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# Sustainability Matters

## Why and How Corporate Boards Should Become Involved

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# Sustainability Matters

## Why and How Corporate Boards Should Become Involved

RESEARCH REPORT R-1481-11-RR

by Matteo Tonello, LL.M., S.J.D. (Editor)

# Introduction

In response to legislative changes and increased public scrutiny on the activities of corporations, governance and sustainability issues have taken root in the business community. Today, leaders of public companies are becoming increasingly aware that their access to capital and ability to implement a long-term business strategy depend on support from multiple stakeholders. However, when it comes to social and environmental matters, the board of directors often faces a knowledge gap that can impair the performance of its oversight responsibilities.

Corporate sustainability can be broadly defined as the pursuit of a business growth strategy by allocating financial or in-kind resources of the corporation to a social or environmental initiative. Several factors have been contributing to elevating corporate sustainability to the attention of the senior leadership in the corporation:

- Awareness has increased among leaders that durable business models cannot be solely based on the maximization of financial performance, and that shareholder value is feeble if the company fails to recognize a broader nexus of stakeholder interests—including those of employees, customers and suppliers, regulators, and the local communities where the company operates.
- Legal doctrine has emerged that underscores the protection granted under state laws to corporate fiduciaries making the informed decision to choose a long-term sustainability program aligned with the business strategy over a short-term investment opportunity.
- The general public has become more sensitive to environmental and social issues in response to new scientific research documenting the effects of globalization on the health of the planet and new technologies enabling the rapid dissemination of information on human rights violations or other social injustices.

Today, more than ever, corporate sustainability has risen to the status of strategic business matter and demands supervision from the top. However, despite the extensive body of literature available on corporate governance and sustainability as separate areas of research, minimal attention has been paid to the interaction between the two. In particular, there is limited knowledge of the role that should be performed by the board of directors in designing, endorsing, and overseeing the implementation of a corporate sustainability program.

This publication responds to the need expressed by many members of The Conference Board (both corporate directors and senior managers with board-related duties, including general counsel, corporate secretaries, and investor relation officers) for additional guidance on how to approach the task of overseeing a sustainability strategy. The report highlights a series of issues for a pragmatic boardroom discussion on the subject.

Editor's Note: *Sustainability Matters* adapts and updates a series of Director Notes and an Executive Action that The Conference Board published on this theme in the last two years. Director Notes is a series of online publications in which The Conference Board engages experts from several disciplines of business leadership in an open dialogue about topical issues of concern to member companies. To subscribe to Director Notes and access its archive, visit www.conference-board.org/directornotes

**The business case for sustainability** There is empirical evidence of the payoff of corporate sustainability programs to companies as well as their stockholders. In fact, when it comes to sustainability, one business case just won't do: the potential bottom-line benefits may be well diversified and include cost and risk reductions, gains in competitive advantage, enhanced reputational capital, and cross-organizational synergies. Business leaders should be aware of these potential benefits and discuss which, based on the circumstances facing the company, are within reach.

**The legal case for sustainability** For too long, the business community, especially in the United States, has narrowly interpreted the corporate fiduciary imperative of growing shareholder value. Today, corporate boards should no longer be hampered by the misconception that the legal system does not protect socially outward-looking business decisions. In fact, a review of state laws of corporate governance and constituency statutes confirms that the opposite is true, and exculpatory clauses included in the charters of many companies offer additional protection. Moreover, shareholders themselves are increasingly worried about the risk of ignoring pressing sustainability issues, and environmental and social proxy resolutions are on the rise.

**Emerging sustainability practices** Despite formal assignment of responsibilities to top corporate leaders, many U.S. companies still lack a framework to enable proper director oversight of sustainability programs. In particular, what appears to be missing is access to independent sources of information and detailed procedures for effectively integrating sustainability objectives into daily business activities. Many organizations do not employ any of the current, widely endorsed standards that address many areas of social and environmental concern nor do they assess the impact of their sustainability activities on the company's financial performance. A recent survey of corporate secretaries conducted by The Conference Board sheds light on emerging board practices in this field. (See "Emerging Sustainability Practices" on page 36.)

**Sustainability and customer value** Any social or environmental investment decision should begin with a stakeholder value analysis that will serve as a basic tool to design a coherent sustainability program tied to the business strategy. This is particularly true for customer value, since it is one of the most multi-faceted types of stakeholder value. Consumers may find a product or service appealing for disparate reasons, ranging from efficiency or excellence of the product itself to the personal joy or aesthetic appreciation experienced from using it. To be effective, a sustainability program should generate additional value for the consumer, such as the social esteem or spiritual reward from choosing an ethical and sustainable product over its conventional counterpart. The corporate board should participate in this critical strategic discussion.

## Defining Sustainability

As documented in "The Business Case for Sustainability," (p. 21), there is a persuasive school of thought on the need for the business community to abandon the "corporate social responsibility" (CSR) term to illustrate the phenomena described in these pages—that is because CSR inadequately emphasizes the notion of responsibility instead of the strategic, long-term growth rationale that should motivate a sustainable corporate program. In recent years, The Conference Board has endorsed this perspective and chose "sustainability" over "CSR" to name several of its initiatives—including a center dedicated to engaging member companies committed to sustainable growth, an annual conference, and a periodic "Sustainability in the Boardroom" survey of corporate boards (see "Emerging Sustainability Practices," on p. 36). However, for the purpose of this report, the terms "sustainability" and CSR are used interchangeably as all-inclusive descriptors of any business initiative that the corporation pursues based on considerations involving the interest of a critical stakeholder. This choice is practical and responds to two observations on the current state of the debate in the United States:

- Many U.S. public companies continue to prefer the term "CSR," and use it in annual reports on these matters. This observation is particularly true among large companies across different industries—including Campbell's, Hershey, Microsoft, and JPMorgan.
- Many academics and experts, including some of those who contributed to this report, continue to prefer the term "CSR" and observe that while "sustainability" may be adequate to capture the debate on short-term versus long-term business investment, it fails to give sufficient attention to the social connotations of these endeavors.

**Sustainability performance assessment** As business organizations invest in corporate sustainability programs, it becomes critical to accurately examine the effects of these endeavors. In particular, business leaders should be able to rely on a coherent set of metrics to assess and prioritize the goals of different stakeholders and to regularly evaluate the progress made by the company toward such goals. Ideally, once a tested and well-proven set of sustainability performance metrics is available, board members should weave it into top executive compensation policy.

**Sustainability communication** Since creating stakeholder awareness is a key prerequisite for reaping the strategic benefits of any business initiative, corporate leaders instituting a sustainability program should have a deep understanding of the key issues related to its communication, inside and outside the corporation. In particular, board members overseeing the initiative should feel comfortable that the message is coherent with the business mission and objectives and that delivery channels for messages about the initiative are not only effective but also independent and perceived as such. Communication is what ties corporate sustainability to the business strategy: a communication misstep may compromise the initiative and have disastrous effects on corporate reputation as a whole.

**Sustainability and philanthropy** Sustainability is much more than philanthropy, but a coherent corporate contribution program remains a formidable, traditional way for a corporation to enhance its business strategy and reward loyal stakeholders. In some cases, the link between corporate philanthropy and shareholder value is undisputed. In others, however, charitable giving mostly furthers the goals or aspirations of those managers who get to decide on its recipients. For this reason, it is essential for the corporate board to scrutinize the motives of charitable contributions, demand a strategic rationale, and establish adequate transparency safeguards.

# Corporate Sustainability Today

by David J. Vidal

While the shift toward sustainability is not universal and still raises business case and cost questions at some companies, the evidence suggests that sustainability—however defined or understood—is not a passing business fancy. Rather, it is increasingly seen as the pivotal driver in a fundamental business and social transition likely to be of enduring global significance.

## Gaining Marketplace Traction

While climate change plays a crucial role in the shift of sustainability to the forefront of business thinking, it is not the sole defining driver. The challenge for companies is how to make sustainability-centric approaches deliver not only on the financial bottom line but also on a broader platform of ecological and social accountabilities and goals that make up the sustainability blend.

Until recently, this expanded set of goals was a mainstream concern for large European companies but not for their U.S. counterparts. To the frustration of the Europeans, these goals were widely seen in the United States as a distraction to core business purpose or, at best, defensive reactions to public concerns about negative business impact on the environment. Change is also occurring in such economies as China, India, and Brazil, part of the group of nations whose contribution to global economic growth is increasing. Stock exchanges in China and Brazil, for example, have initiated sustainability programs for listed companies or their senior managers.

As a result, the measurement of company performance by using environmental, social, and governance (ESG) factors is gaining marketplace acceptance and becoming more integral to company plans for generating value. The evolving global financial crisis does not seem to have significantly dented this trend.

This section of the report addresses:

- Key change factors and trends that have made sustainability such a talked about business, social, and governmental question, including the scope and breadth of its emergence as an influential factor.
- Company responses to sustainability and the distinctions between business as usual and sustainable business practice as well as sustainability performance and sustainability impacts on the bottom line.
- Future trends and developments in sustainability that companies can expect and should be prepared to address.

## Key Findings

**Trend** Sustainability is a major and deepening trend in business and other segments including civil society, local and national governments, and multilateral and global institutions. Sustainability is at "the end of the beginning" of its life cycle as a significant business issue.[1] Going forward, it will gain increasing importance as a source of differentiation and competitive positioning across sectors, industries, and regions. Climate change is a “threat multiplier” that accelerates the momentum for sustainability but is not a unique causal driver.

**Response** Because conventional business approaches have largely failed to deliver on the balance of financial, ecological, and social outcomes on the scale needed for sustainability in the long term, leading firms are adopting sustainability as a guidance system that promises more balanced outcomes. For companies who are lagging in their response, an essential first step is to simply recognize the need for sustainability, and then take action on it. New sustainability-induced industries are emerging and capital is flowing into them, notwithstanding that equity markets are only beginning to recognize the potential magnitude of that change.

**Performance** Leading-edge companies are discovering ways to lower costs and improve profitability with sustainability-driven choices, sometimes unexpectedly. Wal-Mart, who arguably has the biggest corporate sustainability make-over underway in the world today, cites seven areas of specific performance gains: efficiency, revenue, income, productivity, transparency, engagement, and innovation.

While some business sectors seem disposed to respond sooner than others, all companies will eventually be affected as the competitive landscape is reconfigured. This new landscape will result from value shifts prompted by business and public policy decisions around sustainability. Policy changes to curb carbon emissions in the United States and elsewhere will be among the significant catalysts of change. Also, as occurs in any significant business transformation, competitive advantage will likely adjust in favor of early movers who take action before there is certainty in policy frameworks or expectations in positive financial returns. Metrics to capture sustainability performance within and across companies are not currently standardized but sectoral and other initiatives are underway to address the problem of comparability and also aid decision making in sustainability performance.

**Future** Sustainability is likely to continue to grow as a business and social force that factors into corporate performance, expectations of business leadership, consumer and market perceptions of companies, and ultimately the bottom line. Measurement of sustainability results across industries and firms will likely develop further and achieve greater standardization. Employment patterns and opportunities in many countries will be more influenced by sustainability and relate more directly to general economic growth.

Also, factors other than climate change will shape a continued focus on sustainability, for example, the emergence of a new global middle class of some 2 billion new consumers in emerging market economies who are tomorrow’s drivers of global economic growth.[2] Therefore, companies whose success depends on growth and from emerging economies in particular, have an incentive to integrate and anticipate sustainability expectations into planning and growth assumptions now.

### How Companies and Media Define Sustainability

**Alcoa** At Alcoa, sustainability is defined as using our values to build financial success, environmental excellence, and social responsibility through partnerships in order to deliver net long-term benefits to our shareowners, employees, customers, suppliers, and the communities in which we operate.

**Brundtland Commission** “...development that meets the needs of the present without compromising the ability of future generations to meet their own needs.”[a]

**DuPont** The creation of shareholder and societal value while we reduce the environmental footprint along the value chains in which we operate.

**MIT Sloan Management Review** At root it’s the idea that systems—including natural and human ones—need to be regenerative and balanced in order to last. We believe that means all kinds of systems: economic, environmental, societal, and personal. The sustainability question is: How can we design and build a world in which the Earth thrives and people can pursue flourishing lives?

**Stora Enso** Sustainability is the term we use to describe economically, socially, and environmentally responsible business operations. These three aspects need to be in balance for our business to be successful.

**Wal-Mart** Sustainability is simply about actions that support the quality of life—environmental, societal and financial—now and for generations to come.

**The U.S. White House** Executive Order on Federal Leadership in Environmental, Energy, and Economic Performance, October 5, 2009 says “sustainability” and “sustainable” means to create and maintain conditions, under which humans and nature can exist in productive harmony, that permit fulfilling the social, economic and other requirements of present and future generations.

a “Report of the World Commission on Environment and Development,” World Commission on Environment and Development, published as Annex to U.N. General Assembly document A/42/427, 1987

## CHANGE FACTORS AND TRENDS

The recognition of sustainability is in evidence in long-term trends as well as in recent developments in business, government, mass media, popular culture, and even religion.

### In Business

Research on the views of U.S. chief executives conducted in October 2009 by the Business Council in collaboration with The Conference Board found that:[3]

- Almost two-thirds of survey respondents indicate that sustainability has reached a tipping point and has become a mainstream concern for business.
- Fifty-six percent agree global climate change is an important business opportunity, even as 47 percent think it is a major source of business risk and uncertainty and 41 percent believe it is principally a policy issue for governments.
- Eighty-one percent of Business Council respondents agree that business leadership will increasingly be judged by the ability to create enterprises that are economically, socially, and environmentally sustainable.

**Wal-Mart and Sustainability 360** In the summer of 2009 Wal-Mart asked its 100,000 global suppliers to respond to a survey on their sustainability practices. The "Sustainability Product Index" sought information on supplier performance in such areas as energy and climate, natural resources, material efficiency, and people and community. In addition to quality and cost benefits, the assessment sought information to measure the sustainability of individual products, improve total sustainability performance of the entire value chain, and eventually inform customer choices on the sustainability effects of the range of products on Wal-Mart's shelves. One measure of the potential impact on consumer attitudes and preferences is that the company has an annual customer base of 200 million people, or nearly two-thirds of the total U.S. population. Additional market impact of the program—named *Sustainability 360* for its all-encompassing intentions— is that it will cascade through the network of the other Fortune companies that count Wal-Mart as their biggest customer.

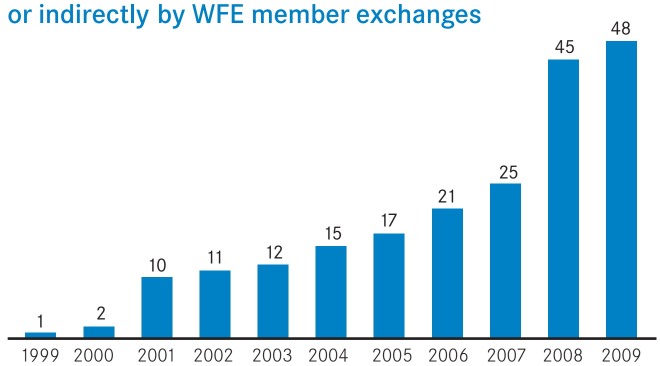
**Public transparency grows** Ninety-eight of the top 100 non-financial corporations in the world now make public at least some information related to environmental issues and 87 provide explicit information about greenhouse gases emissions, according to a study by The United Nations Conference on Trade and Development (UNCTAD).[4] The report said two-thirds of the companies have assigned responsibility for environmental performance at the level of the board of directors. It found "substantial adoption" of voluntary policies on corporate social responsibility and climate change by the largest corporations, of which it said 75 percent disclose distinct policies on greenhouse gas emissions and 72 percent reference the Global Reporting Initiative's (GRI) sustainability reporting guidelines. The GRI is a widely used framework of principles and indicators for organizations to report their economic, environmental, and social performance. Companies in the study included Anheuser Busch Inbev from the Netherlands, BASF from Germany, CEMEX from Mexico, Diageo and Anglo-American from the United Kingdom, Endesa from Spain, Ford, GE, and HP from the United States, Holcim from Switzerland, Hyundai and Samsung from Korea, Petronas from Malaysia, and Rio Tinto Alcan from Australia and Canada.

