

REPUTATION, RELATIONSHIPS AND RISK

A CSR Primer for Ethics Officers

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Over the past few years, I have had many conversations with ethics and compliance professionals about what is now commonly called corporate social responsibility (CSR). Frequently these conversations have involved hacking through a dense thicket of related terms and definitions that have sprouted over the last decade. Terms like corporate responsibility, sustainability, corporate citizenship, corporate social performance, the triple bottom line and numerous others have proliferated, and are often used interchangeably, even though they can mean different things.^a Without attempting here to untangle myriad technical concepts, I argue that they all point in the same direction: throughout the industrialized world and in many developing countries there has been a sharp escalation in the social roles corporations are expected to play and in the number of stakeholder groups to whom they are expected to be accountable, in addition to shareholders.¹

After offering some observations on the essential nature of CSR, this article will give an overview of some global trends that have been driving its rise to prominence. I will argue that a number of factors are bringing the fields of CSR and business ethics closer together. Finally, I will hazard some predictions as to the effect of these changes on professionals in both fields.

I have found that ethics officers — or at least those working for American corporations — tend to react in one of three ways at the mention of CSR. A small (but apparently growing) minority exhibits what I would call interested and active engagement; they view CSR as having strategic business importance and perceive a direct or indirect connection to the work that they themselves do. At the other extreme is another minority — whom we might call the Friedman rearguard^b — that is skeptical, if not openly hostile to the concept of CSR. This attitude is exemplified by one respondent to CBE's October 2005 survey, *Managing the Responsible Corporation*,² who opined that "CSR is ideological in

^a Sandra Waddock, professor of management at Boston College and Senior Research Fellow at the Center for Corporate Citizenship, has catalogued nine categories comprising over 30 terms currently in use. (See Waddock, Sandra. "Parallel universes: companies, academics and the progress of corporate citizenship," *Business and Society Review*, Vol. 109 No. 1, 2004, pp. 5-42.)

^b Milton Friedman's much-quoted article in *The New York Times Magazine* on September 13, 1970, was based on his earlier book, *Capitalism and Freedom* (Chicago: University of Chicago Press, 1962) in which he argued "there is one and only one social responsibility of business — to use its resources to engage in activities designed to increase its profits so long as it stays within the rules of the game..." The shareholder orientation appears to have lost ground in recent years to the increasingly influential stakeholder orientation, developed in its modern form by R. Edward Freeman, Olsson Professor of Applied Ethics at the University of Virginia's Darden School.

nature” and that his/her company’s involvement in it would be tantamount to “enforcing ideology.” In the middle are the majority of ethics officers, whose attitude I would describe as informed but circumspect: they recognize that business pressures and expectations of companies appear to be changing, though they are unsure of the likely impact on their own firms; they do not feel strongly invested in the issues or their companies’ attempts to address them.

CSR: What You Do, How You Do It

It is probably fair to say that the proliferation of terminology has done as much to confuse the debate about CSR as it has to enrich the vocabulary of those participating in it. Quite possibly, therefore, suspicion or hostility towards CSR may in some cases be based on misapprehensions as to its nature and purpose. Some would say, for example, that CSR is a subversive “anti-capitalist” doctrine, citing the co-opting of some of its principles by demonstrators opposed to globalization. In reality, most thoughtful proponents of CSR stress that it is fundamentally *part* of business, not against it. So to avoid unnecessary misunderstandings, and to help those whose radar screen has recently picked up CSR, I will offer some brief definitional observations.

