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Essay

Is there an optimal degree of sustainability?

By Robert G Eccles, Ioannis Ioannou, and George Serafeim

Corporate sustainability is not a one size fits all concept. Successful strategy balances other pressures

In a recent paper – The Impact of a Corporate Culture of Sustainability on Corporate Behaviour and Performance – we reported on a study of a matched sample, two virtually identical sets of firms in terms of size, financial performance and growth prospects, of 180 US companies over the period from the beginning of 1993 to the end of 2010.

We classified 90 of these companies as High Sustainability firms because long ago they adopted corporate policies regarding commitments to enhance environmental and social performance, while the other 90 we classified as Low Sustainability firms because they had not. The Low Sustainability firms correspond to the traditional model of profit maximisation in which social and environmental issues are predominantly regarded as “externalities” created by the firm’s actions.

The High Sustainability firms, in contrast, take into account these externalities in their decisions and operations; this is manifested in their relationships with stakeholders such as employees, customers and NGOs representing civil society. In other words, the notion of “sustainability” appears to be embedded in a holistic and multidimensional manner within and throughout the organisation.

In particular, our data and analysis show that High Sustainability firms are characterised by distinct governance mechanisms that directly involve the board in sustainability issues and link executive compensation to sustainability objectives; a much higher level of and deeper stakeholder engagement, coupled with mechanisms for making it as effective as possible, including reporting; a longer-term time horizon in their external commu-

nications that is matched by a larger proportion of long-term investors attracted to these firms; greater attention to non-financial measures regarding employees; a greater emphasis on external environmental and social standards for selecting, monitoring and measuring the performance of their suppliers; and a higher level of transparency in their disclosure of non-financial information.

Stock performance

We also found that firms in the High Sustainability group significantly outperformed firms in the Low Sustainability group in terms of both stock market performance (although both sets did better than the market as a whole) and accounting measures.

Investing \$1 in the beginning of 1993 in a value-weighted (equal-weighted) portfolio of sustainable firms would have grown to \$22.6 (\$14.3) by the end of 2010, based on market prices.¹ In contrast, investing \$1 in the beginning of 1993 in a value-weighted (equal-weighted) portfolio of traditional firms would have only grown to \$15.4 (\$11.7) by the end of 2010.

We found similar results for the measures of return-on-assets and return-on-equity. As with almost all empirical studies in the social sciences, it is difficult to convincingly demonstrate causality – i.e. that it is the management practices of the High Sustainability firms that result in their superior performance and not some unobservable factor resulting both in superior performance and the adoption of the specific practices. In our paper, we discuss the causality problem and provide some evidence for why we think it is business practices promoting sustainability, and not some other

High Sustainability firms are characterised by distinct governance mechanisms that directly involve the board

¹ In a value-weighted portfolio, investment allocations are made based on the company's market capitalisation. In an equal-weighted portfolio each company receives the same investment allocation.

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The sustainability balance can be tricky

variable, which is indeed the cause, at least partly, for this superior performance.

Our paper focused on differences between the two sets of companies in terms of the relative results between them. In this essay, we will instead focus on the absolute results that raise the important question, “Is there an optimal degree of sustainability?” In other words, is sustainability something a company can always have more of or, at a certain point, does the cost of sustainable business practices outweigh their benefits?

Balancing acts

Improving non-financial performance (eg in environmental, social, and governance terms) in a way that is neutral to or synergistically improves financial performance is difficult to do. Quite often, companies find that critical trade-offs are involved, at least in the short term. At a certain point, greater sustainability from a societal point of view could come at a cost to shareholders. This suggests that there is indeed an “optimal” degree of adoption of such practices, beyond which point a commitment to it becomes value-destroying, at least in the short term.

It appears that many companies have already plucked the low-hanging fruit of finding fairly obvious ways to improve energy efficiency and reduce carbon emissions in a relatively short time span. They are now struggling with where to go next – whether into other environmental domains (such as water and waste), social issues (such as diversity and working conditions), or better governance and risk management (such as supply chain and reputational risk). In our field, research and case writing, we have found that simultaneously improving financial and non-financial performance typically requires innovation – sometimes at a major scale – in processes, products, and business models.

Innovation is a way of extending the efficient frontier of performance. Commitment to improve some dimension of non-financial performance when the mechanism for doing so is unknown at the time this commitment is made is also a type of “forcing function” for innovation. Such prior commitments introduce a high level of uncertainty in terms of how to simultaneously improve financial and non-financial performance, the capital investment that will be necessary, and the payback period.



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old plant was the primary employer in the local community.