**Financial markets awakening to the transformative potential of sustainability** There is a realization within financial markets that sustainability is escalating as a factor of how attractive and competitive companies will be in the long term.

- In February 2009, the U.S.-based Private Equity Council, an advocacy, communications and research organization, adopted guidelines for responsible investment by its members, that include major private equity participants such as The Blackstone Group, Carlyle Partners, and Kohlberg, Kravis, Roberts & Co. The guidelines say members will consider environmental, public health, safety, and social issues associated with target companies "when evaluating whether to invest in a particular company or entity, as well as during the period of ownership."

Chart 1

**Number of sustainability indices offered directly or indirectly by WFE member exchanges**




*Source*: WFE Sustainable Exchanges Report, August 2009.

- In a May 2009 report, Goldman Sachs said climate change "is at a tipping point at which the issue's importance to business performance and investors will escalate." Also, that the equity market "is only beginning to reflect the magnitude of the change that lies ahead."[5] Significant changes in population, resource utilization, climactic patterns, and employee and consumer attitudes, on top of the accelerating changes prompted by globalization, are the reasons for the outsized change the report predicts. The effectiveness of industry responses to climate change will determine the redistribution of value and competitive advantage and will impact the value chain of every industry, the study said. In July 2009, the Fiduciary II team of asset managers formed by the United Nations Environment Programme (UNEP) released a report which concluded that the global economy "has now reached the point where ESG issues are a critical consideration for all institutional investors and their agents."[6] This conclusion built on an earlier study by UNEP in 2005 which the UNEP Fiduciary I Asset Management Working Group (AMWG) commissioned to the London-based international law firm Freshfields Bruckhaus Deringer, and concluded that: '…integrating ESG considerations into an investment analysis so as to more reliably predict financial performance is clearly permissible and is arguably required in all jurisdictions.'[7]
- A study of its 51 members commissioned by the World Federation of Exchanges found in August 2009 that sustainability-related indices provided by its membership had increased significantly since 2007, as had the number of exchanges entering the field for the first time. A majority of new entrants were from developing markets such as South Africa, Brazil, Korea, Indonesia and India.[8]

## In Government

Official prominence to sustainability has been granted in the United States by the administration of President Barack Obama. Other countries have also taken actions pushing policy in that direction.

**Sustainability now a U.S. government objective** In October 2009, the U.S. President signed an executive order setting sustainability as an objective of the executive branch of government. In issuing the order, which carries the force of law, the White House cited the role of the federal government as the largest consumer of energy in the country, the need to establish a clean energy economy, and the leadership role of the government as a market actor with more than $500 billion per year in purchases of goods and services, as well as being a policy setter.

The executive order requires Federal agencies to " set a 2020 greenhouse gas emissions reduction target within 90 days; increase energy efficiency; reduce fleet petroleum consumption; conserve water; reduce waste; support sustainable communities; and leverage Federal purchasing power to promote environmentally-responsible products and technologies." The U.S. Army had preceded these directives in issuing its 2007 Sustainability Report, marking the first time a U.S. government agency reported sustainability activities using indicators of the Global Reporting Initiative (GRI) that many global companies also use. In the U.S. Congress, legislation has been introduced in both houses seeking rules and procedures for cutting greenhouse gas emissions produced by U.S. economic activity.

### Sustainability and Climate Change

Sustainability and climate change are interdependent yet distinct. Perhaps the best way to understand the distinction is to know that even without the factor of climate change, the world would still face a formidable sustainability challenge.

The reason for this is that the underlying drivers of the need for sustainability—demographic growth, consumption of natural resources at rates nature cannot replenish, and the degradation of living systems in a manner potentially threatening to all life—are taking place even in the absence of the added phenomenon of climate change.

The strain that sustainability is attempting to ease addresses: a) how to better balance the demand for consumption from many millions of additional consumers, with b) production capacity to supply food, energy and other necessities without overtaxing nature. The core question in climate change is the instability of the earth's weather and climate patterns that are projected to worsen as a result of the accumulation of greenhouse gases in the atmosphere principally from human industrial activity. Climate change can thus accelerate and worsen the conditions already propelling the sustainability response—a 'threat multiplier'—and is thus similar but not equal to sustainability.

*Sources:* Center for Sustainability, The Conference Board; Intergovernmental Panel on Climate Change, Fourth Assessment Report, 2007; National Security and Threat of Climate Change, CNA Corporation, 2009

If approved, the legislation could accelerate investment in technologies to create the "clean energy economy" the President says the nation needs. Previously, the Congress had approved a budget promoting new investments in renewable energy, energy efficiency, the smart grid for electricity distribution and other aspects of a low-carbon or "green" infrastructure. Also:

- Six U.S. states—California, Connecticut, Hawaii, Massachusetts, Maryland ,and New Jersey—have adopted binding caps on global warming pollution from their states' economies. Ten northeastern U.S. states have created a regional cap and trade system for emissions from electric power plants, and 22 states have adopted policies that require a share of their energy needs to be met through energy efficiency improvements.

**Internationally governments are taking action** In November 2009 in Beijing, Chinese authorities and executives from Arizona-based First Solar Inc. announced an agreement to start the world's largest solar power plant on 65 square kilometers of land in the autonomous region of Inner Mongolia. The plant is part of a larger project plan to help China develop a renewable energy industry and lower its greenhouse gas emissions. Also:

- In Europe, the government of Spain in November 2009 announced a new law to promote a "sustainable economy" and setting out "the strategy for sustainable economic growth," including a greater focus on transparency and on developing sectors that will be involved in the fight against climate change. Earlier Denmark introduced a new law making it mandatory for the 1,100 largest Danish companies, investors, and state-owned companies to include information on corporate social responsibility (CSR) in their annual financial reports.
- In December 2009 in Copenhagen, Denmark, the world's governments met at the event named COP15 to continue discussions on how they can each contribute to the reduction of greenhouse gas emissions by making their own national commitments. Prior to Copenhagen, the Presidents of China and the United States had reached preliminary agreement "to take significant mitigation actions."
- A study by the banking firm HSBC found that around 15 percent of fiscal measures it studied from 20 countries "can be associated with investments consistent with stabilizing and then cutting global emissions of green-house gases."[9] The study identified over US$430 billion in fiscal stimulus for key climate change themes, said that China and the United States were in the lead, that the construction and capital goods sectors will be primary beneficiaries as governments expand green infrastructure, and that it expected the emphasis on a low-carbon recovery to intensify as part of the G-20 process and the Copenhagen negotiations.

## In mass media, popular culture, and religion

Mass media attention to the sustainability theme has produced special "green" editions and front covers in many mass circulation magazines during the past two years. Recent examples are an October 2009 edition of Time magazine reporting on "the rise of the citizen consumer" and "the beginnings of a responsibility revolution." In November, the Newsweek Green Rankings 2009 were released by that magazine, naming the "greenest companies in America" from among the top 500 U.S. corporations. Other recent events:

- In September 2009, the Good Housekeeping Research Institute—the product-evaluation laboratory of the Hearst magazine—announced the first seven products to receive its new Green Good Housekeeping Seal, "developed to help consumers sift through the confusing clutter of 'green' claims on hundreds of products on store shelves today." The first batch of certifications includes household cleaners and beauty products and paints and appliances are expected to follow.
- The 79th Academy Awards in 2007, during which the climate change documentary *An Inconvenient Truth* was awarded an Oscar, were presented as the "greenest ever" and presenters and stars rode to the event in hybrid fuel vehicles.
- In Rome in July 2009, Pope Benedict XVI released an encyclical letter on the global economic crisis, a moral framework for moving forward, and the environment. In what amounted to a statement about sustainability, the Pope wrote: " projects for integral human development cannot ignore coming generations, but need to be marked by solidarity and inter-generational justice, while taking into account a variety of contexts: ecological, juridical, economic, political and cultural."[10] Previously, the Vatican agreed in 2007 to an offer from a Hungary-based forest offsets company to help it become the world's first carbon neutral sovereign state.

## COMPANY RESPONSES TO SUSTAINABILITY AND PERFORMANCE

A study of the sustainability initiatives of 30 large corporations found that sustainability was "a mother lode of innovation" and that the experiences of those companies can be grouped into five stages of sustainability response.[11] The five stages identified are:

1 **Viewing compliance as opportunity**, in which the ability to anticipate and shape regulations and the skill to work with other companies—including rivals—leads to creative solutions. An example cited was HP's decision in the 1990's to gradually eliminate lead as a solder in its manufacturing of components, anticipating the toxic substance would one day be banned. When the European Union issued a directive banning hazardous substances in 2006, the company was prepared to capture the business opportunity for the non-lead-based products it had decided to experiment with years earlier. Between 2003 and 2007 the study reports HP saved $100 million by creating its own European Recycling Platform with three other manufacturers. The partnership was formed in response to an EU-sponsored recycling arrangement the company thought would be expensive.

2 **Making value chains sustainable**, in which techniques like carbon management and life cycle assessment aid in redesign of operations to consume less energy, produce less waste, and generate fewer emissions. Cargill's and Uniliver's efforts to create sustainable practices for cacao, palm oil, and soybean cultivation are examples, as are Wal-Mart's requirements that its China suppliers meet stringent new sustainability goals.

3 **Designing sustainable products and services**, in which knowledge of environmental impacts permits creation and scale-up of products while avoiding the "greenwashing" label. This owes partly to the know-how acquired by managers and opportunities to apply techniques like biomimicry in product development. One of the examples cited was Proctor & Gamble's switch to creating detergents that could work well with cold water. A product life cycle assessment had uncovered that much of the product's carbon footprint was in the customers' use of electricity and that reducing the footprint meant lowering the amount of energy needed to use the product. SC Johnson developed a "greenlist" process to measure and track the performance of products by classifying raw materials inputs according to their impact on the environment and human health. It subsequently decided to permit interested companies to license its process royalty-free.

4 **Developing new business models**, in which the emphasis is on capturing and delivering value in new ways that alter the basis of competition. Understanding consumer needs and partner capabilities matter to generating opportunities to monetize models relating to services rather than products, and to combine digital and physical infrastructures into new business models.

5 **Creating next practice platforms**, in which the central challenge is to question through the sustainability lens the dominant logic behind business today. One example is developing products that do not need water in categories traditionally associated with it, such as cleansing products. An example that is not specific to the study but relevant to this point is that of Wal-Mart China. As part of a summit of 1,000 leading suppliers, Chinese officials and NGOs held in October 2008 in Beijing, Wal-Mart China said it "will continue to rely on the expertise of NGOs to driver greater innovation in its stores and higher environmental standards in the supply chain" and that its partnerships aim to help the company overall "drive returns on defective merchandise virtually out of existence by 2012."

### Sustainability as Offense, Not Defense

"What has been amazing to me is what I thought was going to be a defensive strategy…is turning out to be entirely opposite. This is an offensive strategy. This is a strategy about merchandise. This is a strategy about attracting and retaining the best people and the most creative minds."

**Lee Scott, Chairman of the Executive Committee of the Board of Directors, Wal-Mart Stores***

* Cited in Wal-Mart presentation to The Conference Board Working Group on Corporate Governance and Sustainability, June 22, 2009.

## Business as Usual Versus Sustainable Business

Following are conclusions describing the differences between conventional business practice and a sustainability business approach:

**Saving on cost but losing on opportunity** A standard emphasis on cost can produce savings, but using a cost as the sole decision rule can mean loss of sustainability opportunity if the decision-making context is too narrow. Similarly, front-loading decisions with metrics can be limiting if this is not done as part of a broader review of how a company's products, processes, technologies, and markets are affected when the sustainability question is strategically posed holistically and is systematically addressed. A current example could be of a company choosing not to undertake carbon foot printing or product life cycle analyses to save money during the downturn, only to discover later that it lacked knowledge the market wanted in the upturn.

### Sustainability as a Differentiator

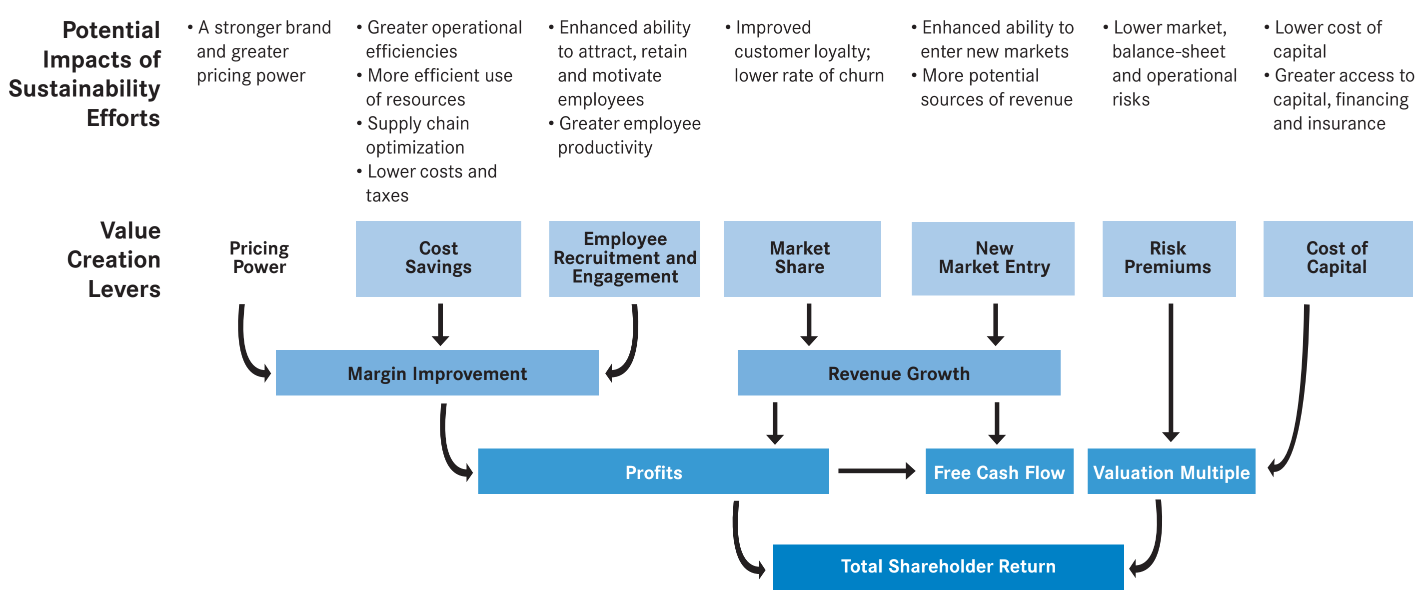
> "Here's the thing: Sustainability has given my company a competitive edge in more ways than one. It has proven to be the most powerful marketplace differentiator I have known in my long career. Our costs are down, our profits are up and our products are the best they've ever been."

**Ray C. Anderson, Founder and Chairman, Interface Inc.**[*]

* Ray C. Anderson, Robin White, *Confessions of a Radical Industrialist, Profits, People, Purpose-Doing Business by Respecting the Earth*, St. Martin's Press, 2009.

Exhibit 1

### How Sustainability Affects Value Creation




*Source:* MIT Sloan Management Review Fall 2009.

