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Incorporating ethics into strategy: developing sustainable business models

Ethics are pivotal in determining the success or failure of an organisation. They affect a company's reputation and help to define a business model that will thrive even in adversity. This paper sets out how finance professionals can shape their organisations' ethical agendas and incorporate ethics into strategy to ensure long-term sustainability.

Discussion paper February 2010

About CIMA

CIMA, the Chartered Institute of Management Accountants, founded in 1919, is the world's leading and largest professional body of management accountants, with 172,000 members and students operating in 165 countries, working at the heart of business. CIMA members and students work in industry, commerce and not for profit organisations. CIMA works closely with employers and sponsors leading edge research, constantly updating its qualification, professional experience requirements and continuing professional development to ensure it remains the employers' choice when recruiting financially trained business leaders.

CIMA is committed to upholding the highest ethical and professional standards of members and students, and to maintaining public confidence in management accountancy. Details of CIMA's activities on standards and ethics can be found at **www.cimaglobal.com/ethics**

High ethical and professional standards are an integral part of the CIMA qualification.

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Conclusions

1. Strong ethical policies that go beyond upholding the law can add great value to a brand, whereas a failure to do the right thing can cause social, economic and environmental damage, undermining a company's long-term reputation and prospects in the process.

2. Once they have adopted an ethical approach, companies will often find there are bottom line benefits from demonstrating high ethical standards.

3. The ethical tone comes from the top.

4. High quality management information on social, environmental and ethical performance is vital for monitoring the environmental and social impacts of a company and for compiling connected reports showing how effective its governance arrangements are.

5. Management accountants have a particular ethical responsibility to promote an ethics based culture that doesn't permit practices such as bribery.

Recommendations

1. Ethics must be embedded in business models, organisational strategy and decision making processes.

2. Senior managers and business leaders must demonstrate an ethical approach by example. This will show that middle and junior managers will be rewarded for taking an ethical stance.

3. Non-executive directors should act as custodians of sustainability, with the particular duty of ensuring that their executive colleagues are building a sustainable business.

4. Managers must come to problems with `prepared minds', looking at ways in which an organisation can benefit from an ethical approach rather than one that relies narrowly on cost cutting or compliance.

5. Finance professionals must play an active role as ethical champions by challenging the assumptions upon which business decisions are made. But they must do so while upholding their valued reputation for impartiality and independence.

6. Management accountants are encouraged to help ensure that their businesses are measuring performance on an appropriate timescale that will deliver sustained and sustainable success.

7. Business leaders should use the skills of the finance team to evaluate and quantify reputational and other ethical risks.

8. Finance professionals need to take social, environmental and ethical factors into account when allocating capital, so that sustainable innovation is encouraged.

In 2009 CIMA staged a series of high level round table discussions on the future of business ethics. Senior business decision makers met experts in ethics, corporate responsibility and environmental sustainability. Together they discussed how organisations should approach social, environmental, economic and ethical issues that go beyond the financial bottom line. Over three sessions the group explored how companies can respond to society's changing ethical demands and why Chartered Management Accountants are uniquely placed to add value. This paper distils the group's findings and sets out its recommendations for action.

When we talk about sustainability, we talk about "are we going to be around?" this is really about your reputation and whether people trust you.

Businesses can be tempted to make short-term gains by turning a blind eye to ethics. Despite codes of practice, regulatory oversight and ever increasing public pressure, many firms routinely ignore ethical considerations. Some even claim that a business simply needs to abide by the law without concerning itself with broader ethical issues. Yet such disregard can undermine the wider economy and, in time, cause irreparable damage. Lessons must be learned from the corporate collapses of the past decade: myopic strategies can create massively profitable entities, yet impressive initial results may turn out to be unsustainable.

There is a strong business case for running companies in an ethically responsible way and for finance professionals to facilitate this. A socially and environmentally ethical approach ensures a company's ability to thrive in the long-term by protecting its reputation, its licence to operate, its supply chain, its relationships with partners and its ability to recruit talent. It's about avoiding corporate collapse as a result of litigation or fraud.