Business for Social Responsibility (BSR), the San Francisco-based CSR membership organization and thought-leader, defines corporate social responsibility as “achieving commercial success in ways that honor ethical values and respect people, communities, and the natural environment.” Focusing on the way that companies address the legal, ethical and other expectations that society has for business, and make decisions that fairly balance the claims of all key stakeholders, BSR says that in its simplest terms CSR is: “what you do, how you do it, and when and what you say.”¹³

Mallen Baker, development director for Business in the Community (a membership organization of over 700 of the U.K.’s top companies), believes that CSR is about how companies manage the business processes to produce an overall positive impact on society. In addition to the nature and quantity of a corporation’s impact on society in various areas (see Figure 1, right), Baker identifies a critical internal component of CSR: the quality of the company’s management, both in terms of people and processes.⁴ Financial analysts have always seen the quality of a company’s management as a predictor of future

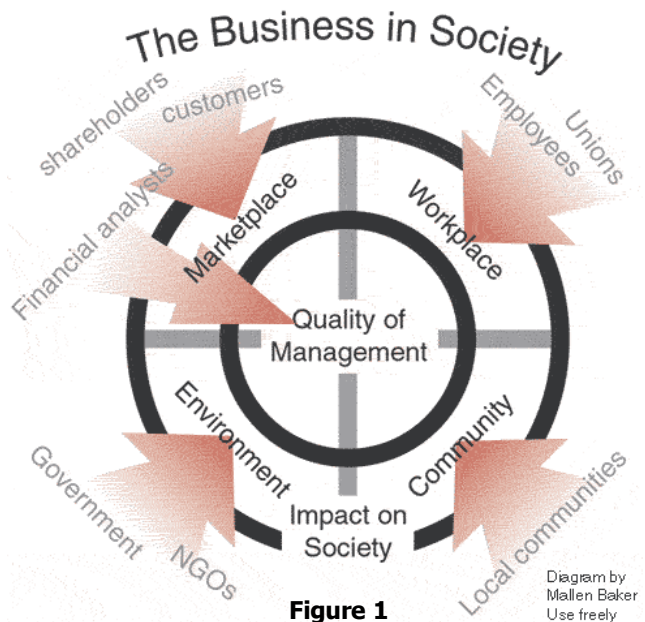


Figure 1

Diagram by Mallen Baker
Use freely

performance. Now, the manner in which management addresses (or ignores) CSR issues is increasingly entering the performance equation. It is interesting to note this new forward-looking perspective. Although outside stakeholders have been taking an increasing interest in companies' activities for some while, most (observes Baker) have been retrospective in their analyses — looking at what a company has actually done, good or bad, in terms of its products and services, its impact on the environment and on local communities, or in how it treats and develops its workforce.

CSR is more than philanthropy — or “giving back to society” as some companies put it. However, many — if not most — corporations, especially in the United States, continue to interpret CSR mainly in philanthropic terms. Not in any way to decry the value to society of corporate philanthropy, there is a now greater awareness that CSR encompasses not only what companies do with their profits, but also how they make them. The website of the Kennedy School's CSR Initiative expresses the view that CSR has now become a matter of strategic importance for company management and boards:

[CSR] goes beyond philanthropy and compliance to address the manner in which companies manage their economic, social and environmental impacts and their stakeholder relationships in all their key spheres of influence: the workplace, the marketplace, the supply chain, the community and the public policy realm. These issues need to be addressed as a matter of strategic importance at the level of the company's Board of Directors and its Chair and Chief Executive.⁵

For me, the above definitions strike at the heart of the objections to CSR raised by Friedman and those influenced by his thinking. They make clear that CSR is not simply about corporate managers disbursing shareholders' money or misguidedly involving their companies in matters that are supposedly best left to government and community organizations. Instead, we are concerned with fundamental questions about why and how corporations should exist in society and the roles they play in generating economic and social value.

Quite obviously, expectations of the role that companies should play in society differ widely around the world. It is fair to say that, as a concept, CSR has gained far more traction in Europe and some other parts of the world (notably Australia, India and parts of Latin America) than in the United States. There are myriad cultural, legal and socio-political reasons for this, which are beyond the scope of this article. It is important to note that the European model of CSR focuses more on operating the core business in a socially responsible way and on investing in communities for solid business case reasons.⁶ Mallen Baker argues that this is the model that is likely to be sustainable in the long term because it positions social responsibility as an integral part of the wealth creation process. Subject to the important caveat of proper management, this should enhance business competitiveness and maximize the value of wealth creation to society. It also means that when times get hard, there is the

incentive to practice CSR more and better. Baker observes that a philanthropic initiative which is peripheral to a company's main business will always be the first thing to go when push comes to shove.