**Seeing the company tree but missing the sustainability forest** Since sustainability implies interconnections that may not be apparent until the process itself begins, decision making needs to consider relationships that extend beyond the boundaries of the company. This is a model for delivering services and capturing revenues that cannot work if the company is acting alone. An approach that focuses exclusively on the company can miss opportunities that actually reside in the supply chain. An MIT Sloan Management Review study found that “effective collaboration with stakeholders” plays a critical role because the solutions sustainability requires are interdisciplinary by nature.[12] Examples of companies reaching out to collaborate in product development, design, and marketing with civil society and non-profit organizations include Clorox and the Sierra Club for the Green WorksTM natural cleaning products product line, GE and the World Resources Institute for the Ecomagination initiative, and NRDC (National Resources Defense Council) and private equity specialists Kohlberg Kravis Roberts & Co. and Texas Pacific Group in the buyout of the utility giant TXU in Texas. A PricewaterhouseCoopers study for The Carbon Disclosure Project said that “looking at the impacts of carbon and climate change on supply chains, it is difficult to understand why some companies are questioning ‘if’ they should do something.”[13]

**Doing product impact remediation later instead of designing for reduced impact up front** Product design that ignores sustainability concerns up front may lead to environmental impacts later that could be costlier. Managers are also deprived of needed know-how to better respond to changing market expectations, such as on product stewardship. Many companies are responding by adopting tools such as carbon and water footprint analysis and setting goals for establishing a sustainability standard in their own industries. Life cycle assessment is also being used to find opportunities for process and cost improvements that were only apparent after a company looked for them.

**Focusing on the “what” and not the “how” of production** In traditional business practice, the quality of inputs and the efficiency of their processing could be relied upon to yield good products the market would accept. Under a sustainability approach this standard of performance is not enough. In fact, in sustainability it is not only the “what” elements of input quality that matter, but also the “how” elements of the sustainability impacts along the value chain of production meet or fail to meet sustainability goals and objectives. With the sustainability impact of products and the transparency surrounding them are likely to become a bigger part of brand identities, companies that fail to recognize the importance of the “how” may lose out.

**Keeping the focus on best practices that lag instead of next practices that lead** At a moment of huge and continuing change in the economic and business landscape, companies may tend to favor survival in the present over sustainable prosperity in the future. In sustainability, the choice is not an either/or. A short-term focus on current best practice—tomorrow’s mediocrity—can let companies

Exhibit 2

## We are close to a tipping point

**2000** → **2009** → **?**

### Early stage adoption

- Limited business awareness
- Science debated
- Niche social issue
- Focus on risks rather than opportunities
- Financial costs and benefits unclear
- Regulation very limited, imperfect
- Emerging leaders

### Tipping point

- Increasing business awareness
- Shift from niche social issue to mainstream concern
- Widespread agreement on science of impacts and causes
- Costs become tangible and begin to become material to profitability
- Regulatory structure becomes clearer
- Increased visibility on extent of market opportunities
- Companies differentiated by early leadership in adaptation

### Mainstream adaptation

- Increasing physical impacts strengthen resolve
- Expectations on companies established at a high level
- High and intensifying regulation
- Costs are clear and sizeable
- Large and growing market for climate resilient products
- Companies differentiated by failure to adapt

*Source*: Change is Coming: a Framework for Climate Change – a Defining Issue of the 21st Century, Goldman Sachs Investment Research, May 21, 2009.

lose sight of the "next practice" platforms that are being designed all around them by those employing a broader perspective. Having a wider perspective is especially important in the context of the substantial lead times that may be required in some sectors to begin projects having significant sustainability impacts.

## Businesses have been responding

A global survey by The Economist Intelligence Unit in 2007 found that companies had made the following responses to sustainability in the previous five years.[14] While the percentages cited have more than likely changed with the surge of interest in sustainability since 2007, the topics of company responsiveness remain valid.

Set policies to reduce energy consumption (55 percent)

- Xerox has adopted, as a purpose, becoming carbon neutral and being a leader in paper sustainability. Its goals include : developing a "zero waste to landfill" aim for company-wide operations, ensuring that 100 percent of its paper meets the requirements of a sustainable paper cycle, and eliminating hazardous materials uses to achieve a "zero toxic footprint."

### Xerox Finds the Unexpected

"We were an early leader in the sustainability movement because we thought it was the right thing to do for the environment. But we discovered something else along the way. Every one of our innovations ended up either saving us money or creating new markets and new revenue. We found, in other words, that we don't have to choose between the environment and profit. We can do both."

Anne Mulcahy, Chairman and Ursula Burns CEO,
Xerox Corporation 2009 Report on Global Citizenship

- In December 2009 , the Las Vegas-based MGM Mirage gaming and real estate development company inaugurated its $9 billion CityCenter project, one of the biggest construction project ever in North America.It also is a LEED Gold certified facility conceived and executed with sustainability as well as luxury as a guide.[15] While oil, mining or gas companies can easily and quickly realize the significance to their businesses of carbon and sustainability issues, the MGM Mirage came to sustainability by another route. Following a period of study and field consultation by its then CFO, the company concluded that the city of the future had to be sustainable and, with the support of the CEO, elected to proceed on that basis.

Taken steps to improve governance in relation to the organization's environmental and social performance (51 percent)

- A recent U.S. study for the Sustainable Enterprise Institute is less optimistic, finding that "most of the largest and most valuable companies in the U.S, have an environmental policy in name, but little else to indicate appropriate management of environmental issues," adding that "the boards of directors of the vast majority of large U.S. companies do not oversee or manage environmental issues, nor do they assign responsibility for them to the firm's most senior executives."[16]

Revised and tightened controls to support ethical business dealings/avoid allegations of corruption (40 percent)

- The Publish What You Pay Campaign, a coalition of more than 300 NGOs calling for the mandatory disclosure of payments made by oil, gas and mining companies to all governments for the extraction of natural resources, is an example of what companies are being asked to do to help reduce corruption.

Other steps taken included:

- Incorporating sustainability issues and policies in global employee training programs (31 percent)
- Upgrading IT systems to enable improved reporting and performance management on sustainability issues (27 percent)—a 2009 report by Symantec, the Green IT Survey, found that "Green IT has reached critical mass
- Implemented new checks or requirements on suppliers relating to sustainability issues (19 percent)

## SUSTAINABILITY'S FUTURE

Some marketplace signals may help managers better discern the road ahead for sustainability. The interconnectedness and globality that are core to sustainability mean that multiple sources are bound to influence its future. Therefore, the first important thing managers need to be aware of, and prepare for, is to know that the sources of influence on sustainability's future will be dispersed. Economic and commercial actors alone will not have the last word. Companies will need to share the sustainability marketplace—and learn how to be effective within it—with many other actors including governments, non-profit organizations (NPOs), civil society organizations (CSOs), social entrepreneurs, and other influencers as they may emerge. The sustainability playing field is unlevel, filling up with many players, and does not have a set of rules observed by all. In this context, there are five topic areas that can shape the future of sustainability. Developments in these areas should be integral to any managerial scenario created to assist decision making in the sustainability transition. The five areas are:

1. Changes in the Rules of the Road
2. Changes in Disclosure and Transparency
3. Changes in Collaboration and Competition
4. Changes in Consumer and Investor Demand
5. Changes in the Roles and Influence of the BRIC Economies

### Changes in the Rules of the Road

Even markets that are called "free" have rules that participants abide by. In the relatively uncharted terrain of sustainability, official and unofficial rule making will have an especially significant influence in directing trends and reshaping markets. At the global and national levels, mandatory legislative and regulatory decisions will likely be accompanied by voluntary guidelines, standards, and directives specific to industries or supply networks. Process norms and certification schemes promoted by civil society and non-profit organizations across the globe already have established a foothold in many areas of global business and may also expand. For global companies and others seeking to expand into global markets, the fundamental choices will be to decide which official or unofficial practice guidelines or requirements to adapt to, and at what pace and cost.

Examples of rules changes currently in discussion from various sources include:

- The15th United Nations climate change conference—COP15—held in December 2009 in Copenhagen. This global gathering of 192 nations represented the continuation of efforts by countries to agree on how their national economies will conform to global needs to reduce greenhouse gas emissions. The nature of energy that is produced and consumed around the world, as well as the public and private investment flows for activities to achieve emissions reduction goals, will be at least initially influenced by the choices that were or were not made there.
- National-level legislation such as that now under consideration in the U.S. House of Representatives and Senate to create '"cap and trade" or other systems to prompt markets to favor low-carbon over more carbon-intensive economic activities. The Obama administration has issued an executive order that gives the $500 billion annual purchasing and procurement market power of the federal government a sustainability preference. Also, the Environmental Protection Agency has paved the way for rules to limit carbon emissions by industries in the event a nationally legislated framework does not come into play from the Congress.
- In Geneva in 2010, the International Standardization Organization is due to publish a new ISO 26000 guideline on social responsibility. As a "guidance standard" the guidelines will be voluntary and will lack requirements that would qualify it as certification standard. Although its actual impact on global business activities is only speculative at this point, the fact of its creation is one indicator of the level and the direction that the platform for corporate responsibility is heading in globally.

### Changes in Disclosure and Transparency

The transformation and expansion of corporate practices in disclosure and transparency is another outgrowth of sustainability to watch and be prepared to handle. According to a 2008 report by KPMG, eighty percent of the Global Fortune 250 now release corporate responsibility data in stand alone reports or integrated into annual financial reports, up from 50 percent three years ago.[17] The further integration of sustainability and corporate citizenship with traditional financial reporting—along with the possible addition of new reporting explicitly on carbon performance—is another development to monitor.

The U.S. Securities and Exchange Commission announced on January 27, 2010 that it will "provide public companies with interpretive guidance on existing SEC disclosure requirements as they apply to business or legal developments relating to the issue of climate change". The SEC decision responded to a petition by institutional investors, non-profit groups, and some state treasurers to issue guidance on corporate climate risk disclosure. A 2009 report released by three non-profits prominent in the issue found that 76 percent of annual reports filed by S & P 500 companies in 2008 did not include any mention of climate change.[18] CalPERS, the California Public Employees' Retirement System, joined with others in an Investor Network on Climate Risk to urge greater disclosure in SEC filings. At a November 2009 meeting of global stock exchanges at UN headquarters in New York, a "comply or explain" proposal to put an annual sustainability report to a shareholder vote at annual meetings of listed companies was discussed as one path for eligible exchanges to pursue.

Worldwide, the growth in "non-financial" reporting is tracked by an organization in the United Kingdom, *CorporateRegister.com*. It plans to provide systems to streamline the flow of non-financial information from companies to stakeholders and increase the availability of corporate carbon performance information. In the United States, the expansion of carbon performance information from the corporate to the product level is bound to accelerate, as are life cycle and cradle-to-cradle analyses of supply chains and products to provide consumers with sustainability-impact information on products they may be purchasing. Interest and attention to water foot printing is also gaining currency, joining carbon foot printing and carbon neutrality in the lexicon of sustainability activities.

The Sustainability Consortium, together with the World Resources Institute and Duke University, is undertaking a global survey of eco-labeling to create an index of product labels that claim an environmental or social benefit. Jointly administered by the University of Arkansas and Arizona State University in the United States, the consortium is a collaboration of business, academic, government, non-profit, and other partners who are seeking to build "a scientific foundation that drives innovation to improve consumer product sustainability." Creating systems and standards for sustainable product index reporting is among its key objectives. Some of the Consortium's 20 corporate founding partners include Disney, HP, General Mills, KPMG, PepsiCo, P&G, SC Johnson, TetraPak, Unilever and Wal-Mart.

## Changes in Collaboration and Competition

Taking action for sustainability often requires new combinations and arrangements of disparate actors coming together to advance that goal, both within and across companies, industries, and sectors. Companies seeking to have an impact in their own and in others' sustainability achievements will need to be skilled in creating and joining collaborative projects. Knowing which ones to get involved with can have competitive implications. For example, if a collaborative group comes up with a process that saves its members significant sums of money, that benefit would not be readily available to a non-participant, who can then be at a competitive disadvantage. A decision to collaborate, or not, can have strategic and competitive implications and is an area that managers looking to the future should watch closely. Some examples of collaborations at the company, cross-sectoral, and systems levels include:

- At the company level, GE has been employing energy "treasure hunts" to motivate employees to drive energy efficiency, reduce greenhouse gas emissions, and achieve a sustainable impact. A visiting cross-functional team of GE employees is pulled together and trained to identify opportunities at a facility where energy and resources are being used that do not need to be. Events are planned for weekends when facilities are not in full operation and findings are implemented after consultation with on-site colleagues. GE says the program has trained more than 3,500 of its global employees to think in new ways about energy and water and that more than 5,000 projects have been identified. According to the company, the projects have the potential to eliminate 700,000 metric tons of greenhouse gas emissions and save $111 million in operational costs.
- At an industry level, in 2007 Google and Intel started the Climate Savers Computing Initiative. The goal was to significantly increase the energy efficiency of computers and servers by bringing together industry, consumers, government, and conservation organizations. Energy efficiency is a common focal point of many corporate sustainability initiatives because it is through the energy system, and particularly the electrical system, that sustainability issues like climate change and greenhouse gas emissions circulate. The companies said a typical desktop PC loses more than half of the power coming into it from an electrical outlet. By 2010, the initiative aims to realize a 50 percent reduction in annual power consumption by computers and a potential of $5.5 billion in collective energy cost savings for participants.

- At the systemic impact level, two examples from Unilever in Indonesia and Alcoa in Brazil illustrate a collaboration approach whose focus is on the relationship of company activities to the entirety of systems surrounding it. In 2005, Unilever published a report on the results of a joint project with Oxfam GB of the U.K. and Oxfam Novib of the Netherlands, two aid and development organizations, exploring the impact of the company on Indonesia.[19] Specifically, the focus was on how the local operations of Unilever could contribute to sustainable poverty reduction in that country. The company reported that it learned a lot from intensive and difficult debate with Oxfam. It found that the value created by people working at either end of the value chain is much lower than the value captured by those at the center of the chain. To effectively redress poverty, the company concluded that a concerted effort is required between business, governments, international institutions, civil society, and others. The company followed up its 2005 report on Indonesia with a 2008 study by a professor at INSEAD on the economic impact of Unilever's operations on South Africa.[20]

In Brazil, a systems and partnerships approach to managing a company impact on its community and environment over a period of decades is being undertaken by Alcoa in western Para state. There, as part of a $2.2 billion bauxite project near the town of Juruti by the banks of the Amazon River, a port facility, a mine, and a railway are being developed under sustainability commitments agreed to with local and regional communities. At 700 million metric tons, the bauxite reserves in the area are one of the largest deposits in the world. To mine, process, and transport them in an area equally rich in biodiversity, a "Sustainable Juruti" plan was developed and includes a commitment by the company "to mine bauxite and return the area to the same, if not better, condition than when we initially arrived."

The Center for Sustainability Studies of the Getulio Vargas Foundation and the Brazilian Biodiversity Fund engaged with the company, which was opening its first bauxite mine in the world in more than 50 years. Juruti Sustainability Indicators were established in consultation with the local community, and a Sustainable Juruti Fund to support environmental, social, and economic initiatives was formed, along with a Juruti Sustainability School to train area residents in sustainability planning. The plan's impact area was defined as territorial, or beyond the immediacy of the town, and a "dialogue with reality" premise required consideration of global trends in examining the situation on the ground in the Amazon.

While the outcomes of the project can only be known over a period of many years, so far the company's efforts have earned it recognition as one of the most sustainable enterprises in Brazil by the business magazine *Exame*.

