitudes toward corporate citizenship, involving 25,000 individuals in 26 countries, found that more consumers form their impression of a company on the basis of its corporate citizenship practices than do so on brand reputation or financial factors. Almost 60 percent of those interviewed cited labour practices, business ethics, responsibility to society at large, or environmental impact as factors that influence their views of companies.[14]

With this level of public interest, it is no surprise to find that companies with the most direct relationships to consumers are working hard to ensure that their suppliers demonstrate high standards of corporate citizenship. As more and more retailers and brand owners commit themselves to environmental and social standards, their suppliers face increased pressure to comply with similar standards. For example, wood-product retailers have been switching away from suppliers that refuse to commit to sustainability standards. At the same time, chocolate manufacturers are among a long line of companies facing pressure from retailers to demonstrate that no child labour is used in their supply chains.[15]

Operational Efficiency

Focusing on corporate citizenship goals can lead to direct improvements on the bottom line. Reducing material use and waste can save money, as well as reduce environmental impact, as those companies that have been taking eco-efficiency seriously can testify. For example, by increasing its fibre recovery rate, a U.S. recycled paper manufacturer saved the equivalent of 20,000 tons of waste paper and became the industry’s lowest cost producer. The company’s focus on eco-efficiency is also leading to new opportunities. After eliminating all its effluent discharges and becoming a zero-emission producer, the company is now considering creating a nationwide network of small recycling plants. The economics for such a plan are suddenly favourable now that recycling stations no longer need to be located near effluent treatment plants.[16]

Licence to Operate

The perceptions that stakeholders have of a company's corporate citizenship performance can significantly affect the business's licence to operate. Companies with a poor reputation in this area can find themselves continually responding to criticism of their approach to a whole range of environmental and social issues. This was the situation for the pulp and paper industry at the beginning of the 1990s—lambasted in the press as a rainforest destroyer and creator of carcinogenic compounds, as well as the focus of international environmental campaigns against waste and inadequate corporate social responsibility. Consequently, the industry ended up facing increased restrictions on its access to timber and land, as well as growing regulatory interest in its bleaching processes. Company staff members were forced to spend significant amounts of time and effort responding to their critics.

The industry's response was to commission an independent study on the economic, environmental, and social sustainability of the sector and to develop a more systematic dialogue process with its stakeholders.[17] Once the industry was seen as taking corporate citizenship issues seriously, its critics were more willing to engage in a dialogue. As understanding among different stakeholders grew, campaigners became more focused on working with the industry to develop solutions. As a result, the reputation of the sector has gradually improved.

Conversely, those with a good reputation for corporate citizenship are more likely to be given a second chance in the event of problems. One of the best examples of this phenomenon was a major pharmaceutical company with a long history as a good corporate citizen and seen as highly trustworthy by its customers. When several people died after one of its best-selling products was tampered with, the company responded immediately by removing every product in that range from the shelves. Although the company's share price dipped initially, it recovered quickly and there was no lasting damage to the company's reputation or financial performance.[18]

Dealing with Tragedy

In the summer of 1996, a plane crashed into the Everglades in Florida killing all 110 people on board. The airline was a leading low-cost operator that had experienced huge growth in the mid-1990s and was a popular stock. The day after the crash, the share price dropped 20 percent and continued to plummet. The airline insisted that it did not have a safety problem, despite the crash, and continued to operate its normal flight schedule. However, the media soon revealed that the airline had a record of aborted takeoffs and unscheduled landings. A month later, the airline was grounded by the FAA and trading in its stock was consequently suspended. The event lead to extensive restructuring of the company, including a reduction in the number of contractors and the laying off of many staff.[19]

Conversely, in 1999, a plane run by a major U.S. airline crashed into a steel structure near the end of the runway and broke apart, killing 11 people and injuring 89. The company immediately set up a call centre and handled 13,000 calls in the first 90 minutes after the crash. The airline president held a press conference just hours after the event, giving hard facts about the aircraft and the crew. Members of the public interviewed at the time appeared nervous about the crash, but were willing to accept that it was a rare accident. The airline has since pre-empted any potential regulatory changes by taking quick steps as a result of its own internal investigation. By acting swiftly, the airline was able to anticipate the actions of regulators and public opinion at every stage. Its effective crisis management salvaged a situation that could have severely damaged its reputation. The event had little or no impact on the share price.

Conclusion

Companies that take corporate citizenship seriously can improve their reputations and operational efficiency, while reducing their risk exposure and encouraging loyalty and innovation. Overall, they are more likely to be seen as a good investment and as a company of choice by investors, employees, customers, regulators, and joint venture partners.

While there may be a lack of consensus as to the extent of a company's moral responsibility for corporate citizenship, the range of business benefits that can result should be sufficient to make any forward-thinking organisation see increasing corporate citizenship as an integral part of good business management.

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About Arthur D. Little

Arthur D. Little is one of the world's premier consulting firms working at the interface of business and the technologies that drive innovation and growth. Drawing on its unique blend of knowledge and hands-on experience with a broad range of industries worldwide, the firm collaborates with its clients to achieve breakthroughs in practices, products, and processes that lead to dramatic growth and the creation of new value.

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