Society should not let unethical companies make the returns that they have been allowed to.

Of the 28 companies that fell out of the world leading S&P 500 index in the past ten years, comparatively few casualties were claimed by shifts in technologies and markets. More were victims of massive fraud (as with Enron and WorldCom) or had leaders who'd failed to create a sustainable business model. This was evident most graphically in the financial services industry, with the likes of Lehman Brothers, Bear Stearns and Wachovia choosing huge short-term gains at the cost of their long-term survival. Similarly, UK electronics company Marconi was brought down by its unsustainable plan for its business.

While some firms consistently fail to consider ethical factors, others have given themselves a competitive edge by establishing strong credentials in this area. For instance, in the nineties Toyota boosted its global standing with pioneering work on the hybrid Prius model. Coca-Cola thought it commercially worthwhile to take a minority stake in the UK fruit drinks firm Innocent, which boasts that it gives away a tenth of all its profits. And McDonald's is investing heavily in activities aimed at associating it with ethical and environmental awareness as it rebuilds its brand and attempts to overcome decades of negative publicity.

The round table discussions highlighted that the link between ethics and business success has become far clearer in recent years, as companies realise that corporate interests must be aligned with the broader concerns of society if they are to survive. In a successful company, ethics are embedded in decision making and long-term strategy. `Doing the right thing' is not an afterthought that's bolted on to the mainstream activities that generate its profits. Successful, sustainable firms aspire to integrate ethics into all aspects of strategy.

Society and the bottom line are the two issues that will put pressure on companies to be ethical.

The financial crisis has certainly highlighted the need for capital market decision making to reflect long-term considerations. It has shown the extent to which corporate reporting fails to highlight systemic risks. A shift to a reporting model that supports the information needs of long-term investors and reflects the connected nature of environmental, governance and societal factors is an essential step towards building a sustainable economy.

The Prince's Accounting for Sustainability initiative has set out the need for 'new approaches to accounting and reporting to reflect the broader and longer-term consequences of decisions taken. Without more complete and comprehensive information, companies, investors and others cannot make the fully informed decisions needed to survive and prosper.'

For companies it is often about much more than reputation issues: it's real cost burdens that they incur for being corrupt.

Work has already begun to tackle these issues. Accounting for Sustainability believes that the establishment of a connected and integrated reporting framework, overseen by an International Connected Reporting Committee, is essential to help the transition to a sustainable economy (see Panel 2).

Ethical businesses are not a new phenomenon, of course. During the industrial revolution many companies in the US and Europe thrived on a strong philanthropic tradition. What is new is the way in which ethics now needs to be seen as a core part of companies' strategies and how it is being embedded into management culture at all levels. There are numerous explanations for this new prominence. One suggestion from the round table discussion was that, thanks to modern communications technology and an increase in living standards, the circle of concern has grown among the public. Young people in particular seem to be much more aware of the social and environmental effects that businesses can have around the world – and more critical of those that they see as part of the problem.

The global growth in population and per capita consumption as a result of industrialisation is another factor. Once abundant resources are growing scarcer and can no longer be considered a free gift from nature. And, in the jargon of economics, the `externalities' – i.e. the negative effects of economic activity – are increasing steeply. Indeed, they may actually outweigh the economic benefits of the goods rolling off the production line, which is something not captured by traditional reports and accounts.

We need to get beyond putting the environment as the thing you do after you have made your profit. Instead we need to do the profitable thing now and do it as responsibly as possible.

A more managerial factor is the increasing value placed on corporate reputations. A multinational supplier of consumer goods, for example, can replace a burnt out factory more easily than it can restore a tarnished brand. In the 1970s Ford calculated that the cost of recalling all its Pinto cars, which were prone to fuel tank fires, would probably exceed that of handling all the accident victims' claims for damages, so it initially decided not to recall the model. For the most part, corporate culture rejects such an approach today. Dealing swiftly and openly with problems can serve to establish a firm's credibility as trustworthy brands. Toyota management has discovered this year that it is judged as much on its handling of the recall of millions of vehicles with suspected defects as on the specific engineering problems.