## Changes in Consumer and Investor Demand

One of the common concerns of managers and proponents of sustainability has been the seemingly passive interest of consumers and mainstream investors. Detecting any signs of the onset of a tipping point from passivity to preferential demand for sustainability products and services is valuable knowledge. The difficulty is that gaining an advantaged competitive position requires that decisions and actions be made before any such tipping point is obvious for all market actors to see and respond to. One of the key factors that can affect a shift in consumer and investor behavior is the increased availability of information relevant to their decision making on products or services.

On the eve of the opening of the UN Climate Change Conference in Copenhagen, a group of 187 investment institutions called on world leaders to produce a global agreement with "clear, credible long-term policies." The investors, who said they collectively represented assets of US $13 trillion, said such policies were critical to helping them integrate climate change considerations into their decision-making processes, and into supporting investment flows into a low-carbon economy and into measures for adaptation. The group said investors can influence how companies respond to climate change not only through the allocation of capital, but also by engaging on the issue with the companies in their portfolios. The investors include several who are regarded as "universal" because of the breadth of the holdings in their portfolios. The call's signatories included large U.S., European, Australian, South African, and New Zealand pension funds, foundation endowments and asset managers such as CalSTRS, Norges Bank Investment Management, Deutsche Bank, HSBC, Societe Generale, Swiss Re, and the London Pensions Funds Authority. Also involved were many well-known SRI or socially-responsible investors—such as Aviva, Calvert, Henderson, Storebrand and Walden.

Expanding the flow of information to those interested in environmental, social, and governance (ESG) solutions is the goal of another group that has been operating since 2005 called The London Accord. It is a collaboration of investment banks, research houses, academics and NGOs who agree to act as an open source in sharing and disseminating their sustainability research. By 2009, they had issued 40-co-published reports from 26 contributing organizations.

In the United States, the private equity group Kolhberg, Kravis, Roberts & Co (KKR) has been collaborating with an NGO, the Environmental Defense Fund, since 2008 in a "Green Portfolio Project" to improve the environmental performance of companies within KKR's U.S. portfolio. In 2009, the partnership announced it had already achieved savings of $16.4 million at three companies—U.S. Foodservice Inc, PRIMEDIA Inc. and Sealy Corporation.

As to consumer attitudes, in October 2009 Edelman, the public affairs consultancy, released its third annual global consumer study, covering more than 6,000 consumers aged 18-64 across ten countries. The broad strokes of its findings were that significant changes in consumer attitudes are underway. Specifically, it said brands are expected to play greater roles in social issues and that companies are expected to devote equal attention to society and business needs. "Mutual social responsibility and return on involvement are shifting the CSR/Cause conversation," the report said, also asserting that "social purpose is the new social status."[21]

Consumer and investor demand for sustainable products and services may also be influenced by projected demand and investing in renewable energy. According to the International Energy Agency's (IEA) World Energy Outlook 2009, energy accounts for two-thirds of today's greenhouse gas emissions and thus is core to any solution. The IEA says additional investment of $10.5 trillion is needed globally in the energy sector in the period 2010-2030 if greenhouse gas concentrations in the atmosphere are to be stabilized at a reference goal of 450 ppm. Deployment of renewables would account for 20 percent of carbon savings.

## Changes in the Role of the BRIC Economies

The same year 2050 that is used as the target date for which global greenhouse gases need to be reduced, may mark an epochal shift in economic and demographic dominance from the global West to the global East. Over the next several decades it will be the economies of these BRIC economies—Brazil, Russia, India, and China—that economists predict will be the expected drivers of global growth, displacing the role previously dominated by the United States and Europe. Because economic growth is closely related to energy consumption, and because demographic growth in emerging economies increases production as well as consumption, strains on the availability of food and fresh water for a world population projected to increase to 9 billion by 2050 are likely to grow.

The issues of sustainability and global economic growth will be intertwined. Any divination of the sustainability future is thus tethered to the growth paths chosen in the BRIC economies. Trade dependencies between those economies and others in the West—particularly between the United States and China—also mean that decisions in those economies regarding sustainability influences companies throughout the world. As an example of how trends in the BRIC economies can influence sustainability worldwide, following are developments of note in China:[22]

- President Hu Jintao described the "harmonious society" as a principle of Chinese government policy for balancing economic growth, environmental concern and the narrowing the country's wealth gap.
- The 11th Five Year Plan (2006-2010) described an objective of going "from growth rate to sustainable development."
- China's company law introduced a social responsibility obligation, broadening a company's accountabilities beyond shareholders to stakeholders as well.
- The Shenzen Stock Exchange issued social responsibility guidelines for listed companies in 2006 and in 2008 the Shanghai Stock Exchange announced the "Shanghai Corporate Social Responsibility (CSR) Notice" suggesting disclosure of a company's net social contribution value per share. That same year, SASAC, the body overseeing China's state-owned enterprises released a "CSR Guideline for State-Owned Enterprises." It indicated that corporate responsibility was "a key criterion worldwide when people assess the value of a company."[23] The rules promulgated for China's state enterprises also apply to foreign firms investing in the country.

The CEO of GE, Jeffrey R. Immelt, speaking to students at the NetImpact 2009 Conference in November 2009 at Cornell University in the United States, offered this perspective on the changing order of global business: "There's more growth outside the United States than there is inside the United States. We have to recognize that our destiny is connected to the emerging world." He added that 10 million new jobs will be created in green energy in the next decade but it was unclear where these jobs would be created—whether in the United States, China or elsewhere. Public policy, energy demand, the evolution of technology, and costs would be the decisive factors, he said, noting the only value he saw GE bringing to the student's conference was "the merger of capitalism to sustainability" which he said GE is doing."

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# The Business Case for Sustainability

by Archie B. Carroll and Kareem M. Shabana

In the last decade, in particular, empirical research has brought evidence of the measurable payoff of CSR initiatives to companies as well as their stakeholders. Companies have a variety of reasons for being attentive to CSR. This section documents some of the potential bottom-line benefits: reducing cost and risk, gaining competitive advantage, developing and maintaining legitimacy and reputational capital, and achieving win-win outcomes through synergistic value creation.

The term “corporate social responsibility” is still widely used even though related concepts, such as sustainability, corporate citizenship, business ethics, stakeholder management, corporate responsibility, and corporate social performance, are vying to replace it.* In different ways, these expressions refer to the ensemble of policies, practices, investments, and concrete results deployed and achieved by a business corporation in the pursuit of its stakeholders’ interests.

This section of the report discusses the business case for CSR—that is, what justifies the allocation of resources by the business community to advance a certain socially responsible cause.The business case is concerned with the following question: what tangible benefits do business organizations reap from engaging in CSR initiatives? This section reviews the most notable research on the topic and provides practical examples of CSR initiatives that are also good for the business and its bottom line.

## The Search for a Business Case: A Shift in Perspective

Business management scholars have been searching for a business case for CSR since the origins of the concept in the 1960s.[1]

An impetus for the research questions for this report was philosophical. It had to do with the long-standing divide between those who, like the late economist Milton Friedman, believed that the corporation should pursue only its shareholders’ economic interests and those who conceive the business organization as a nexus of relations involving a variety of stakeholders (employees, suppliers, customers, and the community where the company operates) without which durable shareholder value creation is impossible. If it could be demonstrated that businesses actually benefited financially from a CSR program designed to cultivate such a range of stakeholder relations, the thinking of the latter school went, then Friedman’s arguments would somewhat be neutralized.

Another impetus to research on the business case of CSR was more pragmatic. Even though CSR came about because of concerns about businesses' detrimental impacts on society, the theme of making money by improving society has also always been in the minds of early thinkers and practitioners: with the passage of time and the increase in resources being dedicated to CSR pursuits, it was only natural that questions would begin to be raised about whether CSR was making economic sense.

#### The socially responsible investment movement

Establishing a positive relationship between corporate social performance (CSP) and corporate financial performance (CFP) has been a long-standing pursuit of researchers. This endeavor has been described as a "30-year quest for an empirical relationship between a corporation's social initiatives and its financial performance."[2] One comprehensive review and assessment of studies exploring the CSP-CFP relationship concludes that there is a positive relationship between CSP and CFP.[3]

In response to this empirical evidence, in the last decade the investment community, in particular, has witnessed the growth of a cadre of socially responsible investment funds (SRI), whose dedicated investment strategy is focused on businesses with a solid track record of CSR-oriented initiatives. Today, the debate on the business case for CSR is clearly influenced by these new market trends: to raise capital, these players promote the belief of a strong correlation between social and financial performance.[4]

As the SRI movement becomes more influential, CSR theories are shifting away from an orientation on ethics (or altruistic rationale) and embracing a performance-driven orientation. In addition, analysis of the value generated by CSR has moved from the macro to the organizational level, where the effects of CSR on firm financial performance are directly experienced.[5]

The CSR of the 1960s and 1970s was motivated by social considerations, not economic ones. "While there was substantial peer pressure among corporations to become more philanthropic, no one claimed that such firms were likely to be more profitable than their less generous competitors." In contrast, the essence of the new world of CSR is "doing good to do well."[6]

CSR is evolving into a core business function, central to the firm's overall strategy and vital to its success.[7] Specifically, CSR addresses the question: "can companies perform better financially by addressing both their core business operations as well as their responsibilities to the broader society?"[8]

## One Business Case Just Won't Do

There is no single CSR business case—no single rationalization for how CSR improves the bottom line. Over the years, researchers have developed many arguments. In general, these arguments can be grouped based on approach, topics addressed, and underlying assumptions about how value is created and defined. According to this categorization, CSR is a viable business choice as it is a tool to:

- implement cost and risk reductions;
- gain competitive advantage;
- develop corporate reputation and legitimacy; and
- seek win-win outcomes through synergistic value creation.[9]

Other widely accepted approaches substantiating the business case include focusing on the empirical research linking CSR with corporate social performance (CSP) and identifying values brought to different stakeholder groups that directly or indirectly benefit the company's bottom lines.

### Who Cares, Really?

Who cares about the business case for CSR?

Obviously, corporate boards, CEOs, CFOs, and upper echelon business executives care. They are the guardians of companies' financial well-being and, ultimately, must bear responsibility for the impact of CSR on the bottom line. At multiple levels, executives need to justify that CSR is consistent with the firm's strategies and that it is financially sustainable.[a]

However, other groups care as well. Shareholders are acutely concerned with financial performance and sensitive to possible threats to management's priorities. Social activists care because it is in their long-term best interests if companies can sustain the types of social initiatives that they are advocating. Governmental bodies care because they desire to see whether companies can deliver social and environmental benefits more cost effectively than they can through regulatory approaches.[b] Consumers care as well, as they want to pass on a better world to their children, and many want their purchasing to reflect their values.

a K. O'Sullivan, "Virtue rewarded: companies are suddenly discovering the profit potential of social responsibility." *CFO*, October 2006, pp. 47–52.

b Simon Zadek. *Doing Good and Doing Well: Making the Business Case for Corporate Citizenship.* New York: The Conference Board Research Report, 2000, 1282-00-RR.

**Broad versus narrow views** Some researchers have examined the integration of CSR considerations in the day-to-day business agenda of organizations. The "main-streaming" of CSR follows from one of three rationales:

- the social values-led model, in which organizations adopt CSR initiatives regarding specific issues for non-economic reasons;
- the business-case model, in which CSR initiatives are primarily assessed in an economic manner and pursued only when there is a clear link to firm financial performance[10]; and
- the syncretic stewardship model, which combines the social values-led and the business-case models.

The business case model and the syncretic models may be seen as two perspectives of the business case for CSR: one narrow and one broad. The business case model represents the narrow view: CSR is only recognized when there is a clear link to firm financial performance. The syncretic model is broad because it recognizes both direct and indirect relationships between CSR and firm financial performance. The advantage of the broad view is that it enables the firm to identify and exploit opportunities beyond the financial, opportunities that the narrow view would not be able to recognize or justify.

Another advantage of the broad view of the business case, which is illustrated by the syncretic model, is its recognition of the interdependence between business and society.[11]

The failure to recognize such interdependence in favor of pitting business against society leads to reducing the productivity of CSR initiatives. "The prevailing approaches to CSR are so fragmented and so disconnected from business and strategy as to obscure many of the greatest opportunities for companies to benefit society."[12] The adoption of CSR practices, their integration with firm strategy, and their mainstreaming in the day-to-day business agenda should not be done in a generic manner. Rather, they should be pursued "in the way most appropriate to each firm's strategy."[13]

In support of the business case for CSR, the remainder of this section of the report discuss examples of the effect of CSR on firm performance. The discussion is organized according to the framework referenced earlier, which identifies four categories of benefits that firms may attain from engaging in CSR activities.[14]

## Reducing Costs and Risks

Cost and risk reduction justifications contend that engaging in certain CSR activities will reduce the firm's inefficient capital expenditures and exposure to risks. "[T]he primary view is that the demands of stakeholders present potential threats to the viability of the organization, and that corporate economic interests are served by mitigating the threats through a threshold level of social or environmental performance."[15]

**Equal employment opportunity policies and practices** CSR activities in the form of equal employment opportunity (EEO) policies and practices enhance long-term shareholder value by reducing costs and risks. The argument is that explicit EEO statements are necessary to illustrate an inclusive policy that reduces employee turnover through improving morale.[16] This argument is consistent with those who observe that "[l]ack of diversity may cause higher turnover and absenteeism from disgruntled employees."[17]

**Energy-saving and other environmentally sound production practices** Cost and risk reduction may also be achieved through CSR activities directed at the natural environment. Empirical research shows that being environmentally proactive results in cost and risk reduction. Specifically, data shows hat "being proactive on environmental issues can lower the costs of complying with present and future environmental regulations ... [and] ... enhance firm efficiencies and drive down operating costs."[18]

**Community relations management** Finally, CSR activities directed at managing community relations may also result in cost and risk reductions.[19] For example, building positive community relationships may contribute to the firm's attaining tax advantages offered by city and county governments to further local investments. In addition, positive community relationships decrease the number of regulations imposed on the firm because the firm is perceived as a sanctioned member of society.

Cost and risk reduction arguments for CSR have been gaining wide acceptance among managers and executives. In a survey of business executives by PricewaterhouseCoopers, 73 percent of the respondents indicated that "cost savings" was one of the top three reasons companies are becoming more socially responsible.[20]

## Gaining Competitive Advantage

As used in this section of the report, the term "competitive advantage" is best understood in the context of a differentiation strategy; in other words, the focus is on how firms may use CSR practices to set themselves apart from their competitors. The previous section, which focused on cost and risk reduction, illustrated how CSR practices may be thought of in terms of building a competitive advantage through a cost management strategy. "Competitive advantages" was cited as one of the top two justifications for CSR in a survey of business executives reported in a Fortune survey.[21] In this context, stakeholder demands are seen as opportunities rather than constraints. Firms strategically manage their resources to meet these demands and exploit the opportunities associated with them for the benefit of the firm.[22] This approach to CSR requires firms to integrate their social responsibility initiatives with their broader business strategies.

**EEO policies** Companies that build their competitive advantage through unique CSR strategies may have a superior advantage, as the uniqueness of their CSR strategies may serve as a basis for setting the firm apart from its competitors.[23] For example, an explicit statement of EEO policies would have additional benefits to the cost and risk reduction discussed earlier in this report. Such policies would provide the firm with a competitive advantage because "[c]ompanies without inclusive policies may be at a competitive disadvantage in recruiting and retaining employees from the widest talent pool."[24]

**Customer and investor relations programs** CSR initiatives can contribute to strengthening a firm's competitive advantage, its brand loyalty, and its consumer patronage. CSR initiatives also have a positive impact on attracting investment. Many institutional investors "avoid companies or industries that violate their organizational mission, values, or principles... [They also] seek companies with good records on employee relations, environmental stewardship, community involvement, and corporate governance."[25]

**Corporate philanthropy** Companies may align their philanthropic activities with their capabilities and core competencies. "In so doing, they avoid distractions from the core business, enhance the efficiency of their charitable activities and assure unique value creation for the beneficiaries."[26] For example, McKinsey & Co. offers free consulting services to nonprofit organizations in social, cultural, and educational fields. Beneficiaries include public art galleries, colleges, and charitable institutions.[27] Home Depot Inc. provided rebuilding know-how to the communities victimized by Hurricane Katrina. Strategic philanthropy helps companies gain a competitive advantage and in turn boosts its bottom line.[28]

CSR initiatives enhance a firm's competitive advantage to the extent that they influence the decisions of the firm's stakeholders in its favor. Stakeholders may prefer a firm over its competitors specifically due to the firm's engagement in such CSR initiatives.