The simple economic argument would be to model both scenarios in terms of the net present value of future earnings from each and choose the one that has the greatest value. But what if the results are the same within the margin of error, perhaps even greater than is known because of the difficulty of predicting future states of the world? For example, legislation limiting the amount of carbon emissions as a function of units produced would make the new plant even more economically attractive, but this could be offset by damage to the company's reputation caused by the community's and media reaction to this decision.

Alternatively, unbeknown to the company, a wind farm operator might be planning a large installation near the existing factory, but this could be offset by new legislation that raises wages and taxes for the country's social security fund. Of course, it's possible that through some type of innovation, financial, environmental, and social performance can all be improved. But the more variables that are added to the objective function, the more difficult it becomes to achieve it. Thus not only is there an optimal degree of sustainability, but choices need to be made as to which dimensions of sustainability are to be optimised.

Optimum sustainability

Data from our paper provides further insight into the question of the optimal degree of sustainability. We compared the two groups of companies in terms of corporate governance (five metrics), stakeholder engagement (11 metrics), employees (four metrics), customers (11 metrics), suppliers (11 metrics), and auditing (13 metrics).

For the five metrics on corporate governance, the percentage of adoption ranges from 8.1% to 21.6% (average of 15.4%) for the Low Sustainability firms and from 17.6% to 52.7% (average of 35.7%) for the High Sustainability firms. On only one of the five metrics – the board has taken formal responsibility for sustainability – have more than half of the High Sustainability firms implemented this practice. Only 40.9% of the High Sustainability firms have a board committee responsible for sustainability. Standards of best practice regarding corporate governance evolve as the legal and social context changes.

In the United States, it is only within the past 10 years or so that sustainability has become a prominent topic on management's agenda and so a lag in terms of companies figuring out how to deal with this at the board level should be expected. The explanation for the lower percentages on linking executive compensation to non-financial metrics regarding social, environmental, and customer performance dimensions is the difficulty of coming up with reliable measures. As standards for non-financial measurement are developed, it will be

Uncertainty also exists about future social expectations and regulations. These can work in favour of a company, such as being an early adopter of a policy regarding some aspect of sustainability at its own pace, before it is required to do so by law or convention, and reaping the economic and reputational benefits that ensue. The reverse can also be true, such as when a company anticipates a future event, such as a tax on carbon, that doesn't happen within a relevant time frame. In other words, not only the type of corporate action, but in fact, the timing of adoption and implementation is important.

A further complication is that rarely is it simply a case of finding a way to improve financial and non-financial performance in a general sense. Setting financial performance aside, trade-offs often exist in the various dimensions of non-financial performance. Shutting down a manually intensive and low-productivity plant in a location that inefficiently uses "dirty energy" and building a new, more automated and more energy efficient plant in a location that uses renewable sources of energy is clearly beneficial to the environment. But this comes at a cost of jobs, a cost that can be exacerbated if the

As standards for non-financial measurement are developed, it will be easier to make non-financial performance a factor in executive compensation

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easier to make non-financial performance a factor in executive compensation for those companies that choose to do so.

In terms of stakeholder engagement broadly and suppliers in particular, nearly all of the differences between the two groups are highly statistically significant. This is driven more by the low numbers from the Low Sustainability companies than by the high numbers from their High Sustainability counterparts.

For stakeholder engagement, the range across the 11 metrics is 0.0% to 13.5% (average of 4.2%) for the Low Sustainability companies and 14.9% to 45.9% (average of 28.7%) for the High Sustainability ones. For the 11 metrics on suppliers, the ranges are 0.0% to 25.7% (average of 8.3%) and 6.6% to 62.9% (average of 24.2%) for Low and High Sustainability companies, respectively. There is almost no adoption of sustainability practices regarding stakeholder engagement and suppliers by the Low Sustainability companies and only around one-quarter of the High Sustainability companies have done so.

There are three possible explanations for this. The first is that the importance of these practices varies across industries since in certain industries



Good practice is a cost of good business

the practice may simply not be that important. For example, certain business-to-business (B-to-B) industries that have little visibility to the public – such as general industrials, electronics, industrial engineering, and industrial transportation – may feel less need to focus on stakeholder engagement than highly visible business-to-consumer (B-to-C) industries such as beverages, leisure goods, personal goods, retailers, and media. However, these B-to-B businesses may find managing their supply chain especially important. This would be less important for companies that are at the beginning of the supply chain, such as those in industries

which extract natural resources (eg oil and gas production, and mining) or convert natural resources into products (eg chemicals and industrial metals); for these industries we would expect a high level of attention to the environmental, health, and safety of their workers.

