CORPORATE PERFORMANCE IS CLOSELY LINKED TO A STRONG ETHICAL COMMITMENT

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BACKGROUND

In line with the international trend, Americans are holding the management of large public corporations to greater ethical accountability. The scrutiny covers a broad spectrum of stakeholders so that a company's effect on its employees, customers, vendors, franchisees, the environment and the communities in which it operates is emerging as an important benchmark of corporate performance. At the same time, corporate directors and senior managers are paying greater attention to the importance of intangible corporate assets like a highly motivated workforce, trustworthy suppliers, a loyal customer base and, most important, a reputation for fair dealing. A number of researchers have investigated whether any connection exists between the social or environmental and the financial performance of a corporation.

Study Objective: To demonstrate a link between a large corporation's performance in both financial and non-financial terms and a public commitment by its management to follow a code of ethical corporate conduct.

Populations:

1. Business Week's 500 largest public U.S. companies.
2. Fortune's 200 largest U.S. industrial, non-regulated utility and non-financial service corporations (by market capitalization) – subjects of Market Value Added (MVA) analysis which measures the excess value a company has provided to its shareholders over the total amount of their investments.
3. 100 additional companies with largest market capitalization in the industries for which MVA is calculated.
4. "Most admired" large U.S. companies per Fortune.

STUDY HIGHLIGHTS

Public Reports on Internal Control by Corporations

- Approximately three-quarters of the 500 largest public U.S. companies include management statements on internal control in the company's annual report to shareholders.
- Virtually all of these companies use the same internal control strategies:
  Segregation of functions.
- Programs of selection and training of personnel.
- Results of internal audit.
- Oversight from the audit committee of the board of directors.
- Work of the company's external auditors.
- Code of ethics – mentioned by a much smaller proportion of companies.
- Only 27% of these 500 companies make a public representation that ethics is part of their internal control system.
- 14% of the 500 have a more explicit commitment to ethical accountability.

Linkages of Ethics with Corporate Performance

- Companies publicly committing to follow an ethics code as an internal control strategy achieved significantly higher performance measured in both financial and non-financial terms using 3 published measures.

1. 300 companies surveyed for Market Value Added (MVA):

a. Average MVA of 87 companies that mention code of ethics as part of management control strategy was $8.1 billion greater, or 2.5 times greater, than those that do not mention code of ethics or conduct.
b. In the case of the 47 companies with more explicit commitment to ethics code, the MVA was 3 times larger than that of companies not mentioning ethics publicly.

2. Business Week's ranking of 500 largest companies by financial performance.

. Average ranking of companies with a public commitment to ethics was 13.8 percentiles higher than those with no ethics emphasis.

a. Average ranking of companies with more explicit ethics commitment was 14.8 percentiles higher than those with no ethics emphasis.

3. Fortune's ranking of "most admired" large companies by corporate reputation (non-financial measures).

. Average reputation score of companies with a public commitment to ethics code was 4.7% higher than those without commitment.

a. Average reputation score of companies with a more explicit ethics commitment was 6.7% higher than those without commitment.

Causes of the Favorable Ethics Effect

- Hypothesis: A strong relationship exists between companies making a public commitment to ethics and Ethics Officers Association (EOA) membership.
- NOT upheld by the study.
- Only 29.3% of largest 500 companies in sample who make a commitment to ethical accountability are members of EOA (18.8% of grand total).
- No significant difference in corporate performance of EOA members as against non-members.
- Alternative hypothesis: Cause of superior performance is that an ethical tone has been set at the top of certain organizations whose values permeate throughout all levels.
- Code of conduct is a reflection of values.
- Values-based code is more effective than legalistic code in motivating the kind of behavior that results in long-term profitability and success.

Conclusion

- Extent of a company's commitment to its ethics program does not appear to be a strong determinant of superior corporate performance.
- More plausible cause of superior performance is that an ethical tone has been set at the top of certain organizations whose values permeate throughout all levels – in such companies, code of ethics is merely a reflection of values.
- Critical factors leading to superior corporate performance:
- Nature of the values upon which the corporate culture is based.
- Strength of the top management commitment to ethical treatment of stakeholders.
- Expression of commitment to ethics through actions and not just words.