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BRIDGE PAPERS™ Uniting best thinking with leading business practice.

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FOREWORD

The Business Roundtable Institute for Corporate Ethics is an independent entity established in partnership with Business Roundtable—an association of chief executive officers of leading corporations with a combined workforce of more than 10 million employees and $4.5 trillion in annual revenues—and leading academics from America's best business schools. The Institute brings together leaders from business and academia to fulfill its mission to renew and enhance the link between ethical behavior and business practice through executive education programs, practitioner-focused research and outreach.

Institute *Bridge Papers™* put the best thinking of academic and business leaders into the hands of practicing managers. *Bridge Papers™* convey concepts from leading edge academic research in the field of business ethics in a format that today's managers can integrate into their daily business decision making.

Building the Business Case for Ethics, an Institute *Bridge Paper™* based on the research of Joshua Margolis and James Walsh, provides an analysis of the almost one hundred research studies which have sought to determine whether or not positive social performance leads to positive financial performance.

The accompanying *Thought Leader Commentary™* with Kenneth I. Chenault, Chairman and Chief Executive Officer of American Express Company, provides a CEO perspective on the relationship between social performance and financial performance.

THE RESEARCH

In the Business Roundtable Institute for Corporate Ethics' seminars with Chief Executive Officers and their senior executive teams, an introductory module poses the question "Does Ethics Pay?" During this interactive session we explore the business case for whether or not corporations should care about ethics. We have found that in our Institute's seminars, the answer from these influential attendees is a clear "yes." This is apparent most importantly from the depth of discussion, but we also recognize the fact that these leaders take a full day of their busy schedules to participate in the seminars – through their attendance they do indeed "vote with their feet" their belief that "ethics pays."

While we are reassured by the seminar participants' anecdotal evidence, we also analyze the research that has explored the relationship between the ethical foundations of companies and their financial performance. Managers and executives today are expected to build the "business case" for all corporate initiatives, including programs and activities that encompass social or ethical performance. Beyond searching only for the link between social (or ethical) and financial performance is a more fundamental question: Why are companies called upon to engage in social initiatives in the first place?

There appear to be two related responses to the question: (1) Social trends result in continuing reevaluation of the roles and responsibilities of firms, changing the expectations of companies, and (2) Firms find themselves in situations that demand response, independent of any systematic consideration of a firm's purpose. The most prominent recent examples are the natural disasters of the Asian Tsunami and Hurricane Katrina. Companies were expected to respond and they collectively answered the call by providing hundreds of millions of dollars worth of aid. Perhaps more valuable than the dollars provided is the extent to which businesses responded with their "core competencies" – logistics infrastructure for moving goods quickly to those in need, medical supplies for the injured, mobile telecommunications systems, and many other essential goods and services. These "competencies" represent the products, services, and skills that are quite simply among the best developed in the world, and they could not have been quickly achieved through traditional monetary aid. A *Fortune* magazine cover trumpeted "Government Broke Down. Business Stepped Up." in its post-disaster coverage of Hurricane Katrina to recognize the contributions of the corporate community. (*Fortune*, October 3, 2005)

...companies, as the engines of economic growth, might be able to expand what they do to help humanity

For many of the forces drawing firms into social performance initiatives, the logic rests on the conviction that companies, as the engines of economic growth, might be able to expand what they do to help humanity beyond merely their contributions to economic growth. This may even be viewed by certain interest groups as a moral imperative. However, from the viewpoint of executives, managers, and shareholders, this logic of targeting firms for moral and social appeals doesn't speak to the impact that such activities have on the firm itself. Business cases that can document financial gains from social and ethical

Can a firm effectively attend to both people and profits in conducting its business?

performance may hasten efforts to rally corporate involvement, allay fears about costs to the company, and provide value in communications and branding for the company and its executives. In designing such a business case for corporate social performance, an important first step is to analyze the research studies. One of the most complete compendiums of research in this area—"*People and Profits? The Search for a Link Between a Company's Social and Financial Performance*" by Joshua Margolis and James Walsh—provides this initial analysis.[1]

This compendium analysis of 95 studies covering over 30 years of research indicates a positive relationship between social performance and financial performance. For today's business leaders, a more focused analysis in their own organizations will hopefully not only support the general conclusion of a positive relationship between social performance and financial performance, but will also contribute to more effective identification, support, and management of corporate social and ethical initiatives. If these initiatives can be shown to contribute to improved financial performance, then companies benefit from adopting practices that provide value to a variety of stakeholders.