A second explanation, which is a slight variation on the first, is that sustainability practices involve transaction and other costs. Beyond a certain point, the marginal benefit becomes negative and so companies allocate these costs across those sustainability activities where they think they'll get the greatest return. While a number of practices may be seen as "the right thing to do" taken individually, in the aggregate choices must be made. In other words, managing sustainability practices as a portfolio of activities rather than individually may be the reason behind the apparent heterogeneity and indeed low adoption numbers.

Early stages

The third explanation is that we are simply at the early stages of adoption of sustainability practices. These will undoubtedly spread, starting with the High Sustainability companies, especially if social expectations continue to place increasing emphasis on sustainability. Companies will vary in terms of the sequence in which they adopt sustainability practices, perhaps driven by those that are most immediately important to them. They will also learn from each other. An important innovation by a firm in an industry for improving some aspect of non-financial performance in a way that contributes to financial performance will be imitated, to the extent possible, by its competitors, thereby spreading this practice. Furthermore, companies are still at the early stages of learning exactly what the best sustainability practices are and a period of experimentation will be required before these are well-defined.

The percentages of adoption are higher for the four employee metrics, ranging from 16.2% to 89.5% (average of 39.6%) for the Low Sustainability companies and from 54.1% to 95.2% (average of 72.8%) for the High Sustainability companies. The fact that on average nearly three-quarters of the High Sustainability firms have adopted these practices regarding employees raises the question of why the other 25% have not done so. Similar to the argument above, it could be that these practices regarding environmental, health, and safety of workers just aren't that important in some industries, perhaps such as mobile telecommunications and software and computer services. Or it simply could be that there are some laggards even among the High Sustainability firms that will eventually adopt these practices.

Raising the average for both groups is "KPI Labour/EHS Performance Tracking" which is practised by nearly all firms in both groups due to occupational safety and health administration regulations. When a practice is mandated by the

government, companies have no choice but to implement it. However, the way in which they do so will determine whether it is simply a “cost of doing business,” as it would be perceived by Low Sustainability firms following a traditional business model, or if the company actually finds ways to create economic value in doing so, as is the case with the High Sustainability firms. An example of the latter would be where the company doesn’t simply “track” environmental, health and safety performance, but uses this information to improve processes in a way that results in fewer accidents and fatalities, thereby improving product quality, reducing downtime of manufacturing facilities, and lowering insurance costs.

In terms of customers and auditing, the percentages for both groups of companies are very low and, as a result, there are few statistically significant differences between the two groups. For customers, the range for the seven metrics for the Low Sustainability companies is 2.7% to 10.8% (average of 6.2%) and for the High Sustainability companies the range is 5.4% to 18.9% (average of 12.7%). For auditing, Low Sustainability firms range from 0.0% to 8.1% (average of 4.3%) and High Sustainability firms range from 5.4% to 16.2% (average of 12.3%). Only about 10% of even the High Sustainability companies have adopted on average practices regarding customers and auditing.

For customers, we believe that one explanation is similar to the low adoption rates for linking non-financial performance to executive compensation – the lack of measurement standards. For example, it is clearly difficult to measure the potential lifetime value, customer lifestyle, and cost of service of a customer. However, such metrics as geographical segmentation, customer generated revenues, historical sales trends, and products bought would seem to be relatively straightforward to measure.

Systems required

The fact that most companies in our sample are not doing so suggests that either the appropriate customer relationship management systems do not exist or have not been installed since the company sees no value in doing so. We see this domain of customer metrics as one ripe for innovation. Those companies that can figure out how to take these measures and use this information to improve financial performance will see a big benefit in doing so.

The low rates on auditing are a consequence of the lack of measurement standards. Without measurement standards, it is virtually impossible to create rigorous auditing standards. Exacerbating this is the potential liabilities auditing firms perceive in conducting such audits. They already face substantial risk in their financial audits, even after years of development of accounting and auditing standards and supporting technologies. Audit firms are not able to purchase insurance and so they self-insure, with so-called “practice protection costs”



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You can't value what you don't measure!

purported to be the largest cost item in their budget after partners' income. Even if measurement standards are developed upon which auditing standards can be developed, it is likely that the spread of the practice of auditing non-financial information will require some kind of liability reform. This is a public policy issue and not something that can be resolved by auditors, companies and investors.

So is there an optimal level of sustainability? The answer, our research suggests, is “yes”. But that level is increasing due to three interrelated reasons: (1) new government regulations, (2) changing social expectations, and (3) innovation.