### The Business Case in Practice

The following CSR initiatives offer practical example of the business value generated by the allocation of resources in socially responsible pursuits.

#### Reducing costs and risks

- Equal employment opportunity policies and practices
- Energy-saving and other environmentally sound production practices
- Community relations management

#### Gaining competitive advantage

- EEO policies
- Customer relations program
- Corporate philanthropy

#### Developing reputation and legitimacy

- Corporate philanthropy
- Corporate disclosure and transparency practices

#### Seeking win-win outcomes through synergistic value creation

- Charitable giving to education
- Stakeholder engagement

## Developing Reputation and Legitimacy

Companies may also justify their CSR initiatives on the basis of creating, defending, and sustaining their legitimacy and strong reputations. A business is perceived as legitimate when its activities are congruent with the goals and values of the society in which the business operates. In other words, a business is perceived as legitimate when it fulfills its social responsibilities.[29]

As firms demonstrate their ability to fit in with the communities and cultures in which they operate, they are able to build mutually beneficial relationships with stakeholders. Firms "focus on value creation by leveraging gains in reputation and legitimacy made through aligning stakeholder interests."[30] Strong reputation and legitimacy sanction the firm to operate in society. CSR activities enhance the ability of a firm to be seen as legitimate in the eyes of consumers, investors, and employees. Time and again, consumers, employees, and investors have shown a distinct preference for companies that take their social responsibilities seriously. A Center for Corporate Citizenship study found that 66 percent of executives thought their social responsibility strategies resulted in improving corporate reputation and saw this as a business benefit.[31]

**Corporate philanthropy** Corporate philanthropy may be a tool of legitimization. Firms that have negative social performance in the areas of environmental issues and product safety use charitable contributions as a means for building their legitimacy.[32]

**Corporate disclosure and transparency practices** Corporations have also enhanced their legitimacy and reputation through the disclosure of information regarding their performance on different social and environmental issues, sometimes referred to as sustainability reporting. Corporate social reporting refers to stand-alone reports that provide information regarding a company's economic, environmental, and social performance. The practice of corporate social reporting has been encouraged by the launch of the Global Reporting Initiative (GRI) in 1997-1998 and the introduction of the United Nations Global Compact in 1999. Through social reporting, firms can document that their operations are consistent with social norms and expectations, and, therefore, are perceived as legitimate.

## Seeking Win-Win Outcomes through Synergistic Value Creation

Synergistic value creation arguments focus on exploiting opportunities that reconcile differing stakeholder demands. Firms do this by "connecting stakeholder interests, and creating pluralistic definitions of value for multiple stakeholders simultaneously."[33] In other words, with a cause big enough, they can unite many potential interest groups.

**Charitable giving to education** When companies get the "where" and the "how" right, philanthropic activities and competitive advantage become mutually reinforcing and create a virtuous circle. Corporate philanthropy may be used to influence the competitive context of an organization, which allows the organization to improve its competitiveness and at the same time fulfill the needs of some of its stakeholders. For example, in the long run, charitable giving to education improves the quality of human resources available to the firm. Similarly, charitable contributions to community causes eventually result in the creation and preservation of a higher quality of life, which may sustain "sophisticated and demanding local customers."[34]

The notion of creating win-win outcomes through CSR activities has been raised before. Management expert Peter Drucker argues that "the proper 'social responsibility' of business is to … turn a social problem into economic opportunity and economic benefit, into productive capacity, into human competence, into well-paid jobs, and into wealth."[35] It has been argued that, "it will not be too long before we can begin to assert that the business of business is the creation of sustainable value—economic, social and ecological."[36]

An example: the win-win perspective adopted by the life sciences firm Novo Group allowed it to pursue its business "[which] is deeply involved in genetic modification and yet maintains highly interactive and constructive relationships with stakeholders and publishes a highly rated environmental and social report each year."[37]

**Stakeholder engagement** The win-win perspective on CSR practices aims to satisfy stakeholders' demands while allowing the firm to pursue financial success. By engaging its stakeholders and satisfying their demands, the firm finds opportunities for profit with the consent and support of its stakeholder environment.

## Conclusion

The business case for corporate social responsibility can be made. While it is valuable for a company to engage in CSR for altruistic and ethical justifications, the highly competitive business world in which we live requires that, in allocating resources to socially responsible initiatives, firms continue to consider their own business needs.

In the last decade, in particular, empirical research has brought evidence of the measurable payoff of CSR initiatives on firms as well as their stakeholders. Firms have a variety of reasons for being CSR-attentive. But beyond the many bottom-line benefits outlined here, businesses that adopt CSR practices also benefit our society at large.

### Endnotes


* This section is based on "The Business Case for Corporate Social Responsibility: A Review of Concepts, Research and Practice," which appeared in the *International Journal of Management Reviews* in 2010.

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# The Legal Case for Sustainability

by Janet E. Kerr

Due to the size of their operations and their access to capital market resources, large public companies are particularly well positioned to seize sustainable business opportunities. Their corporate boards should not be hampered by the misconception that the legal system does not protect socially outward-looking business decisions. In fact, a review of state laws of corporate governance and constituency statutes confirms that the opposite is true, and exculpatory clauses included in the charters of many companies offer additional protection. Moreover, shareholders themselves are increasingly worried about the risk of ignoring pressing sustainability issues, and environmental and social proxy resolutions are on the rise.

Corporate sustainability is strategic investing that generates two interrelated results: social progress and financial returns. In response to the inefficiencies shown by many governments, charities, and other not-for-profit organizations in solving the world's most obstinate ills of poverty, disease, and pollution, sustainable entrepreneurship is gaining legitimacy for its application of the tools of business and finance to socially relevant issues. As such, sustainable businesses approach a social or environmental problem in the same way a traditional business would embark on a market opportunity.

Today, sustainable ventures are no longer at the fringe of the business world. An increasing number of companies are adapting their business practices to sound environmental, social, and governance (ESG) standards, out of concern for the communities in which they operate or as part of a strategic plan for future growth. (See "Two Notable Cases of Sustainable Entrepreneurship" on p. 28.) This section examines the implications of sustainability on business corporations and on the body of law that governs them.

In particular, from the perspective of a board of directors of a public corporation, the section explores:

- whether the decision to pursue sustainable projects, as investments that add both social and financial value to the corporation's bottom line, should be considered within the scope of the business judgment rule; and
- whether directors have a duty to be informed about the potential for sustainable entrepreneurship in their company.

In light of increased demands from shareholders and potential changes in the regulatory environment, this section of the report highlights a range of considerations for directors as they approach the oversight of their companies' sustainability programs.

**Sustainability is not charity or philanthropy** Sustainable ventures are not about giving; they are about investing. What sets business sustainability apart from philanthropy and charity is the pursuit of profits.[1] Whereas not-for-profit organizations have strict requirements regarding capital raising and investment activities, the business corporation structure—with access to capital markets and other sources of financing, and the ability to pursue a wide array of investment opportunities—is better positioned to achieve its goals. Social entrepreneurship scholar Gregory Dees notes that progress, even in the social and environmental sphere, will continue to be fostered most effectively through market-based solutions: "If there is something that can be done and done well through a business or market-based structure, it's probably better to take advantage of that and use philanthropy for something that can't be well funded simply through the market."[2]

**The double bottom line** When adequately designed and executed, sustainable business projects can fulfill the social and financial interests of publicly held corporations and their shareholders. A key aspect of the debate on sustainability is what has become known as the "double bottom line"—the view of profits as having financial and social components. Business sustainability achieves measurable results in both areas by harnessing innovation, people, and resources to develop an enterprise that solves a social problem and yet is self-sustaining and makes money. To the extent that they comply with this double bottom line paradigm and fulfill the duties of care and loyalty owed by corporate fiduciaries to shareholders, sustainable ventures can only be supported by the laws governing corporate decision making and, ultimately, are protected by the business judgment rule.

### Two Notable Cases of Sustainable Entrepreneurship

**Google.org** Founded by Larry Page and Sergey Brin as a for-profit arm and integral part of Google Inc. that would pursue both financial and social goals. Among its first projects was to develop a mass-produced plug-in hybrid electric vehicle that can attain 100 mpg (miles per gallon). Another initiative promoted by Google.org is RE<C (Renewable Energy Cheaper Than Coal), an investment of several hundred million dollars to produce renewable energy at a profit from wind and solar sources, particularly solar thermal energy.

**Grameen Bank** A financial services company started in Bangladesh that makes small loans (known as microcredit) to the impoverished without requiring collateral. The word "grameen" is derived from the Bengali "gram" (village) and means "of the village." The business concept applies a system of group-based microcredit to the idea that the poorest people in the world have underused skills. Although each borrower must belong to a five-member group, the group is not required to give any guarantee for a loan to one of its members. Repayment responsibility rests solely on the individual borrower, while the group and the centre share oversight to ensure that members behave in a responsible way and avoid repayment problems. The bank also accepts deposits, provides other services, and runs several development-oriented businesses including fabric, telephone, and energy companies. Another distinctive feature of the bank's credit program is that a significant majority of its borrowers are women. The organization and its founder, Muhammad Yunus, were jointly awarded the Nobel Peace Prize in 2006.

*Sources:* www.google.org; www.gremeen-info.org

**Sustainability and corporate governance** The notion of sustainability is consistent with corporate governance standards for at least three main reasons:

1. Judicial action and recent shareholder constituency statutes have opened the door for corporate leaders to consider non-shareholder interests and concerns when making investment decisions.
2. There is a growing body of knowledge on measuring financial and social impact that shows that sustainable ventures can be sound, profitable investments generating long-term wealth.
3. Fierce global competition compels corporate leaders to seek new investment opportunities; such opportunities may include those in emerging markets, where lower ESG standards lead to suboptimal investment performance.

For these reasons, it can be argued that directors' duty of care extends to being informed about those sustainable investment opportunities with a measurable double bottom line that the company might pursue. Such information is material to responsible board action and should be part of any sound decision-making process.

## Fiduciary Duties and Stakeholder Interests

The role of business in society has been the subject of long-standing debate.[3] Should the board of directors of a business corporation have a duty to consider the interests of its non-shareholder constituents—including bondholders, employees, customers, suppliers, and the local communities in which the company operates? Or is the exclusive focus of the board to maximize financial profits solely for the benefit of the business owners? Given that the operating revenues of large American corporations exceed many countries' GDP, the question of just how "socially responsible" a corporation must be merits the attention of thought leaders, policy makers, and the business community.[4]

It is widely recognized that members of the board of directors of a business corporation are instilled with the duties of due care, good faith, and loyalty. Those duties form the core of corporate governance and build an overarching foundation of trust and confidence. Under the Model Business Corporation Act (MBCA), "[e]ach member of the board of directors, when discharging the duties of a director, shall act: (1) in good faith, and (2) in a manner the director reasonably believes to be in the best interests of the corporation."[5]

In addition to setting the baseline standard for due care, MBCA states that directors "shall discharge their duties with the care that a person in a like position would reasonably believe appropriate under similar circumstances."[6] Also incorporated in the directors' fiduciary duty of care is the duty to act on an informed basis, which requires directors to consider all material facts reasonably available before making a decision.[7]

**The business judgment rule** Fundamentally related to directors' duty of care is the business judgment rule. The business judgment rule gives a rebuttable presumption that, when making business decisions, directors act loyally and diligently and are therefore in compliance with their fiduciary responsibilities. Although for the most part not codified in statutes, the business judgment rule is well established in case law, and the presumption holds true even in states that have their own statutory due care standards.[8]

Because of the presumption instituted by the rule, the burden of proof is shifted to the plaintiff, who must allege sufficient facts to raise doubts that directors have indeed satisfied their duties.[9] Other ways to overcome the presumption include proving that the director was acting fraudulently, illegally, or in conflict of interest, or showing that the director's action lacked any rational business purpose. Justification for maintaining this presumption is based on three policy goals, as the business judgment rule:

- promotes risk taking;
- avoids judicial meddling; and
- encourages directors to serve.[10]

Without such protection, legal responsibilities imposed on directors would generate a disincentive to pursue entrepreneurial initiatives.

**Evolving court standards** Primarily, corporate law is established in state courts. Interestingly, courts asserted early on that corporate fiduciaries, while pursuing value maximization for the owners, may also consider the interests of key stakeholder groups. For example, in *Shlensky v. Wrigley* (1968), an Illinois court decided a case of potential director liability under the business judgment rule and held that "the effect on the surrounding neighborhood might well be considered by a director."[11] In addition, several holdings by the Supreme Court of Delaware—the most prominent state of incorporation—sanctioned the consideration of third party interests. In *Unocal Corp. v. Mesa Petroleum Co.*[12] (1985) and *Paramount Communications, Inc. v. Time Inc.*[13] (1989), two influential legal precedents in the following decades, the court underscored the importance of assessing the impact on key stakeholder relations of a business decision made in the context of hostile takeovers and shareholder-instituted derivative actions.

Today, a growing number of legal theorists view the corporation as a nexus of complex relations and hold that the ultimate interest of the business should be analyzed with regard to its key interest constituencies.[14] Corporate practices are gradually adapting to this approach, as organizations introduce the use of metrics designed to evaluate the link between such business relations and stock prices. In a research report by The Conference Board, the stakeholder theory of the firm has also been applied to the notion of reputation capital—a corporate asset resulting not from the reputation of the firm within the public at large but from those stakeholder relationships that are instrumental to the company's pursuit of long-term shareholder interest.[15]

As such, reputation capital is quantifiable in dollar value and, with its economic connotation as a shareholder value enhancer, it places reputation risk management within the boundaries of directors' and officers' fiduciary duties.

**Constituency statutes** During the 1980s, the large majority of state legislatures across the country enacted corporate governance statutes for the purpose of "provid[ing] corporate leaders with a mechanism for considering stakeholder interests without breaching their fiduciary obligations to shareholders."[16] Thanks to these "constituency statutes," corporate decision-makers have broken with the past role "to simply create jobs, deliver goods and services, increase shareholder wealth, and demonstrate goodwill to the community through philanthropy."[17] In general, these statutes have granted more freedom to the strategic decision-making process of boards of directors across the nation. The underlying theme of these statutes is that a director may determine what is in "best interests of the corporation" apart from what directly and immediately benefits the shareholders.

## Shareholder Pressure

Shareholders themselves are increasingly worried about the business risks that may result from ignoring pressing sustainability issues. For this reason, in recent years, institutional investors appear to be increasingly incorporating social and environmental considerations into their proxy voting decisions, as demonstrated by voting trends and institutional investor initiatives.[a]

Until recently, the SEC had consistently reiterated a policy under which shareholder proposals relating to the evaluation of risk could be excluded from a company's proxy materials based on the view of risk and risk management as matters related to a company's day-to-day business operations.[b] In 2008, on this basis, Washington Mutual, Bear Stearns, and Lehman Brothers were able to dismiss shareholder proposals asking for a report on subprime lending practices and risks.