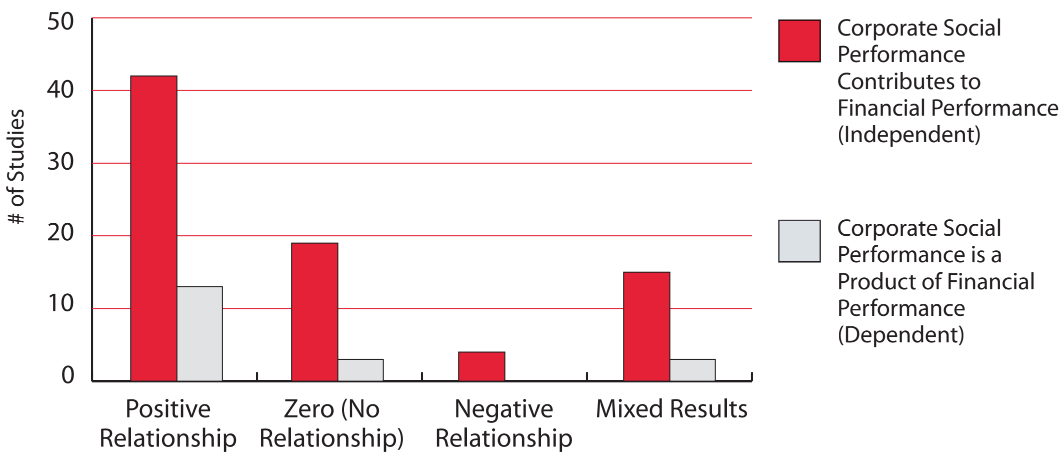
It is first worth noting that the collective research reviewed in *People and Profits* utilizes an exceptionally broad definition of *social performance*. Falling under the definitional umbrella of social performance are organizational programs, charitable contributions, community investment, environmental practices, human rights, human relations, quality of services/products, and all-encompassing omnibus measures such as the *Fortune* Most Admired rankings. Indeed, the social performance measures evaluated may be cumulatively understood to represent the interests of a broad range of a corporation's stakeholders, including employees, customers, communities, and the like. A more contemporary version of the question addressed by *People and Profits* is to ascertain the relationship between the social, or stakeholder, performance of companies and their financial performance. Can a firm effectively attend to both people and profits in conducting its business?

Research Results

The research studies in *People and Profits* look at corporate social performance as both an independent and dependent variable. Put another way, whether corporate social performance contributes to, or is a product of, corporate financial performance. In the 80 studies evaluating whether corporate social performance contributes to corporate financial performance, 53% of them point to a positive relationship. No relationship is identified in 24% of the studies, 4% find a negative relationship, and the remaining 19% of the studies yield mixed results. The conclusion often drawn from these cumulative results is that social initiatives contribute to the bottom line – companies do well by doing good.