The shift is not complete by any means, though. Companies that don't deal directly with consumers can still be tempted to risk a good reputation for quick profits. But even firms that aren't directly consumer-facing must consider the effects of negative reporting about their activities or of falling foul of legislation. And the steady growth in the use of ethical criteria by institutional investors means that lapses in corporate social responsibility can dent a plc's share price or a private firm's prospects of finding investment.

> *There is an overlap between the moral imperative on one hand and the business case on the other, but it is not a complete overlap.*

With ethics now centre-stage globally, there's a chance to create a win-win situation in which companies can find out how a sustainable approach benefits the bottom line, thereby convincing even the most profit hungry of investors. This is what UK retailer Marks & Spencer did with its `Plan A' environmental marketing initiative, what the UK's Co-operative Group has consistently done and what BP attempted with its `Beyond Petroleum' rebranding campaign.

Encouraging businesses to listen to public opinion is a step in the right direction. But inevitably there have been accusations that their stated commitment to corporate social responsibility may be opportunist or only skin deep. Accusations of `greenwash' abound, with environmentalists arguing that firms have seen the new interest in ecological issues as simply another chance to market products as `environmentally friendly' to gullible consumers.

> *Environmental issues are economic issues. They are also social justice issues – the people most exposed to all of these issues are poor and in the developing world.*

One problem for businesses is that, although some ethical issues are straightforward, many are highly debatable. Are nuclear power stations bad and wind turbines good, for example? Should an armaments business quit markets where bribery is rife or simply behave better than its rivals? And terms such as `predatory lending', `excessive risk taking' and `greed' are all notoriously hard to define.

Another problem, which was highlighted by the financial crisis in the West, is that shareholders cannot be relied upon to defend their own interests. The fashionable drive to maximise shareholder value has seen investors and business leaders combine in a quest for short-term advantage. Far from being champions for sustainable business, the equity markets have imposed huge pressures on senior managers for quick returns. Today it could be seen that one of the duties of a tough CEO is to resist such pressure by delivering more realistic financial results in the short-term, if need be. This hardly squares with current remuneration practices, of course – especially in investment banking.

> *Most of these [unethical actions] are motivated by greed and by compensation structures that almost force them.*

Panel 1. Questions boards must ask themselves

1. Do we understand our model for delivering projects and all the risks we are taking? What are the circumstances under which we would fail? Are we happy with the risk mitigation?
2. Do we spend enough time discussing strategic issues? Do we have a workable process for overseeing strategy? Do we get the right information?
3. Do we focus on long-term sustainability?
4. Do we have a healthy, ethical and thoughtful culture that encourages constructive challenge?
5. Do we have effective collaboration between the board and the management team, with the latter guaranteeing the most relevant management information on which to base decisions?

As the Enron scandal dramatically illustrated, there is a strong correlation between short-termism and the cutting of ethical corners. By its nature, a long-term approach is more concerned with various aspects of sustainability. Many companies take the long view. But it is often huge multinationals, such as HSBC and Nestlé, that can see they have a greater stake in the future. Larger companies arguably have more resources available to undertake scenario planning for decades ahead and are more likely to feel that factors such as food security, water scarcity or climate change will have a material effect on their commercial prospects.

Leadership is the key factor that establishes whether a company is long-sighted and able to integrate ethics successfully into strategy – the tone comes from the top. Only effective and dynamic leadership can set a corporate culture that goes beyond merely averting the reputational damage risked by unethical behaviour. It can also transform the dangers posed by ethical challenges into commercial opportunities, thereby ensuring that the organisation is fit for the future.

Leaders who fail to understand the changing context in which they operate are not providing a sustainable foundation for their companies. They will permit outmoded business models to be pursued, even when the assumptions that these were based on have altered. Specifically, leaders need to recognise the threats and opportunities posed by factors such as climate change, the declining reserves of fossil fuels and the corrosive economic impact of endemic bribery in certain sectors and regions.