The policy in question was reversed in October 2009, in recognition of the fact that the inadequacy of risk oversight played a major role in the recent financial crisis and produced severe consequences for many companies and their shareholders. In a Staff Bulletin, the SEC noted "that there is widespread recognition that the board's role in the oversight of a company's management of risk is a significant policy matter regarding the governance of the corporation. [Therefore,] a proposal that focuses on the board's role in the oversight of a company's management of risk may transcend the day-to-day business matters of a company and raise *policy issues so significant* that it would be appropriate for a shareholder vote."[c]

Climate change risk issues In particular, the policy reversal is expected to reinvigorate investor demands on disclosure of risk resulting from the company's policy on environmental and social issues, including proposals for additional disclosure on climate change risk.

In fact, on February 2, 2010, the SEC issued new guidance to public companies regarding the application of disclosure requirements to climate change matters. Under the guidelines, companies—including many that might not otherwise have considered the topic as relevant to their business—will need to broaden their review of climate change issues from thinking primarily about the costs of compliance with existing and pending environmental laws to considering, among other things, the potential physical impacts of climate change on their businesses (such as changing weather patterns) and the effects of climate change on the demand of their products and services or their costs of goods sold.[d]

Consistently with the new disclosure guidance and the October 2009 policy reversal, in February 2011, the SEC's Division of Corporation Finance denied a no-action request submitted by Goldman Sachs, which intended to exclude from the proxy statements a proposal "that the board prepare a report disclosing the business risk related to developments in the political, legislative, regulatory, and scientific landscape regarding climate change." In denying exclusion, the Staff noted "that the proposal focuses on the [risk related to the] *significant policy issue* of climate change."[e]

Proponents of these types of resolutions argue that a significant risk to the business and its shareholders may stem from the growing scientific proof that the burning of fossil fuels causes global warming and possible future legislation making companies financially liable for their contributions to global warming. The same considerations persuaded ISS, a proxy voting advisor, to recommend institutional investors to vote in favor of similar proposals.[f]

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a Carolyn Mathiasen, Corporate Social Issues: A 2011 Proxy Season Preview, ISS Governance, February 2011, available at [www.issgovernance.com].

b Rule 14a08(i)(7) under the Securities Exchange Act of 1034.

c Shareholder Proposals, SEC Staff Legal Bulletin No. 14E (CF). Emphasis added.

d SEC Release No. 33-9106; 34-61469, "Commission Guidance Regarding Disclosure Related to Climate Change," February 2, 2010 (available at [www.sec.gov/rules/interp/2010/33-9106.pdf]). For a commentary, see Kenneth Berlin, Don J. Frost, Marc S. Gerber, Jane B. Kroesche, and William L. Thomas, "SEC Issues Guidance on Climate Change Disclosure," Skadden, Arps, Slate, Meagher & Flom, Client Memorandum, February 4, 2010.

e SEC Response to Goldman Sachs' no-action letter of December 20, 2010, Division of Corporation Finance, SEC, February 7, 2011, available at [http://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2011/nationalcenter020711-14a8.pdf].

f 2011 SRI U.S. Proxy Voting Guidelines, ISS Governance, January 2011, p. 74, available at [http://www.issgovernance.com/files/ISS2011SRIUSGuidelines.pdf].

*Source:* Matteo Tonello, *Risk Oversight Handbook: Legal Standards and Board Practices*, The Conference Board, forthcoming, 2011.

Some statutes are limited to decisions affecting corporate control, but most extend to any corporate action, irrespective of the circumstances the corporation faces. In some cases, directors may consider other pertinent factors, such as national and state economies and the long-term and short-term effects of a transaction as well as the benefits of remaining independent.[18] However, conspicuously absent from the list of states adopting constituency statutes is Delaware, the state of incorporation of the majority of Fortune 500 public companies.

**Exculpatory clauses** In 1986, the Delaware legislature amended the Delaware General Corporation Law Code by adding a statutory provision designed to insulate corporate directors from monetary liability for any actions arising from a breach of their duty of care.[19] The majority of other states were quick to follow Delaware's lead and pass similar board of director shield provisions. These exculpatory clauses—which ought to be included in a company's certificate of incorporation and therefore approved by shareholders—provide more freedom and leniency to directors in their decision-making capacity, and encourage them to take strategic risks.[20]

### Pennsylvania's Constituency Statute

Pennsylvania was the first state in the country to adopt a non-shareholder constituency statute. Under such statute, "[i]n discharging the duties of their respective positions, the board of directors, committees of the board and individual directors of a business corporation may, in considering the best interests of the corporation, consider to the extent they deem appropriate:

1 The effects of any action upon any or all groups affected by such action, including shareholders, employees, suppliers, customers and creditors of the corporation, and upon communities in which offices or other establishments of the corporation are located.

2 The short-term and long-term interests of the corporation, including benefits that may accrue to the corporation from its long-term plans and the possibility that these interests may be best served by the continued independence of the corporation.

3 The resources, intent and conduct (past, stated and potential) of any person seeking to acquire control of the corporation."

*Source:* 15 Pa. Cons. Stat. §1715.

## Measuring Social Return on Investment

The driving force behind sustainable entrepreneurship is the maximization of the positive social impact that results from profitable business decisions. For this reason, a company's ability to quantify both financial returns on investment (ROI) and social return on investment (SROI) is crucial in determining whether a certain business undertaking meets the double bottom line and ultimately adds shareholder value.

Measuring ROI is relatively easy and well understood: public companies around the world abide by generally acceptable accounting principles such as the U.S. GAAP or the International Financial Reporting Standards (IFRS). On the other hand, despite a quite developed body of knowledge regarding SROI, there currently is no single, standardized set of metrics on which corporations can rely to quantify the social and environmental performance of a business venture. Poor standardization is primarily the result of the lack of extensive qualitative data on social impacts, given that many analyses appear to be marred by personal or political influences. Needless to say, without standards it is difficult to conduct comparability studies among different businesses or businesses in different industries, which leads to further limitations in the production of qualitative data.

A 2003 study from the Haas School of Business' Center for Responsible Business (CRB) at the University of California at Berkeley presented ten standard guidelines for evaluating and reporting SROI.[21] The study contributed a set of data whose analysis can provide important insights into how social value is actually created (or destroyed), and what it really costs.[22] This section illustrates the methodology introduced with the CRB study as one of the most comprehensive frameworks for understanding the social ramifications of business decisions. However, the CRB framework is far from the only initiative for standardization in this field. The literature on SROI has been expanding over the last decade, as already documented in 2005 by The Conference Board in *The Measure of Success.*[23]

**Calculating SROI** The CRB report defines SROI as "the social impact of a business or nonprofit's operations in dollar terms, relative to the investment required to create that impact and exclusive of its financial return to investors."

To calculate the SROI of a business venture, the report suggests the following five-step method:[24]

1 Quantify the non-financial impact of operations per unit. For example, suppose two units, where the social impact is reduction in visits to the emergency room in Unit 1 and reduction in $CO_2$ emissions in Unit 2. Also suppose a 10 percent reduction in visits to emergency room equals 150 fewer visits per year and a six percent reduction in $CO_2$ emissions equals a reduction of 12,000 tons of $CO_2$ per year.

2 Translate this figure into dollar terms per unit to achieve social cash flows (SCFs). In the example illustrated in the report: the cost of a single ER visit is $250, which, multiplied by 150 visits avoided each year, equals $37,500 in savings per year. Similarly, $CO_2$ costs $1.25 per ton based on the regional emissions trading market; as a result, a 12,000-ton reduction equals $15,000.

3 Calculate annual social cash flow by summing all of the SCFs assessed for all of the units affected by the social business venture. Annual social cash flow in the example is $52,500.

4 Discount the SCFs to present value, using an appropriate discount rate. For this purpose, some companies may decide to refer to the municipal bond rate, while others use the 30-year Treasury bond rate based on the argument that they are saving federal and other governmental funds through their activities. Sufficient disclosure should be provided on the rationale for either choice as well as for assumptions made. As for the time frame for social return on investment projections, there is no standard, but any projection beyond five years may be so uncertain as to be meaningless.

5 Calculate SROI by dividing this number by the investment to date in the social business venture. Assuming that the present value of annual social cash flow — as calculated under the discounted cash flow formula chosen in Step 4 — is $171,993 and that the investment in the social business amounts to $100,000, SROI equals 172 percent.

**Guidelines on SROI application** On its own, SROI is not very useful unless applied and presented in a consistent manner by a large number of companies. For this purpose, the CRB report advocates establishing a contextual framework for the standardization of SROI reporting. The guidelines are based on the analysis of *pro forma* disclosure documents submitted by 88 companies embarking on a social business venture. The aim is to make SROI metrics more comprehensive, credible, and useful for entrepreneurs, managers, and analysts. Such a common framework would also enable investors to compare the social impact of different firms within the same industry. Under the framework guidelines, companies adopting this calculating method should:[25]

1 Include both positive and negative impacts in their SROI assessment.

2 Consider impacts made by and on all stakeholders — including employees — before deciding which impacts are material enough to be included in the final calculation.

3 Include only impacts that are clearly and directly attributable only to the company's activities and avoid crediting the business venture for social impacts for which it is not (fully) responsible.

4 Avoid double-counting the value (financial and social) created by the company, and do not mix this calculation method with the market valuation of social impacts, unless market valuation is fully transparent about total costs and benefits of those impacts.

5 Exclude from the final calculation the social impact created by the business venture in industries or geographic areas where any business — irrespective of its social connotation — would create a similar social impact. SROI should describe only what makes the company different from a standard venture.

6 Only quantify or monetize social impacts if it appears logical given the context of the business or industry. For example, a business manufacturing solar energy technology for use in developing countries identified multiple metrics to explain the company's impact, from electricity savings to increased quality of life to projected lives saved due to reduced harmful pollutants. Not all of these impacts (such as increased quality of life) could be accurately monetized, and some (such as lives saved) could not be meaningfully reduced to monetary terms alone.

7 Put numeric metrics into context (e.g., this period versus last period, or this company versus similar companies) to add meaning to SROI. By itself, SROI coalesces the company's social performance into a single figure and cannot possibly tell the whole story of the company's social impact without contextual information. Comparative information, in particular, is helpful.

8 Address risk factors affecting SROI in the assumptions to the calculation and carefully consider and document the choice of discount rate for SCFs.

9 Carry out a sensitivity analysis to identify key factors, including projected outcomes. The current absence of standards in measuring social impact makes it important to understand how dependent the final calculation is on initial assumptions as well as to determine a range of possible social impacts.

10 Include ongoing tracking of social impact. It is crucial for the SROI assessment exercise to be fully integrated into business operations so that it becomes a continuous and coherent practice. Many of the impacts that would need to be measured across the enterprise would likely require a system to capture even more data than is already used for financial accounting purposes.

As mentioned earlier, the CRB framework is only one of many attempts made by the academic and business communities to foster the standardization of social performance metrics. Together, these initiatives are indicative of a growing body of knowledge in the field that can be of use—alongside financial measures—to a board of directors in its strategic planning and risk oversight activities. In fact, the increasing sophistication of social impact assessment supports the argument made earlier in this section of the report that, as part of their duty to make informed decisions, directors should seek out this new set of data and either hire experts to calculate it or require the company to develop internal capabilities.

## Sustainability as a Strategic Imperative

The third reason why the notion of sustainability is consistent with corporate governance standards is that sustainable ventures can be strategically compelling ventures. A number of factors and research findings support this final argument.

**Business viability** Moral obligations aside, companies pursue social matters because they see a business case for social response. Ian Davis, the former managing director of McKinsey & Company, argues that the "business of business is business" mindset[26] masks the principle that "social issues are not so much tangential to the business of business as fundamental to it."[27] Social issues have a significant effect on the long-term prospects of the corporation and, even in the absence of short-term results, it would be poor strategy for companies to delay preparing for or tackling these issues. Even though academic research has unveiled mixed results, many studies confirm a correlation between ESG-based investment criteria and financial performance. Specifically, in the last few years, reputable publications have documented the positive relationship between stock market prices and employee satisfaction,[28] eco-efficient production processes,[29] and the quality of CSR disclosure.[30] Given the interest shown in the topic by financial analysts around the globe, the body of academic literature addressing the link between ESG factors and financial performance should continue to grow.

**Social innovation** Moreover, corporations that enter into these ventures add both financial and social value to their bottom lines. Sustainability can pursue solutions to some of our society's most obstinate problems while giving the business an entry into emerging markets, either in the form of technological innovation or by importing existing business models to underdeveloped regions of the world. A Harvard Business School study terms this concept "social innovation."[31] The strongest business strategy of the future will most likely include a systematic plan to move beyond corporate social responsibility (CSR) as it has been viewed in the last two decades (that is, as a somewhat passive support of social causes) to a more proactive and ingenious involvement in the development of pragmatic solutions to the challenges humanity faces today.[32] Therefore, social innovation is a new paradigm that considers community needs not as social ills requiring "Band-Aid" remedies, such as donations and volunteer work, but as valuable opportunities to develop ideas, demonstrate technologies, and find and serve new markets.

**Reputation risk** Today, neglecting key stakeholders poses a formidable reputation issue to business corporations. Sensitivity to reputational problems is particularly important for larger public companies whose relation with external constituents is closely scrutinized by financial analysts and other gatekeepers. Sustainability has been described as a combination of the "three Ps: profits, people (employees, customers, and suppliers), and place (environment and community),"[33] which shows that profitability is not disregarded or diminished, but instead supplemented or augmented, by the simultaneous consideration of people and place. Corporations are increasingly susceptible to being affected by consumers' perception of CSR initiatives. This trend has also been extensively investigated by academic researchers, who have generally found that a large majority of American consumers "take corporate citizenship into account when deciding whether to buy a particular company's product"[34] and would be likely to switch brands to one associated with a good cause, if price and quality are similar.[35]

**Cost of externalities** Finally, sustainable business ventures are cost-efficient as they reduce the impact of negative externalities. In economic terms, an externality is any side effect or consequence of an economic activity that is not (fully) reflected in market prices. Externalities can be either positive (when an external benefit is generated) or negative (when an external cost is generated). The most commonly discussed negative externalities involve pollution and environmental degradation.

Examples of positive externalities include investment in products and services that result in better recycling habits and higher standards of living for local communities. Negative societal externalities do not show up on financial statements; although the corporation producing the externality is not always held accountable for it, a number of legislative measures have been introduced over the last two decades to restrain the impact of such externalities (e.g., carbon tax legislation). Similarly, some fiscal policies encourage companies to adopt business models that can systematically generate positive externalities (e.g., incentives for manufacturers of low-cost, fuel-efficient automobiles). The main thrust of the discussion of externalities is that, by strategically undertaking sustainable business goals, corporations can maximize the benefits of positive externalities while mitigating the costs of negative ones.

## Conclusion

Large public companies, because of their size and access to capital market resources, are particularly well positioned to seize sustainable business opportunities. Corporate boards, however, might still be hampered by three misconceptions:

1. decisions having a social impact cannot also have a positive financial impact;
2. social impact cannot be measured and quantified scientifically; and
3. the current legal system does not protect socially outward-looking business decisions.

Concerning the first two misconceptions, some boards still view shareholder profit maximization and consideration for outside stakeholders as an either/or proposition. This assumption is incorrect. Academic research has documented the correlation between ESG investment criteria and stock performance.

Moreover, with the advent of sophisticated computer models, new methods have been created to attach a numeric value to social performance and benchmark results across corporate size groups and business industries. As for the last misconception, under the state laws of corporate governance, any well-informed decision by a board of directors to consider stakeholder interests as a means to pursue durable shareholder value maximization is likely to be fully protected by the business judgment rule. Constituency statutes adopted by many state legislatures in the United States and exculpatory clauses included in the charters of many publicly held corporations offer additional protection.