CSR Drivers

Let me now identify some key influences that have been driving the development of CSR over the past decade.

First is the phenomenal growth of the private sector generally, and the increasing influence and reach of corporations in particular. The shift in the balance of power away from governments in favor of corporations has been an ongoing trend for many years but it is one that has undoubtedly accelerated under the influence of globalization, deregulation, privatization and technological innovation. Private enterprise has grown explosively, the United Nations estimating that the number of multinational corporations (MNCs) has increased from approximately 37,000 in 1990 to over 70,000 today; the number of their affiliates around the world grew from around 170,000 to more than 800,000 over the same period.⁷ There are millions of small and medium-sized businesses that are part of these companies' supply chains and value networks. Significantly, this growth and extended reach of companies has brought them into contact with or enabled them to affect an ever greater number of individuals, communities and natural environments. All of these have become stakeholders — parties interested in or affected by the companies' operations — whether the companies know it or like it. (Companies don't get to choose their stakeholders.) While these developments have clearly presented enormous opportunities and new rights for business, at the same time the risks have multiplied. In an increasingly connected and transparent world the potential for reputation damage is an ever-present threat for corporations.

Secondly, ethical scandals and corporate governance failures in a relatively tiny proportion of companies right across the globe (but perhaps most visibly in the United States) have shaken confidence and trust in business generally. This has caused all kinds of stakeholders — investors, analysts, customers, regulators, prosecutors, non-governmental organizations (NGOs), trading partners, the media, existing and prospective employees and others — to scrutinize corporate activity more closely. Furthermore, it has caused companies to examine their own governance structures, control systems and cultures, whether out of compliance with new legislation — like the Sarbanes-Oxley Act 2002, the stock exchanges' revised listing requirements or the amended Federal Sentencing Guidelines for Organizations 2004 in the United States — or otherwise out of a sense of self-preservation. All of these developments have placed a premium on responsible business conduct. Furthermore, there is a growing realization, even among the most compliance-oriented corporations,

that simply having the right rules in place will not ensure the desired conduct. When a company's management starts to look beyond compliance, inevitably they develop awareness of issues that bring them in touch with CSR. Whether they choose to address them is another matter.

This leads us to a third key factor: the increasing importance of intangible assets as a function of corporate value. Baruch Lev, an eminent professor of finance and accounting at New York University's Stern School of Business, has suggested that between half and two-thirds of the total market value of publicly held corporations may reflect the value of intangibles — brands, reputation and goodwill, intellectual property, knowledge bases, working methods, and so on.⁸ A 2005 study in the United Kingdom of the FTSE 100 companies found that around 60 percent of the firms' market value was not reflected in the balance sheet.⁹ Allen L. White, Vice President and Senior Fellow of the Boston-based Tellus Institute, observes that this means that investors are simply not getting the information about companies that they need to make informed decisions. White terms this the "accountability deficit," which he believes is equally — if not more — troubling for other stakeholders like consumers, employees, suppliers and activists.¹⁰ Perhaps, therefore, it is this "accountability deficit" — especially in a post-Enron world of second-guessing corporate motives and management presentations — that is pulling CSR to prominence. Many companies have become sensitive to the demand for information about the non-financial aspects of their businesses. Consider the rise of CSR reporting, for instance. In 1990, only 70 CSR reports were produced globally; by 2003 the number had increased to more than 1,500.¹¹ Today, Allen White estimates that more than 2,000 companies worldwide are publishing stand-alone citizenship, sustainability, environmental and social reports.¹²

