The Corporate Ethics Boom: Significant, or Just for Show?

In an article on Nov. 13, 2000, in the Financial Times' Mastering Management series, Wharton legal studies professor Thomas Donaldson looks at the increase in corporate ethics programs throughout the world. Which are the most effective? Do they indeed make a company ethical? Do they improve return on investment and/or customer satisfaction? And what are the consequences of not having a program? Below is the text of Donaldson's article.

Corporate ethics programs 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 U.S. to Asia, Africa and Latin America. Most of the 500 largest corporations in the U.S. now boast a code of ethics, and the proportion among a broader collection of U.S. companies has risen to 80%. 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% of the responding companies had a code of conduct, compared with 57% three years ago. (FTSE 350 is a stock market index that tracks the performance of U.K. companies.)

In the 1950s, ethics programs 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 organizations. 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 programs 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 programs, or perhaps change the ones they have?

The vogue for ethics programs does not resolve the most common theoretical question asked of business ethics, namely, what counts as ethical?

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Even the socially screened investment movement that specializes 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 U.S. anti-trust laws, a sin greater in some people's eyes than fermenting grapes.

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

Corporate ethics programs have spread widely, yet no evidence suggests this growth is the result of a decline in standards. Studies indicate that between 25% and 60% of employees in any given year admit to having seen ethical misbehavior, 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 the growing maturity of business institutions. Recently, media exposure of labor standards in Asia prompted a cascade of initiatives by companies such as Nike in the U.S. 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 analyzed these cases, Prudential Group's fraud at Prudential Securities and Prudential Insurance cost it $1.8 billion in fines and settlements; Daiwa Bank's concealment of its trading losses cost it fines and the loss of its U.S. license; Salomon Brothers' government bond auction scandal cost it $500 million in fines and settlements and $1 billion in market capitalization; 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 U.S., the 1994 legal dispute involving 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 programs. In 1991, U.S. Federal Sentencing Guidelines offered companies 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 programs. In turn, compliance-oriented ethics programs, 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 programs. Most of the largest 200 companies in the U.S. 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 programs 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 program has a different goal. Code and compliance programs are the most common and focus on regulating the behavior of employees. These formal documents specify employee behavior in detail and are often written by lawyers. Such codes govern conflict of interest, accepting gifts, anti-competitive behavior, entertaining customers and so on. Some industries have slowly developed highly specialized compliance programs. 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 penalize offenders. Motives for such codes are usually starkly self-interested: Companies hope to avoid legal and reputational harm by specifying and monitoring behavior.

A variant of compliance programs 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 labor standards in factories that supply global companies, as well as to specify standards for other aspects of behavior.

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 programs, 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 emphasizes positive concepts such as integrity, respect for others, teamwork and service to stakeholders. Not unlike mission statements, values programs 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 U.S. corporations possess such programs and companies in other countries are following suit.

Nonetheless, many corporations launch values programs 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 programs is markedly different from compliance codes. They emphasize positive rather than 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" programs, the least common type, emphasize the company's role as a social citizen. Two trends dominate such programs. 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 U.S. Social accounting programs rest on the premise that companies should account for social activities in much 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 programs. To date, social accounting is a legal requirement only in France.

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

One of the first to use a competency-based program was U.S. 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 emphasizing 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 Organization 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 $60 million 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 programs vary significantly. 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 U.S. than elsewhere. The study showed that 64% of all U.S. codes are dominated by self-interested or "instrumental" motives, while 60% of European codes are dominated by "values" concerns.

Despite geographic differences, the Conference Board study demonstrated that increasing numbers of senior managers are involved. About 95% of companies formulating ethics codes include contributions from the chief executive, in contrast to 80% in 1987, and 78% of company boards of directors in contrast to 21% 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 summarized 52 research projects devoted to corporate ethics and profit. At first sight, the results appear encouraging for corporate ethics program 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 programs make better ethics remains.

The 2000 National Business Ethics Survey in the U.S. 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 organizations are not in transition, the presence of ethics program 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 organizations are in transition, pressure to lower ethical standards is significantly higher if formal initiatives are missing.

Evidence is accumulating that ethics programs 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 programs as being oriented towards "values" rather than "compliance", they displayed far more commitment to the organization, more willingness to deliver bad news and more willingness to seek advice.

Another study by the same authors strongly suggests that programs 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 organization 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 U.S. study by the Institute of Chartered Financial Analysts of 5,000 people in the financial services industry showed that only 11% of financial services managers who witnessed unethical behavior 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 behavior and important indicators such as loyalty. The 2000 National Business Ethics Survey undertaken by the Ethics Resource Center in the U.S. indicated that 43% of employees who disagree that the head of their organization "sets a good example of ethical business behavior" also feel pressure to compromise ethics standards. But only 8% 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 programs. The forces that propelled them into being show no signs of abating. Yet not all ethics programs are created equal. Corporate ethics programs 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 programs from ones that simply want to limit legal and public relations problems. Even in the latter case, however, evidence suggests that compliance programs will be more successful when connected to positive values with which employees can empathize. For any ethics programs, furthermore, the evidence is strong that merely having a formal code is not enough. Any such statement must be synchronized with the company's organizational 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 program. Current trends for such programs are towards social accounting systems and making creative social use of a company's core competencies.

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