### Endnotes

1 Note that some experts object to the exclusion of philanthropy from the sub-categories of corporate sustainability and observe that, by benefiting the communities in which a business operates, corporate contributions can generate an intangible return for the business. See, for example, John Peloza and Jing-hi Shang on page 53 and Baruch Lev et al. on page 79.

2 “The Past, Present and Future of Social Entrepreneurship: A Conversation with Greg Dees,” Duke University, Center for the Advancement of Social Enterprise, May 2006, [http://www.caseatduke.org/articles/0506/casecorner.htm].

3 See, generally, E. Merrick Dodd, Jr., “For Whom Are Corporate Managers Trustees?” *Harvard Law Review*, Vol. 45, pp. 1148-50, 1932 and William T. Allen, “Our Schizophrenic Conception of the Business Corporation,” *Cardozo Law Review*, Vol. 14, pp. 261-270, 1992.

4 For example, Wal-Mart’s revenues dwarf the GDP of such developed countries as Norway, Finland, Greece, Portugal, and Saudi Arabia. See Sarah Anderson and John Cavanaugh, *Top 200: The Rise of Corporate Global Power*, Institute for Policy Studies, December 4, 2000, available at [http://www.corpwatch.org/article.php?id=377]. As far back as 2000, only 49 of the world’s largest economies were countries; the remaining 51 were global corporations.

5 Model Business Corporation Act (MBCA) Section 8.30(a).

6 Id., Section 8.30(b).

7 The Delaware Supreme Court has interpreted the duty to be informed to mean that the board of directors does not have to be informed of all facts, but only of those that are material and within the board’s reasonable reach. For a discussion of fiduciary duties under Delaware law and their applicability to corporate directors, see Matteo Tonello, *Corporate Governance Handbook: Legal Standards and Board Practices*, The Conference Board, 2009, pp. 14-17.

8 On the application of the business judgment rule to various business transactions, see Dennis J. Block, Nancy E. Barton, and Stephen A. Radin, *The Business Judgment Rule: Fiduciary Duties of Corporate Directors*, Fifth Edition, 2002 Cumulative Supplement, (New York: Aspen Publishers, Inc., 2002).

9 The business judgment rule does not apply in those cases where directors have manifestly violated their responsibilities (i.e., by virtue of a “manifest” conflict of interest or a “grossly negligent” decision-making process or other situations of bad faith). See, for example, *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156 (Del. 1995).

10 See Edward Brodsky and M. Patricia Adamski, *Law of Corporate Officers and Directors: Rights, Duties and Liabilities*, Thomson Reuters-West, 2009, p. 4-01.

## Endnotes (continued)


11 *Shelnsky v. Wrigley*, 237 N.E. 2d 776, 780 (Ill. App. Ct. 1968).

12 *Unocal Corp. v. Mesa Petroleum Co.* 493 A.2d 946, 955 (Del. 1985), discussing how boards should consider the impact on constituencies other than shareholders when analyzing the reasonableness of defensive measures.

13 *Paramount Communications, Inc. v. Time Inc.*, 571 A. 2d 1140, 1153 (Del. 1989), elaborating on the appropriate use of the *Unocal* analysis.

14 See, for example, Gregory V. Varallo and Daniel A. Dreisbach, "Fundamentals of Corporate Governance. A Guide For Directors and Corporate Counsel," *ABA Section of Business Law*, American Business Association, 1996, pp. 4-5.

15 See Matteo Tonello, *Reputation Risk: A Corporate Governance Perspective*, The Conference Board, Research Report No. 1412, 2007, pp. 17-20.

16 See Kathleen Hale, "Corporate Law and Stakeholders: Moving Beyond Stakeholder Statutes," *Arizona Law Review*, Vol. 45, 2003, p. 829. Although most state constituency statutes are relatively similar, there are four general variations based on: 1. whether stakeholder consideration is mandatory or permissive; 2. whether stakeholder consideration applies to officers in addition to directors; 3. the circumstances in which the statutes apply; and 4. what stakeholder interests corporate leaders are allowed to consider.

17 Bradley K. Googins, A New Business Model for the 21st Century, Boardroom Briefing, Winter 2006, available at [www.directorsandboards.com/ dbebriefing/ December2006/Winter06BB.pdf].

18 Cammon Turner, "Revlon Duties and State Constituency Statutes," *ABA Section of Business Law*, American Bar Association, January/February 1999, available at [http://www.abanet.org/buslaw/blt/8-3shareholders.html].

19 Delaware Code Annotated, Title 8, Section 102(b)(7).

20 For a discussion of exculpatory clauses, see Bernard S. Sharfman, "Being Informed Does Matter: Fine Tuning Gross Negligence Twenty-Plus Years After van Gorkom," *The Business Lawyer*, Vol. 65, 2006, p. 135. The author emphasizes a number of reasons why being sufficiently informed still matters, despite the existence of a board of director shield provision (pp. 137-38): 1. These clauses only protect from monetary damages; 2. Courts view the clause more as an affirmative defense; 3. Directors still want to protect their reputation as well as future demand for their services; and 4. Non-compliance may violate directors' insurance coverage

21 Sara Olsen and Alison Lingane, *Social Return on Investment: Standard Guidelines*, Center for Responsible Business Working Paper, University of California at Berkeley, September 29, 2003, available at [http:// escholarship.org/uc/item/6xp540hs].

22 Id., p. 14.

23 Thomas E. Cavanagh, Anu Oza, and Charles J. Bennett, *The Measure of Success. Evaluating Corporate Citizenship Performance*, The Conference Board, Research Report 1372, 2005.

24 Id., p. 6.

25 Id., pp. 7-11.

26 See Milton Friedman, "The Social Responsibility of Business is to Increase Its Profits," *The New York Times Magazine*, September 13, 1970.

27 Ian Davis, "What Is the Business of Business," *McKinsey Quarterly*, 2005, p. 104.

28 Alex Edmans, "Does the Stock Market Fully Value Intangibles? Employee Satisfaction and Equity Prices," University of Pennsylvania—The Wharton School Working Paper, August 12, 2009, available at [http://ssrn.com/ abstract=985735].

29 Jeroen Derwall, et al., "The Eco-Efficiency Premium Puzzle," *Financial Analysts Journal*, March-April 2005, pp. 51-63.

30 Marc Orlitzky, "Social Responsibility and Financial Performance: Trade-off or Virtuous Circle?" *University of Auckland Business Review*, 2005, Volume 7, Issue 1, pp. 37-43; and Marc Orliztky, Frank L. Schmidt, and Sara L. Reynes, "Corporate Social and Financial Performance: A Meta-analysis," *Organization Studies*, 2003, Volume 24, Issue 3, pp. 403-441.

31 Rosabeth Moss Kanter, "From Spare Change to Real Change," *Harvard Business Review*, May-June 1999, pp. 124-125.

32 Also see Janet E. Kerr, "The Creative Capitalism Spectrum: Evaluating Corporate Social Responsibility Through a Legal Lens," *Temple Law Review*, 2009, Volume 81, Issue 3, pp. 831-870, where the notion of social innovation is further explored. In particular, the study introduces the "Creative Capitalism Spectrum" as a new way to define CSR. Recent scholarship has been devoted to redefining CSR, but it fails to take into account the legal implications of making public statements about CSR. The Creative Capitalism Spectrum provides directors with objective guidelines based on legal principles to corroborate a public statement of a corporation's social responsibility.

33 Deborah Talbot, "From Shareholders to Stakeholders: The Corporate Board's Newest Challenge," *Boardroom Briefing—Directors & Boards Magazine*, 2006, p. 10.

34 Julie S. Roberts, "Responsible Business=Good Business," *Inside Supply Management*, May 2004, p. 7.

35 *2009 Cone Consumer Environmental Study*, Cone LLC, Research and Insights, February 18, 2009. Despite the dire state of the economy, 34 percent of American consumers indicate they are more likely to buy environmentally responsible products today, and another 44 percent indicate their environmental shopping habits have not changed as a result of the economy. Only 8 percent say they are less likely to buy.

# Emerging Sustainability Practices

by Matteo Tonello

Despite formal assignment of responsibilities to top business leaders, many companies still lack the structural framework to enable proper director oversight of corporate sustainability. In particular, what appears to be largely missing is access to independent sources of information as well as the detailed procedures and metrics for effectively integrating social objectives into daily business activities. However, a rapidly developing regulatory climate and the increased sensitivity of enforcement authorities to the risk implications of environmental issues have opened the door to shareholder activism in this field. Most recently, the success rate of social funds demanding change has risen to levels that were unimaginable only a few years ago.

This section of the report discusses the findings from a survey recently conducted by The Conference Board to assess how and to what extent social and environmental issues are integrated into the strategic agenda of the U.S. public company board. (See "The Conference Board Survey" on page 49 for additional discussion of the methodology and participating companies.)

As an exemplification of the breadth of subjects the term sustainability may encompass, Chart 1 illustrates the social and environmental issues that, according to survey respondents, boards of directors will be facing in the near future.

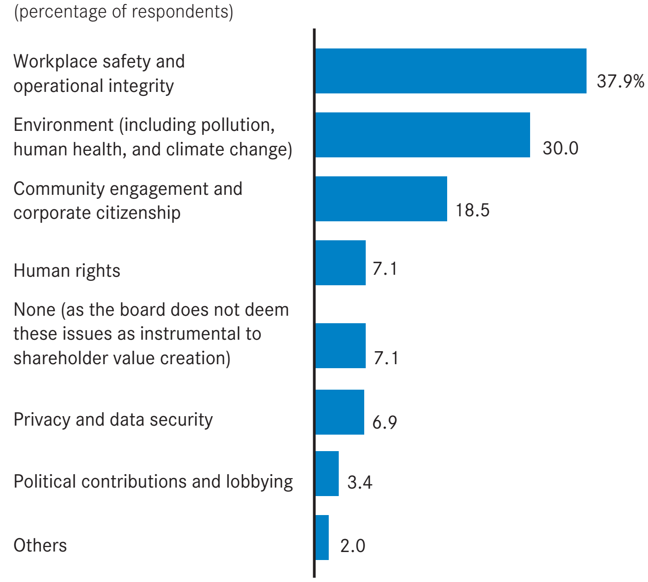
The research findings illustrate the following trends:

- The motivational drivers of board oversight of sustainability initiatives
- Board structure issues, including the allocation of resources and the assignment of responsibility for sustainability initiatives
- The use of widely recognized standards to define and plan sustainability initiatives

Chart 1

**Issues likely to be faced by the corporate board in the coming year**

(percentage of respondents)




N=54

*Source*: The Conference Board, 2010. Based on the potential strategic relevance to the participating company, as assessed by the respondent. Percentages refer to respondents ranking the issue as the most strategically relevant on a scale of 1 to 8.

- Sustainability performance measures and reporting issues, and
- Corporate response to shareholder activism in this area

What follows are the major research highlights:

- The growing interest by corporate directors in social and environmental issues can be explained by several motivational drivers, including the increasing awareness of the critical influence of stakeholder relations on firm performance and the pressure resulting from regulatory bodies, enforcement agencies, and activist investors (p. 38).
- Despite formal assignment of responsibilities to top corporate leaders, many companies still lack the structural framework to enable proper director oversight. In particular, what appears to be largely missing is access to independent sources of information and detailed procedures for effectively integrating sustainability objectives into daily business activities (p. 40).
- Many surveyed organizations do not employ any of the widely endorsed standards existing today in many areas of social and environmental concerns; often, these companies resort to their own definition of sustainability, therefore preventing the development of a level playing field for performance assessment by investors and other constituents (p. 41).
- The majority of companies reviewed by the study do not assess the impact of their sustainability activities on the organization's financial performance (p. 42).
- However, recent regulatory developments and the increased sensitivity of enforcement authorities to the risk implications of environmental issues have opened the door to shareholder activism in this field. In the last couple of years alone, dedicated socially responsible investment companies and large retirement funds have submitted a growing number of resolutions on several matters of corporate sustainability, ranging from climate change to political spending and from board diversity to pay disparity. Today, more than ever, directors are expected to understand the rationale of similar requests for change and adapt business strategies and corporate processes to evolving market trends and emerging standards (p. 45).

## Drivers of Sustainability Oversight

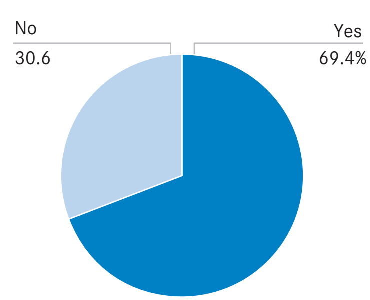
A convergence of factors is contributing to the increased interest in sustainability issues by corporate directors and top business leaders. Overall, these factors help explain why as many as 70 percent of respondents to The Conference Board survey report that their board oversees the organization's initiatives in this area and integrates them into the business strategy and governance practices (Chart 2). Motivational drivers range from changing investor expectations to new regulatory pressures, and the impending need to revisit and adapt business strategies to the increasing awareness of the importance of cultivating stakeholder relations.

**Changing investor expectations** Concerns about social and environmental risks facing the company are no longer shared only by smaller, fringe investors and special interest groups. The level of support received by shareholder proposals related to issues and practices of sustainability has more than doubled over the last decade and signals the growing involvement of mainstream investors.[1] With respect to certain issues, such as climate change, the effort and perseverance of leading environmental organizations such as the Interfaith Center on Corporate Responsibility (ICCR)[2] and Ceres (formerly the Coalition for Environmentally Responsible Economies)[3] were instrumental in launching of successful initiatives such as the Investor Network on Climate Risk (INCR)[4] and the Carbon Disclosure Project (CDP).[5] At the same time, companies have become more open to new forms of constructive dialogue with investors[6] and, at the end of the 2009 proxy season, most filed social and environmental proposals were withdrawn by proponents as a result of negotiations.[7]

Chart 2

**Does your board of directors oversee sustainability issues and integrate them into the company's business strategy and governance practices?**

(number of respondents; percentage of total respondents)




N=49

*Source*: The Conference Board, 2010.

#### Increasing awareness of key stakeholder relations

Today's business leaders have become quite sensitive to indicators of reputational capital, which is the perception of the corporation by those stakeholders whose relationship and support is directly instrumental to the pursuit of long-term growth and shareholder value. Enhancing and protecting key stakeholder relations is increasingly viewed as a critical component of any strategic decision-making process and requires a cautious allocation of resources, which should be made in light of the organizational and industry context in which the firm operates.[8]

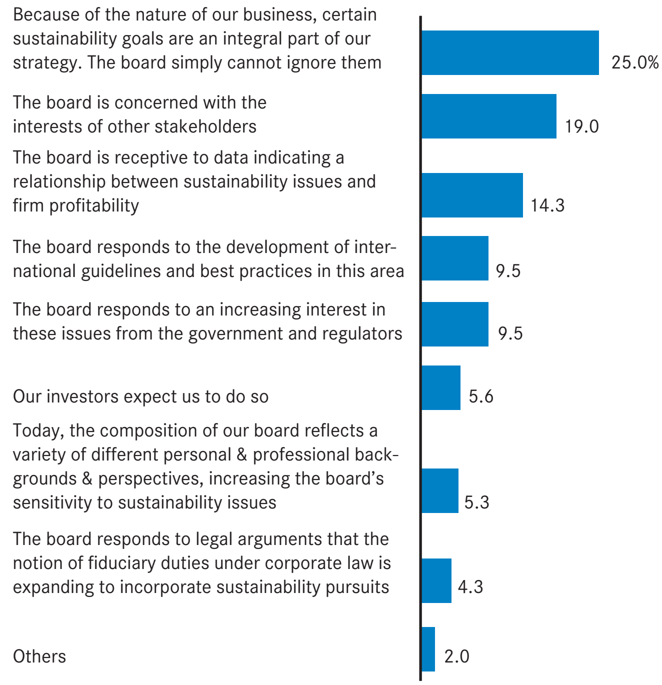
**The pursuit of alternative business strategies** The rise of information technology and the development of new service industries, the globalization of production processes and trade markets, and the capital restraints most recently caused by the financial crisis have posed new challenges on traditional business strategies. Historically, businesses have derived most of their value from tangible assets like plants and equipment. Instead, in today's modern, service-oriented business organization, a firm's value rests on a variety of intangible assets, including innovative production mechanisms, quality controls, customer satisfaction, and third-party relationships. To many companies, from the energy sector to the manufacturing of electronics, the sensitivity to social and environmental issues has become the key to unlock new business potentials associated with those intangibles.[9] In some cases, such as with energy efficiency, the 2008 recession provided an additional stimulus to this transition, as the need to cut operating costs to maintain competitiveness became ever more valued by executives, their boards, and their shareholders.[10]

**Legislative and regulatory pressure** In his January 27, 2010 State of the Union address, President Obama placed the passage of comprehensive energy and climate legislation near the top of his domestic agenda.[11] On the same day, the U.S. Securities and Exchange Commission approved an interpretive release entitled "Commission Guidance Regarding Disclosure Related to Climate Change,"[12] signaling the intention of the new leadership at the regulatory agency to closely monitor social and environmental disclosures included by public companies in their annual filings. The disclosure guidance followed the October 2009 announcement that the SEC Staff would no longer allow management to exclude from the voting ballot shareholder proposals relating to the evaluation of risk,[13] including risk resulting from the company's policy on environmental and social issues.