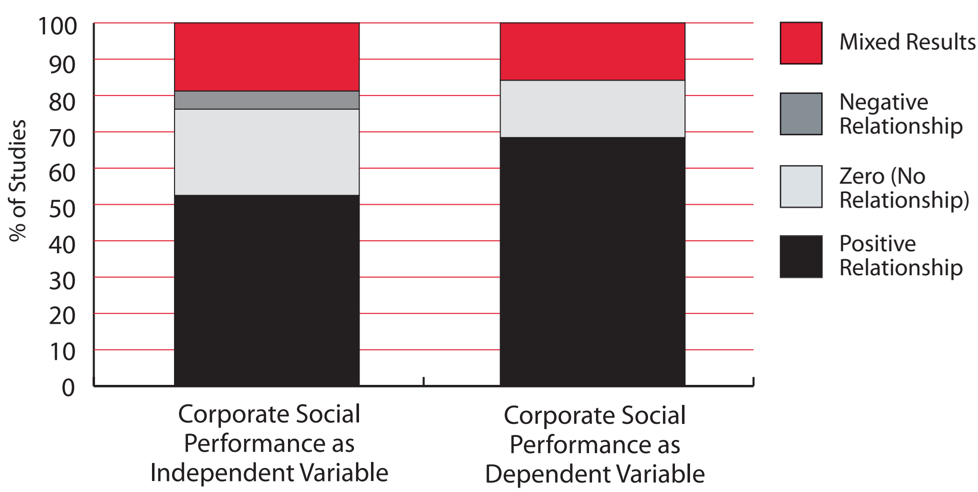
When evaluating corporate social performance as an outcome of financial performance, again the studies support the correlation. With only 19 studies exploring this question, 68% of those identify a positive relationship, with 16% showing no relationship, and 16% providing mixed results. A common conclusion from these studies is that companies which are profitable have the ability to support social initiatives. Exhibits 1 and 2 provide a summary of all of the study results.

Exhibit 1. Summary Results of 95 Research Studies



Source: Margolis and Walsh (2001)

Exhibit 2. Summary Percentage Results of 95 Research Studies



Source: Margolis and Walsh (2001)

EVOLUTION OF "MEASURING" CORPORATE SOCIAL PERFORMANCE

While a definition of corporate social performance has been gradually refined over the course of 30 years, its measurement continues to evolve. Overall, the 95 studies reviewed utilize 27 different data sources in assessing social performance and cover 11 different forms of social performance, such as organizational programs, disclosures, charitable contributions, and others. However, in general, the definition of corporate social performance has evolved from one-issue evaluations toward more broad, multi-faceted analyses, supported by the increased ability of researchers to utilize more reliable and available data. Some of the earliest corporate social responsibility studies from the 1970s reflected the most visible and publicized social issues of that time, such as pollution and withdrawal from South Africa, and broad conclusions were drawn on the study of those single issues. Moreover, the availability and transparency of information at the time resulted in measurement methods that would seem to fall short against the mechanisms used in today's age of increased availability of corporate information. In a 1978 study, for instance, a researcher reviewed annual reports and then coded companies as "*mention*" or "*none*" depending on the percentage of total lines of text dedicated to corporate social responsibility topics.[2] Clearly for a number of reasons, managers would be hard-pressed to build a business case today on "mentions" in an annual report.

...corporate social performance has evolved from one-issue evaluations toward more broad, multi-faceted analyses

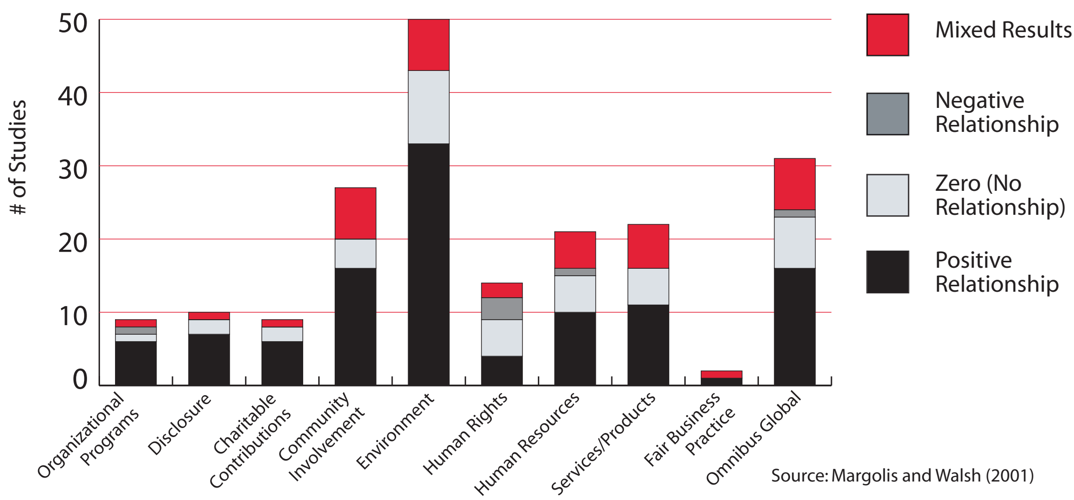
While a firm's environmental practices are the most commonly measured assessment of social responsibility, omnibus measures, including *Fortune* reputation rankings, represent the second most frequent measure and have also become a more common measurement in several of the most current individual research studies. Two examples of omnibus measures illustrate the expanse of what constitutes corporate social performance, both in practice and in research. In 1975, Milton Moskowitz, an advocate for corporate social responsibility, listed the following criteria for evaluating social performance:

> "Pollution control, equal employment opportunity, minority and female representation on the board of directors, support of minority enterprise, responsible and irresponsible advertising, charitable contributions, community relations, product quality, plant safety, illegal politicking, disclosure of information, employee benefits, respect for privacy, support for cultural programs, responsiveness to consumer complaints, fair dealings with customers."[3]

The Kinder, Lydenberg, Domini (KLD) index is a second omnibus assessment widely utilized in the research. The KLD index evaluates companies against a scale for the following five criteria: community, diversity, employee relations, natural environment, and product safety and quality.

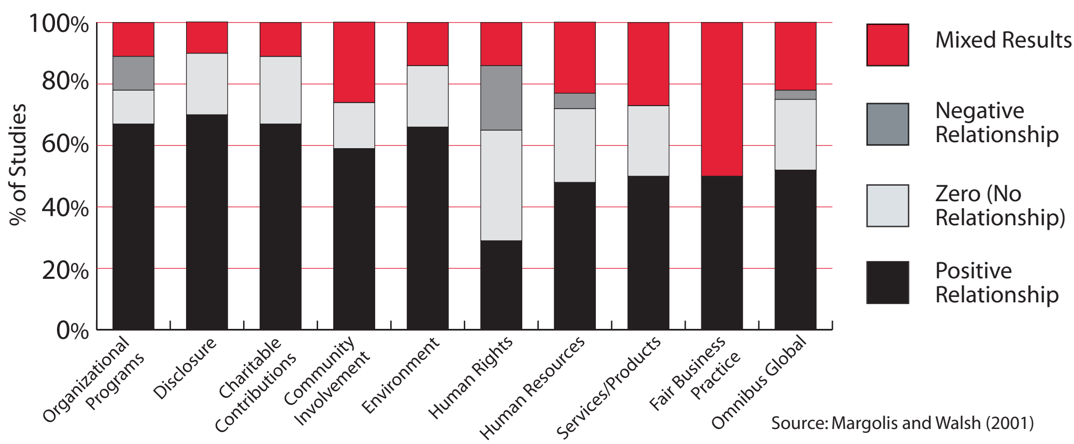
Most recently, the *Fortune* Most Admired measure, in which executives, outside directors, and corporate analysts annually evaluate companies along eight attributes, is utilized in 16% (15 of 95) of the research studies reviewed. Certainly, some scholars applaud the multiple methods, measures, and data sources that have been utilized in assessing corporate social performance. This variety is seen as capturing the diversity of corporate practices that constitute social performance. Critics see it in the opposite way, as an indication that corporate social performance is an incoherent jumble of practices. Exhibits 3 and 4 provide research results by domain of investigation for corporate social performance as an independent variable.

Exhibit 3. Results by Form of Social Performance (Corporate Social Performance as Independent Variable)



Source: Margolis and Walsh (2001)

Exhibit 4. Percentage Results by Form of Social Performance (Corporate Social Performance as Independent Variable)



Source: Margolis and Walsh (2001)

BREADTH OF MEASURING FINANCIAL PERFORMANCE

For the 95 research studies covered, 70 different metrics are used to measure financial performance. The two dominant methods of financial performance are accounting measures (e.g., ROE, ROA, ROS, ratios, etc.), which are taken to be indicators of historical performance, and market measures (e.g., annual return, total return, Alpha, Beta, etc.), which are taken to reflect future performance. Exhibit 5 provides the five most common accounting and market measures of financial performance utilized in the research studies.