A failure to understand these factors has already become evident in some industries – it's arguably a major reason behind the crisis that engulfed US car makers last year. Competitors such as Honda anticipated the increase in petrol prices and benefited from this. Similar scarcity trends are predicted in water, land and food. If companies are to survive these changes to the balance of supply and demand, their leaders must both understand the threats and see the opportunities.

> *Reputational risk has become a big area in the past few years that no one has quantified.*

Dynamic leaders who can see the problems and prospects ahead must use this knowledge to set the right tone across their organisations. This tone from the top is vital in all aspects of governance. In ethics, the CEO's personal perspective is crucial. Once the leader `gets the ethics bug', the whole organisation is more likely to follow suit.

Values and culture can change – and that will be down to the leader and the board.

But leaders must go much further than being merely aspirational. Policy statements need to backed by action that is clear, effective and brings about changes in direction. These changes demonstrate to middle managers that their leaders mean what they say. If they realise that there is a genuine corporate commitment to a particular course of action, they are more likely to support it in practice.

Middle managers need to be given explicit and implicit authority to speak up where they believe that the welfare of the organisation and its employees is being threatened. They must be converts and evangelists for the corporate mission – including the ethical dimension. The leader who understands the value of ethical principles and practices will effect real change only if their zeal can be converted into a strong culture that infects the whole organisation.

Finance professionals are not the champions of the long-term view, but their role is to facilitate the assessment of that view.

So what are the special responsibilities of accountants in making business more ethical? Countering bribery is an obvious starting place. CIMA members are bound by strict standards in the CIMA code of ethics. Because of this, they are valued by organisations as a bulwark against morally questionable practices. They can be instrumental in countering the development of a culture that normalises the payment of bribes.

Management accountants have a further important responsibility: the delivery of accurate management information is vital to understanding a firm's overall sustainability, gauging its environmental impact and showing how effective its governance systems are, for example. They have a key role in compiling the so-called `connected reports' that Accounting for Sustainability is advocating with increasing force.

Some accountants may feel that being a cheerleader for a cause such as sustainability clashes with the dispassionate role of the traditional finance function. Undeniably, people with professional accountancy qualifications are valued because of their ability to stand above the fray and perform impartial analyses. But, as this paper has argued, it's wrong to believe that ethical principles conflict with the long-term viability of a business.

The accounting profession is the ethical spine of organisations.

Panel 2. The Prince's Accounting for Sustainability connected reporting project

Management information is the linchpin for developing better corporate reporting. Conventional reports and accounts can focus excessively on a company's short-term financial performance. They pass over broader factors such as the sustainability of the business model or the company's social and environmental impact. In particular, the environmental, social and economic impacts that occur through the depletion of 'nature's capital'– by the consumption of fossil fuels or the emission of greenhouse gases, for example – typically get ignored. Where companies do disclose such information, it is seldom presented in a way that is connected with the strategic direction and financial performance of the company, clarifies the risks and opportunities or permits year-on-year comparisons.

The Prince's Accounting for Sustainability Project (A4S), in which CIMA has played an active role, seeks to redress the balance by highlighting the need for a far-reaching connected and integrated reporting model. Such a model would present a more complete picture of an organisation's performance and the factors that will influence its long-term success, aligning and linking financial and non-financial, and quantitative and qualitative information.

Chartered Management Accountants are well placed to collate and present this vital data, much of which will be the top slice of routine management information. And their ethical code means that they must present it objectively, whatever the pressures from elsewhere in the organisation to distort unpalatable facts.

A4S is now working with a number of other organisations to develop in more detail recommendations for an International Connected Reporting Committee that would be responsible for over-seeing the development of a connected and integrated reporting model. It is envisaged that such a model would:

- be centred around the strategic and market context within which the business is operating and how this may change over time
- provide clarity on how the business is led and governed and how employees are incentivised and remunerated to deliver sustainable business outcomes
- provide transparency around the dynamics of the business model and the associated risks and opportunities that emerge, including environmental factors, such as climate change and resource usage, and social factors such as employee safety, ethics and human rights
- describe the connection between the delivery of the organisation's strategic objectives and its financial and sustainability performance.