A fourth driver of CSR's growth, linked to the others (especially the third), is the growing activism and clout of institutional investors. Large institutional shareholders such as CalPERS (California Public Employees' Retirement System) have shown themselves increasingly prepared to take stands and use proxy voting rights in connection with social and environmental concerns. In December 2005, for example, 20 leading U.S. institutional investors (collectively controlling \$800 billion in assets) urged 30 of the largest publicly held insurance companies in North America to disclose their financial exposure from climate change and steps they are taking to reduce those financial impacts. The investors cited the enormous risks that insurers face from escalating losses caused by extreme weather events and the financial risks and opportunities associated with climate change.¹³

Fifth, and closely connected to the last trend, is the increasing popularity and influence of the socially responsible investing (SRI) movement. SRI, as an evolving discipline, has been defined in different ways though a durable definition is one advanced in 1983 by Peter Kinder, President of KLD Research & Analytics, Inc:

*"Socially responsible investing' is the incorporation of the investor's social or ethical criteria in the investment decision-making process."*¹⁴

Definitions aside, the rise of SRI cannot be ignored. A survey conducted in late 2004 by Mercer Investment Consulting of 195 investment managers worldwide found that they believed "the adoption of SRI practices and strategies will become commonplace". Specifically, it is interesting to note that:

- ⊕ Almost 80% predicted that active ownership will be a mainstream practice within 5 years (89% in 10 years);
- ⊕ Almost 40% thought that positive or negative screening will be mainstream within 5 years (65% in 10 years); and
- ⊕ 37% predict that the incorporation of social and/or environmental corporate performance indicators will become mainstream within 5 years (73% in 10 years).¹⁵

If not actively helping to drive CSR, SRI is certainly symptomatic of CSR's rising importance.

Clearly, CSR is developing in a complex global environment in which many other factors are at work. Jane Nelson, Senior Fellow and Director of the Kennedy School's CSR Initiative, identifies several additional CSR drivers. She points to the huge growth in the number, influence and sophistication of NGOs, campaigning groups and activist organizations (this growth, she estimates, is at the rate of around 100 new organizations a day, just in the United States). Nelson notes that these groups have unprecedented communications capacity and connectivity and an ability to profile corporate malpractices and bring them to public attention. Furthermore, she notes that there is growing pressure from different stakeholder groups for corporations to fill governance gaps that have arisen, especially in the developing world, where the public sector frequently lacks the capacity and finance to deal with complex social and environmental issues. Finally, Nelson notes the emergence of what Kofi Annan has called "problems without passports," such as global climate change and HIV/AIDS (to these we can now add avian influenza); no single sector or even nation can deal with these issues alone.¹⁶

The 3 R's

One might summarize these developments in terms of three critical pressure points on corporations, which are inextricably connected: "the 3 R's" of Risk, Relationships and Reputation. The risk elements in global business, especially in the context set out above, should not require much elaboration here. Suffice it to say that the increasingly interconnected and transnational nature of business activity presents as many new risks as opportunities for corporations. These risks can almost always be analyzed in terms of how relationships are managed, whether with internal or external stakeholders

(including the natural environment) or with society at large. It has become clear that the degree of sensitivity, skill and foresight with which companies manage those relationships — quite apart from their business processes — will have a direct bearing on corporate reputation. And depending on whether positive or negative outcomes are achieved, companies can find themselves on an upward or downward spiral.

CSR and Business Ethics

I will now briefly explore the connections between CSR and business ethics and explain my belief that the two fields are increasingly converging. Conceptually, there are some strong connections that are rooted in ethical principles concerned with respect for individuals, communities and the natural environment, the duty to do no harm and responsibility for the consequences of actions. I cannot see how a company could claim to be socially responsible if any aspects of its operations are conducted unethically. Conversely, I concede that a company could take great pains to ensure ethical business conduct without really having embraced CSR in the broader, strategic sense we have examined above.

Some commentators identify the common foundations of CSR and business ethics while acknowledging that they may have different areas of practical focus and application. For example, Mollie Painter-Morland, Director of the Center for Business & Professional Ethics at the University of Pretoria, South Africa, observes as follows:

*"CSR and ethics management are underpinned by the same principles, i.e. accountability, transparency, honesty, sustainability, etc. ... Whereas ethics management focuses on managing individual behavior and organizational structures that influence those behaviors within the organization, CSR engages society and a broader group of stakeholders based on exactly the same principles."*¹⁷

It is strongly arguable that the supposed distinction between business ethics and CSR are completely artificial. As I have suggested already, ethics is a crucial element of CSR (not a separate entity) and when practiced with sincerity, commitment and vision, CSR is profoundly ethical in nature.