The increasing economic power and social impact, both good and bad, of the world's largest corporations means that governments will inevitably set new “rules of the game” for what is accepted behaviour by companies. These government regulations will be driven in part by changing social expectations about what companies should and should not do, in many cases changing corporate behaviour even before new regulations are implemented.

Innovation by companies will be necessary in order to adopt more sustainable business practices that create economic value for shareholders. Some of this innovation will be in response to changing social expectations and new regulations, but some of it will be initiated by companies themselves who will see competitive advantages in doing so. Yes, there is an optimal degree of sustainability and its precise definition will vary across countries, industries, and company strategy.

Changing social expectations and regulations suggest that this optimal degree of sustainability will be increasing in the next few decades. The key success factor for corporations, therefore, would be in identifying which practices and in what ways will generate the largest returns in any given context. ■

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Emerging markets

Top tips for developing economies

Toby Webb suggests ten lessons for large companies expanding their sustainability programmes into high-growth markets

Lesson one: Corporate responsibility and sustainability issues are vastly different around the world. This is true even in Europe. There remain huge differences in priorities, for example, between richer, northern Europe and eastern and southern Europe, where many basic institutions remain under-resourced.

Outside the EU, India is as different from China as it is from the UK. Everything is local and culture counts.

Lesson two: Global principles with local implementation are the only way large companies can operate successfully and sustainably. Flexibility for business is essential. The fine balance is between global principles and maintaining consistency with both corporate values and local expectations.

Lesson three: The world is more left-wing than the UK and US. This is often hard to understand for UK companies, and particularly those from the US. Most democracies are much more like those of western Europe than they are the US. This means a very different set of expectations. Most notable is the paradigm that the role of business is to serve social structures, not the other way around.

Lesson four: Governments are unpredictable on sustainability issues. This is becoming clear to western companies. This does not just apply to sustainability issues. China, for example, rules by dictat, and companies had better get in line with the latest pay rise, transparency or five-year plan expectations, and fast.

Lesson five: Institutions as we know them often do not exist. The importance of institutions is perhaps the most undervalued area within the field of global responsibility thinking. We take our essential institutions for granted, from

environmental protection to child education, and often forget they have taken hundreds of years and vast wealth to develop. Expectations, particularly around behaviour, are partly governed by them. Yet by comparison they barely exist elsewhere. This has consequences, both for how companies are expected to behave, and how they might respond to play a role in filling this gap.

Lesson six: Stakeholders are unpredictable. Issues can escalate very quickly. Myriad modern examples demonstrate this is true. Getting the government onside does not mean your project or investment is safe if stakeholder engagement is failing. Vedanta in India, Asia Energy in Bangladesh and Newmont in Peru are all cases that demonstrate how quickly stakeholder reactions can shut down big business operations. When stakeholder voices and protests hit government popularity or cause major social unrest, corporate influence wanes very quickly indeed.

Lesson seven: Culture counts. Local knowledge is essential. An executive in London does not necessarily understand what people in Yorkshire are thinking. The same is true of your managers in emerging economies. Just because your office in the capital says it understands what's happening in the regions does not simply make it so. Localised information is vital to understanding emerging stakeholder risk.

Lesson eight: Agendas are mixed, but skills, education and jobs are always number one. If there is one common theme that unites disadvantaged stakeholders, it is the basics of life. This does not mean a philanthropic focus on giving to education projects will maximise societal contributions: it won't. But it does mean corporate financial or



Fast movers can be winners

When stakeholder voices and protests hit government popularity, corporate influence wanes very quickly indeed

lobbying influence can often be easily focused where it can have most impact. Partnerships with NGOs and measurement of the results will always make a greater difference than simply donating cash and hoping for the best.

Lesson nine: The greener agenda is understood and often consumers are less sceptical than in the west. HSBC/Climate Group research in 2010 found that 57% of Chinese surveyed said climate change is the biggest issue they worry about. There is often a myth that stakeholders in emerging economies do not care about the environment. This is totally untrue. They are on the frontlines of pollution, water shortages and climate change. But they often have less capacity to act or influence. Don't confuse awareness and perceived powerlessness.

Lesson ten: Get ready for a bumpy road ahead. Global business = global complexity. It's clear the large companies, now developing global policies and targets, are just beginning to think about how these will play out on the worldwide stage of their operations and sourcing capabilities. One thing is very clear: there is a difficult path ahead, and only consistent research, awareness, monitoring and stakeholder engagement will assist firms to navigate to lower risk and greater opportunity in emerging countries. ■



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