Exhibit 5. Financial Performance Indicators

Accounting Measures

...indicators of past performance...

Measure	# of Studies where used
Return of Equity (ROE)	31
Return on Assets (ROA)	28
Return on Sales (ROS)	13
Debt/Equity (e.g., Risk)	6
Current Ratio (e.g., Risk)	4

Market Measures

...indicators of future performance...

Measure	# of Studies where used
Alpha	8
Beta	8
Cumulative Annual Returns	7
P/E Ratio	7
Total Returns	6

Source: Margolis and Walsh (2001)

IMPLICATIONS AND TAKEAWAYS FOR MANAGERS

Takeaway #1:
A positive relationship exists between social (ethical) performance and financial performance.

The signal from the 95 studies and 30 years of research reviewed is that a positive relationship exists between social (ethical) performance and financial performance. Paying attention to ethics issues and initiatives does not destroy financial value and does not distract managers from creating value for the company's stakeholders. There are nonetheless lingering questions for further research, particularly about the validity and diversity of measures used to assess social performance.

Takeaway #2:
Evaluating ethical performance solely on financial performance risks ignoring other benefits and beneficiaries.

Numerous great organizations undertake ethical initiatives even in the face of financial reasons not to do so. Why? The positive financial performance supports the initiatives, but it does not mandate such actions. Organizations and their leaders should ultimately engage in ethical initiatives and actions because they see a more expansive definition of "return" and "value creation" – including elements such as employee morale, benefit to the community and society, innovation, and reputation, among other considerations. All of these considerations ultimately tie in to the organization's mission, principles, and values.

Takeaway #3:
It's time to move beyond the question of "Does Ethics Pay?" and toward the action-driven inquiry, "How can managers be equipped to meet rising financial and ethical expectations?"

Moving beyond the question of "Does Ethics Pay?" requires companies to focus instead on other questions such as:

1. What are our organization's objectives, duties and concerns? In other words, what do we stand for and want to accomplish?
2. How is our organization best able to accomplish its ethical and financial objectives?
3. How should our organization respond and act (toward social/ ethical issues) when the two sets of objectives are in tension?

NOTES

1. Margolis, Joshua D., and James P. Walsh. People and Profits? The Search for a Link between a Company's Social and Financial Performance. Mahwah, N.J.: Lawrence Erlbaum Associates, 2001.

2. Margolis and Walsh. p. 51

3. Margolis and Walsh. p. 9

A THOUGHT LEADER COMMENTARY™ with Kenneth I. Chenault, Chairman and CEO, American Express Company

Social Responsibility as a Reflection of Strong Business Ethics

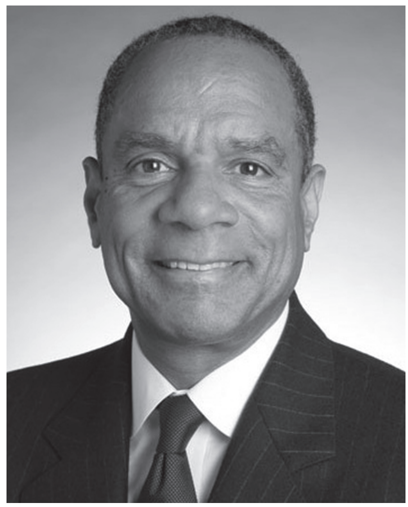
Social responsibility is one of the most visible demonstrations of corporate ethics and, according to Ken Chenault, Chairman and Chief Executive Officer of American Express Company, it has become an important business imperative.

"A socially responsible company strives to meet a standard that's higher than the bottom line," Chenault says. "We must remember that corporations exist because society says they can — and society assumes that we'll contribute to the common good. That's the bargain we strike. The social compact."

Corporate social responsibility goes beyond charitable contributions and employee volunteerism. According to Chenault, a socially responsible global corporation:

- Subscribes to a set of values and lives by them;
- Recognizes people who do the right thing and rewards them;
- Aspires not only to be successful, but to be respected;
- Creates a culture of integrity and accountability;
- And acts to fulfill its enlightened self-interest—seeing that its own objectives are enhanced by serving and strengthening the communities where it operates.