Even when companies engage in both business ethics and CSR initiatives, sometimes the organizational structure or functional implementation can reinforce the idea of a distinction, which can effectively hamper progress in both areas. The business process reengineering literature is replete with calls to do away with functional silos; business ethics and CSR are no less prone to this kind of isolation and lack of integration than other corporate disciplines. The *Managing the Responsible Corporation* survey, referred to above, asked about the degree of interaction between senior managers of ethics and CSR programs in companies that had both. Fifty-three percent of respondents

to the relevant question had little or no interaction or collaboration with their counterparts. Only 13 percent were accustomed to “continuous interaction and ongoing collaboration.” This is also reflected in the anecdotal evidence I have that few ethics officers attend CSR conferences and few CSR professionals are to be found at ethics and compliance conferences.

Signs of Convergence

Even though CSR and business ethics have largely developed in parallel, there are signs that the fields may evolve in much more connected ways in the future. The reasons for thinking this are based on some specific aspects of the trends identified above.

First, as a result of globalization and the evolution of supply chains into value chains, and now value constellations or networks, the boundaries between organizations that are collaborating strategically have become more blurred than ever before. In this kind of global business environment, the traditional inward/outward distinction of business ethics and CSR becomes increasingly redundant. Issues previously thought to fall into one camp or another now are harder to categorize. This is being reflected in terminology that companies now use, such as “ethical sourcing.” So, for example, when a company requires independently-owned suppliers in Guatemala or Cambodia to abide by its code of conduct — on matters such as child labor, factory conditions or workers’ rights, etc. — as a condition of doing business, is it engaged in business ethics or CSR or both, or doesn’t it matter? It usually doesn’t matter to the NGOs, the media or countless others who are constantly on the look-out for abuses. It probably doesn’t matter greatly to the shareholders whose portfolio value would crash in the face of such abuses coming to light. As I have said, no matter how a company chooses to structure its operations and oversight mechanisms, ultimately everything comes down to reputation, relationships and risk.

Secondly, the importance of intangibles as a function of stock value does not show any sign of diminishing. With investors and other stakeholders looking for more and better information about the non-financial aspects of companies’ businesses, we are likely to see more and more companies producing CSR reports. The most widely used reporting framework, the Global Reporting Initiative, contains a number of indicators that pertain to business ethics (e.g. especially among the Social Performance Indicators, S02-07, dealing with matters such as bribery and corruption, political lobbying and funding, competition and pricing.) It will be interesting to see whether these are developed further with the introduction of the revised guidelines in October 2006.

Thirdly, as multinational corporations look to overcome obstacles to doing business in major emerging economies like India and China, the issues of bribery and corruption will become ever more prominent.

Any approach at tackling what are complicated and entrenched socio-economic issues will necessarily have dimensions of business ethics and CSR. This nexus will probably strengthen as time goes by.

So, are there signs that companies are integrating CSR and business ethics? At this stage, few firms appear to be doing so effectively. The evidence suggests that they are still seen as separate disciplines within organizations. I suspect the reasons have to do with the history of their respective evolution and perhaps, to some extent, with managers and departments protecting turf.

Let me be clear about what I mean by integrating CSR and business ethics in corporations. I am not necessarily contemplating that companies would integrate the disciplines at the functional level, with the same person or team taking care of both (although that may be the practical reality in smaller companies). What I have in mind are integrated strategies, developed with the full involvement and support of the board of directors and senior management and implemented by managers with the requisite authority. I envisage processes of strategic planning and implementation that are values-driven, collaborative, cross-functional and indicative of the company's sense of responsibility to its many stakeholders.