Case studies

Case study 1: Westpac comes out with credit

The trading practices of Australian bank Westpac, which had been strongly criticised by environmental activists, attracted even more criticism when the company began a programme of branch closures and hiked customer charges. Traditional PR campaigns were ineffective in countering this, so the executive and board refocused their strategy to try engaging with Westpac's stakeholders. This included social reporting and a commitment to sustainability.

Employees quickly became engaged in the initiative and were enthused by it. The success of the strategy was aided by the commitment of the chairman, CEO and other key senior figures. Westpac became the first Australian bank to produce annual reports conforming to the Global Reporting Initiative framework and complying with AccountAbility's AA1000 standards. As a result, the bank gained global recognition as a leader in social reporting.

Corporate responsibility has become so ingrained at the bank that it has ceased to be regarded as a cost, but rather as part of how the business generates value. The company wants to integrate its sustainable reporting with its financial reporting.

Case study 2: De Beers digs deep

The diamond trade is perceived as one of the most ethically dubious of all industries. Its production of gems in war ravaged regions of Africa led to the coining of the term 'conflict diamonds'. Part of the profit from the production of diamonds flowed to parties engaged in warfare, population dispersals, mass rape, civilian slaughter and the forced recruitment of child soldiers. As a leading operator in the diamond trade, De Beers made a policy decision to declare itself strongly opposed to these practices and obtained certification as innocent of any involvement in malpractice in its current operations.

The company became a leading participant in the Kimberley process, which claims to ensure that more than 99% of the global production of rough diamonds is certified to be from conflict-free sources. The company also commits with third party verification that it operates to the highest standards of integrity: `Accepting or giving bribes in all forms is prohibited in business transactions undertaken by the family of companies or through third parties. This includes subsidiaries, joint ventures or agents.' It is also a founding signatory to the Partnering Against Corruption Initiative of the World Economic Forum.

Case study 3: How the Co-operative Bank found ethics

In 1992 the Co-operative Bank in the UK decided to review its marketing strategy and started by asking its customers why they banked with it. Most customers replied that they did so because it was an ethical bank. This shocked the Co-operative Bank, as it had no formal ethical policy and did not regard itself as particularly ethical. It had gained the reputation because it was one of the few UK high street banks that had no direct relationship with apartheid South Africa. But the bank decided that, if its customers banked with it because they liked this approach, it made sense for it to adopt a formal ethical policy.

The bank's commercial lending has increased from £571m in 1992 to £4.4bn in 2008: an annualised growth rate of 14%. This is despite rejecting £1bn worth of business as breaching the bank's ethical principles – for example, because of a firm's involvement in fossil fuel extraction, the arms trade, animal testing, engagement in financial practices regarded as unsound, or connection with oppressive governments. In one consultation exercise on its ethical policy, 80,000 customers responded. The bank also experienced continued growth during the global banking crisis – in contrast with most of its competitors.

Organisations represented in the responsible business round table discussions included:

Aveva plc, Forum For The Future, Global Witness, the Institute of Business Ethics, the International Business Leaders' Forum, Man Group plc and Warner Bros.

Neither these organisations nor the individuals representing them are responsible for the contents of this paper.

Other relevant CIMA publications

- *Enterprise governance: restoring board room leadership*, 2010
- *Westpac's Squashed Tomato strategy: sustainability strategy in practice* (with the University of New South Wales), 2010
- *Business trust: a critical time*, 2009
- *Climate change survey* (with the Prince's Accounting for Sustainability project), 2009
- *Managing responsible business* (with the Institute of Business Ethics), 2008
- *Accounting for climate change*, 2008
- *Enterprise governance: getting the balance right*, 2004

All are available from **www.cimaglobal.com**

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