At American Express, this is put into practice by an unbending commitment to delivering outstanding service to customers; by fostering a work environment in which all employees can succeed and grow; by providing superior returns to shareholders; and by contributing in meaningful, measurable



COURTESY OF AMERICAN EXPRESS

Kenneth I. Chenault

ways to the communities where it operates.

Chenault believes that without a history of strong social responsibility, a company can collapse under the harsh glare of today's public spotlight. "Reputations that were built over a lifetime can be lost in a moment," he says. "Conversely, a company that is truly a member of the community will earn public goodwill that endures, and will have the credibility to function when others are failing."

American Express' commitment to

social responsibility is an integral part of its 156-year heritage. "It's given us the strength to overcome a myriad of crises," Chenault says. For instance, during the Civil War, American Express employees of what was then a fledgling freight delivery company ventured onto battlefields to deliver packages and letters to soldiers. More recently, even as it dealt with the death of 11 employees and severe damage to its corporate headquarters in Lower Manhattan, American Express' operations continued without interruption after 9/11. Employees quickly shifted into emergency mode, adjusting schedules and procedures to meet the urgent needs of hundreds of thousands of travel customers, cardmembers and financial services clients – plus countless others the world over who needed help and had nowhere else to turn. "We've built a culture where employees understand our commitment to customers and to the communities around us," says Chenault. Today, the company is a key player in the ongoing efforts to revitalize Lower Manhattan. And throughout its history, American Express has offered relief and support to victims of natural disasters, such as the Asian Tsunami and Hurricane Katrina.

In Chenault's words, "social responsibility means doing well; doing right; doing good."

ABOUT THE AUTHORS

Building the Business Case for Ethics

JOSHUA MARGOLIS is an Assistant Professor of Business Administration in the Organizational Behavior unit at Harvard Business School. He teaches Leadership and Organizational Behavior in the MBA program and previously taught the introductory ethics course, Leadership, Values, and Decision Making. He is an Academic Advisor for the Business Roundtable Institute for Corporate Ethics.

JAMES WALSH is the Gerald and Esther Carey Professor of Management and Organizations at the Stephen M. Ross School of Business at the University of Michigan. His research interests include corporate governance and how business serves society.

DEAN W. KREHMEYER is Executive Director of the Business Roundtable Institute for Corporate Ethics.

Thought Leadership Commentary

KENNETH I. CHENAULT is Chairman and Chief Executive Officer of American Express Company.

Mr. Chenault joined the company in September 1981 as Director of Strategic Planning. He was named President of the Consumer Card Group in 1989, and in 1993 he became President of Travel Related Services (TRS), which encompassed all of American Express' card and travel businesses in the United States. In 1995, he assumed additional responsibility for the company's worldwide card and travel businesses and also was named Vice Chairman of American Express. Mr. Chenault became President and Chief Operating Officer in February 1997. He assumed his current responsibilities as CEO on January 1, 2001, and as Chairman on April 23 of that year.

Before he came to American Express, Mr. Chenault was a management consultant with Bain & Co. from 1979 to 1981, and an attorney with Rogers & Wells from 1977 to 1979.

Mr. Chenault serves on the boards of American Express and several other corporate and nonprofit organizations, including IBM, the Arthur Ashe Institute for Urban Health, the National Center on Addiction & Substance Abuse at Columbia University, the Smithsonian Institution's Advisory Council for the National Museum of African American History & Culture, the Phoenix House Foundation and the World Trade Center Memorial Foundation. He also is on the boards of the Partnership for New York City, The Business Council and the Business Roundtable and serves as Vice Chairman of each of these organizations.

A wide variety of civic, social service and community organizations have recognized Mr. Chenault for his public service leadership. He has received the Phoenix House Public Service Award, the Corporate Responsibility Award from the International Rescue Committee and the Wall Street Rising Leadership Award, among others.

Mr. Chenault holds a JD from Harvard Law School and a BA in history from Bowdoin College, and he has received a number of honorary degrees from several universities.

He and his wife, Kathryn, live in New York with their two children.

For more information on the **Business Roundtable Institute for Corporate Ethics** please visit or call

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