What advantages might a more integrated approach offer companies? First, by more fully acknowledging the close conceptual ties mentioned above, companies can achieve a more complete understanding of principles and issues in their ethical and societal contexts. Secondly, when the board and management take a coordinated approach to ethics and CSR, they establish organizational relevance and signal their commitment more effectively. Thirdly, a holistic view of CSR and ethics can inform more coherent and effective strategies, thereby allowing a coordinated focus on risks and opportunities. Fourthly, it will most likely avoid duplication of effort and resource allocation. Fifthly, an integrated approach is consistent with the increasing attention to values, culture and stakeholder engagement. Finally, and perhaps most importantly, a cross-functional approach to ethics and CSR engages and mobilizes the entire organization, not just specialist groups.

The Future

However, for integration to even become an issue for companies, at least two major developments need to occur on a widespread basis. First, a much greater proportion of companies will need to get beyond a compliance mindset in their efforts to ensure ethical or socially responsible business practices. Over and above stressing to employees the importance of complying with the law and codes of conduct, many will need to recalibrate their focus to include building corporate cultures in which legal compliance, ethical conduct and social responsibility are business outcomes rather than ends in themselves. Secondly, and largely dependent on the first, CSR must be perceived as an essential part of generating economic value rather than a philanthropic sideshow.

If one is prepared to accept that integrating ethics and CSR initiatives has merit, what might the practical manifestation of this look like? I suggest a few features below:

- ⊕ The Board's engagement is demonstrated by dealing with ethics and CSR in a specialist committee — either a single committee or in two which have some common membership.
- ⊕ The persons or persons with overall responsibility for ethics and CSR report regularly to the Board.
- ⊕ The above person(s) have appropriate and similar seniority (and ideally will be part of the senior management team).
- ⊕ As I have said, it is not necessary (and in large companies unlikely) that the same person or team will be responsible for both areas. If there is a split, there should be ongoing contact and collaboration in the design and implementation of strategy, policy and processes.
- ⊕ The company's internal and external communications explicitly make the connection between ethics and CSR.
- ⊕ Reporting on CSR issues and activities will include reference to what is done to ensure ethical business practices.

Even though CSR and business ethics may show signs of greater convergence, widespread integration of the disciplines within organizations is still a long way off, and in some organizations it might never happen. Board involvement is certainly critical, but unlike audit committee oversight of ethics and compliance programs (where the U.S. Federal Sentencing Guidelines have provided a handy checklist for committee members), the expectations are not nearly so clear-cut in the CSR field. Peter Drucker, the management guru, said that you can't manage what you can't measure; some cynics might go further and say that what can't be measured doesn't exist. The corollary to that rule is if you cannot provide a one-size-fits-all approach to defining CSR, Boards will focus on ethics at the expense of CSR.

That said, more and more companies are looking for ways to apply metrics that will facilitate the management of ethics and CSR issues. Although it may be problematic to apply metrics to attitudes, it is certainly possible to evaluate and reward management and employees on behaviors and outcomes. For example, it would be feasible to establish an incentive system in which a portion of managers' variable compensation, "promotability", etc. turn on their ethical and social performance, as evaluated according to criteria which can in fact be measured. If you reward the supply chain head for squeezing costs out of suppliers, you will end up with mischievous results. If you balance her

year-end review by assessing the way she achieved efficiencies ethically and responsibly, then you are onto a far more powerful approach.^c

In conclusion, companies all over the world are experiencing dramatic changes in their business environments and these have much to do with *how* they do business as much as what they make or do. This is causing them to reassess traditional approaches to ethics and CSR. Furthermore, a number of global trends are provoking important questions about the very nature of the corporation's dominant role in society and its long-term future. Leading companies are alive to these developments; and they recognize that their ability to fulfill that role in ways that create sustainable economic and social value have much to do with the management of the 3 R's (reputation, relationships and risk), matters in which ethics officers have much to contribute. And, to be sure, in this environment, coherent and effective strategies for ensuring ethically and socially responsible business practices are nothing less than matters of survival.

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