Chart 3

### Motivational drivers of the governance-sustainability integration

(percentage of respondents)




N=54

*Source*: The Conference Board, 2010. Based on the participating company's own experience, as assessed by the respondent. Percentages refer to respondents ranking the driver as the most important on a scale of 1 to 9.

Finally, in the last two years, federal appellate courts and the New York State Attorney General have reported cases of investigation of environmental disclosure practices.[14] Most commentators predict an increased public scrutiny of corporate initiatives in this area as well as the likely comprehensive revision of the reporting framework to which listed companies are subject so as to include disclosure requirements of material environmental, social, and governance risks.[15]

**Research on sustainability and firm profitability** Over the years, research investigating the link between sustainability-based strategies and firm performance has produced mixed results. This is mostly due to the difficulty to interpret findings from the heterogeneous groups of firms composing the most prominent sustainability stock indexes in the world as well as the fact that the inclusion in such indexes is influenced by factors that need not necessarily be directly connected to environmental or social activities.[16]

Most recently, a study published in *Accounting & Finance* showed that leading firms in the Dow Jones Sustainability World Index are significantly larger, have higher levels of growth and a higher return on equity than conventional firms; however, they report suboptimal levels of free cash flows or lower leverage than other firms.[17]

**The expanding notion of fiduciary duty** Today, legal scholars increasingly view the pursuit of sustainable business initiatives as consistent with corporate governance standards and the notion of corporate fiduciary duties. In particular, judicial action,[18] recent stakeholder constituency statutes,[19] and statutory exculpatory provisions permitted under state corporate law[20] have opened the door for corporate leaders to consider non-shareholder interests and concerns when making investment decisions.[21] Moving from similar considerations, in 2009 the Committee for Economic Development issued recommendations on the potential contributions that boards of directors can offer to improve overall business performance while responding to societal concerns.[22]

**Evolving board composition practices** Since Enron and the passage of the Sarbanes-Oxley Act of 2002, U.S. public companies have responded to pressures from regulators and shareholders by strengthening the independence and expanding the expertise of their boards of directors.[23] Today, boards accommodate a large variety of skill sets and are more diverse.[24] Diversity of age, gender, ethnicity, and cultural background is proving to favor new exchanges of ideas and ensures that multiple perspectives are represented as the board engages in strategic discussions and makes long-term business decisions. Recent studies have proven a positive correlation between board diversity and both strategic innovation and corporate reputation.[25]

## Structural and Operational Gaps in Sustainability Oversight

As for any entrepreneurial endeavors, leadership is essential to design and execute a sustainability program that is truly embedded in the business strategy. The Conference Board research shows that, despite the frequent formal assignment of social and environmental responsibilities to top corporate leaders (including board members and C-suite executives), most companies are still at the early stage of developing an integrated, enterprise-wide sustainability program. Several findings (absence of a clear vision and mission statement; inadequate access to independent information by board members; inadequate link between compensation and sustainability objectives) document this conclusion and are discussed below.

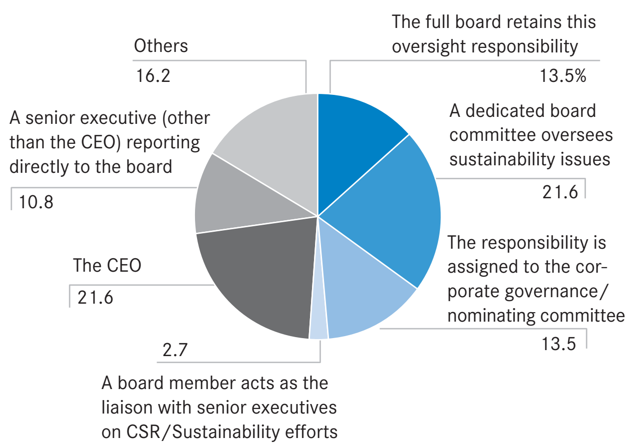
**Sustainability and board structure** Approximately half of the surveyed companies formally assign to their board of directors the responsibility to oversee business sustainability initiatives. In practice, this is accomplished through different structures (Chart 4). While retaining ultimate authority, only in a small number of cases (13.5 percent of respondents) the discussion of social and environmental issues affecting the business takes place at the full-board level. Most often, boards delegate some of their duties to standing committees or sub-groups of independent directors. For a growing number of organizations, sustainability oversight is performed through the formation of a dedicated committee of the board (21.6 percent of respondents); for others, this function is added to the charter of the corporate governance/nominating committee (13.5 percent) or to the individual responsibilities of a sole director who is deemed appropriate for the role based on background and expertise (2.7 percent).

However, Chart 4 also shows that as many as 48.6 percent of surveyed public companies still lack some form of integration of a sustainability program into their governance structure, even though the organization may rely on their CEO (or other senior executive) to elevate major concerns in this area to the attention of corporate directors.

Chart 4

**Who in your company is responsible for overseeing sustainability issues?**

(number of respondents; percentage of total respondents)




N=37

*Source*: The Conference Board, 2010.

**Access to sustainability information** The survey reveals that, even when the responsibilities for sustainability oversight are formally assigned to corporate directors, the corporation might be unequipped to ensure an independent and objective discussion. When asked to indicate the primary source of information used by the board to expand its knowledge of sustainability issues and stay abreast of developments, respondents indicate that their directors continue to rely extensively on reports by senior executives (89.2 percent). Instead, directors almost never avail themselves of those additional sources (including peer-company benchmarks, securities analyst reports, director education programs, and outside consultants) that would enable them to critically verify and analyze any internally produced information on these matters (Chart 5).

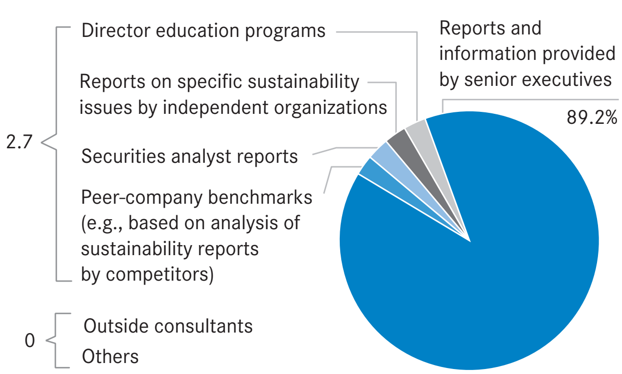
Another symptom of the insufficient top leadership in this area is the scarce use of operational tools to integrate sustainability objectives into daily business activities. The majority of companies that participated in The Conference Board research report missing the basic foundations of an enterprise-wide sustainability program, including a clear mission statement, a dedicated functional department, and proper metrics to link executive pay and accomplishments in social or environmental activities (Chart 6).

Gaps and vulnerabilities at the operational level can only be addressed through a top-down, holistic view of the social and environmental endeavors that are critical to the long-term success of the corporation. In addition to the formal assignment of functions, this requires a system of accountability and, most important, the full appreciation by board members that the pursuit of shareholder value cannot ignore the interest of other stakeholders, which should therefore be discussed in the strategic decision-making process. In fact, when asked about what would be essential to the successful integration of sustainability initiatives in their organization, a plurality of respondents referred to the need to make sustainability goals part of the business strategies that the board of directors oversees (Chart 7).

Chart 5

### What is the primary source of information used by your board to expand its knowledge base on sustainability issues and stay abreast of developments?

(number of respondents; percentage of total respondents)



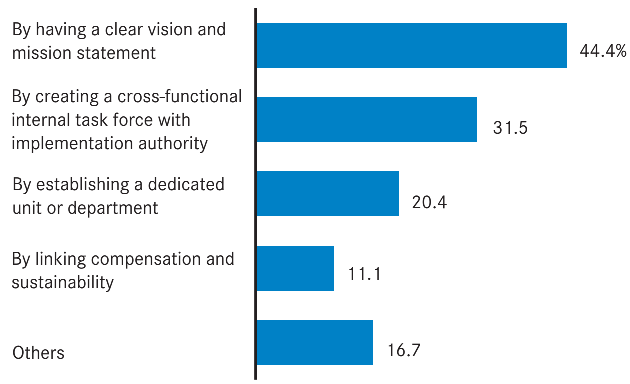

N=37

*Source*: The Conference Board, 2010.

Chart 6

### How does your company integrate sustainability objectives into its business operations?

(number of respondents; percentage of total respondents)



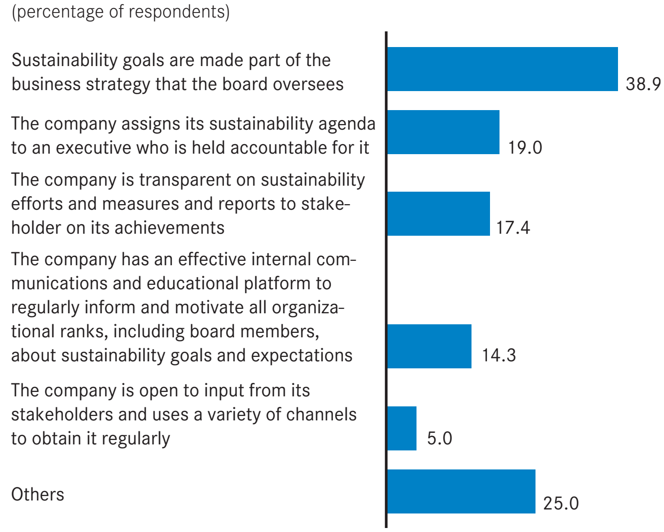

N=54

*Source*: The Conference Board, 2010. Percentages do not add up to 100 due to the possibility of selecting multiple answers.

Chart 7

### Success factors in the governance-sustainability integration

(percentage of respondents)




N=54

*Source*: The Conference Board, 2010. Based on the participating company's own experience or discussions that have taken place at the board level, as assessed by the respondent. Percentages refer to respondents ranking the factor as the most important on a scale of 1 to 6.

## Use of Sustainability Standards

Sustainability encompasses a variety of ethical, social, and environmental topics. In designing a sustainability program, corporations can avail themselves of several widely recognized sets of standards. The common denominator of such standards is that they are substantive, not procedural: in other words, they discuss and regulate the merits of a sustainability issue. Some sets of guidelines focus on a specific issue (e.g. the U.N. Framework Convention on Climate Change (UNFCCC)[26]), while others are multidisciplinary (e.g. the U.N. Principles for Responsible Investment (PRI)[27] or the OECD Guidelines for Multinational Enterprises (GME)[28]).

What appears to be still missing is a comprehensive standard to assist corporations in establishing organizational procedures for the oversight of corporate sustainability initiatives. Even though the Global Reporting Initiative has designed a framework for the voluntary corporate reporting on sustainability issues, its application is limited to the disclosure end of the oversight process (see p. 43). An attempt for more comprehensive procedural standardization in this area is being pursued by the International Organization for Standardization (ISO),[29] by means of the formation, in January 2005, of a Working Group composed of 32 national bodies representing different types of stakeholders (including industry, government, labor, consumers, nongovernmental organizations and others). The official release of ISO 26000 (or "ISO on Social Responsibility") has been announced for late 2010 and should cover the following oversight phases:[30]

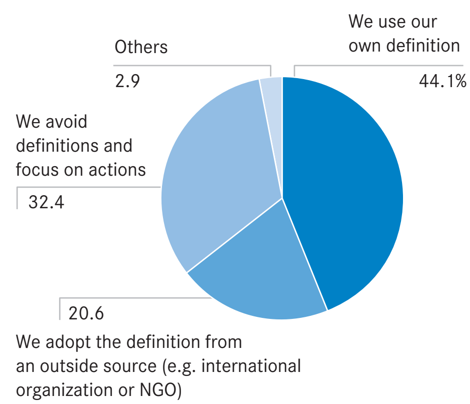
1. Working with stakeholders to recognize their concerns
2. Defining the scope of social responsibility for the organization
3. Designing enterprise-wide procedures to integrate the sustainability program into the organization's vision, strategies, and policies
4. Overseeing the implementation of the procedures
5. Communicating on social responsibility (internally and through public disclosure), and
6. Evaluating the sustainability program (through performance metrics and standards of accountability tailored to the procedure implementation).

Sustainability standards typically rely on the voluntary adoption by the business community. Only a small percentage of participants in The Conference Board survey report using any such standards in their social and environmental activities (Chart 8). Instead, most companies either use their own definition of sustainability (44.1 percent) or do not employ any definition of what sustainability should entail for their organization (32.4 percent). Chart 9 illustrates the percentage of participating companies that formally endorsed the most notable standardization efforts of the last few years.

Chart 8

### How does your company define sustainability?

(number of respondents; percentage of total respondents)



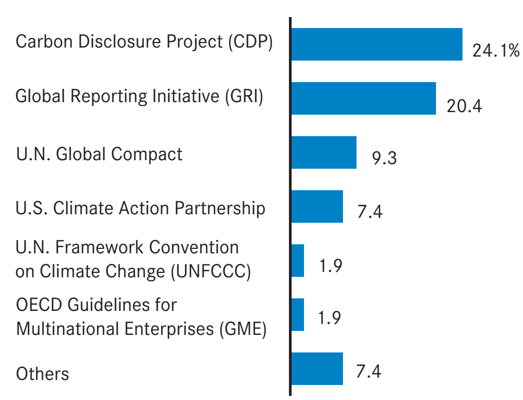

N=34

*Source*: The Conference Board, 2010.

Chart 9

### Which of the following sustainability guidelines or projects has your company been a signatory to or has formally endorsed?

(number of respondents; percentage of total respondents)



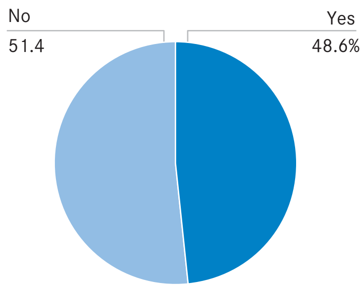

N=54

*Source*: The Conference Board, 2010. Percentages do not add up to 100 due to the possibility of selecting multiple answers.

Chart 10

**Does your company think there is a need for widely accepted principles or standards on how sustainability initiatives are conducted?**

(number of respondents; percentage of total respondents)




N=35

*Source*: The Conference Board, 2010.

However, when asked whether they believe that their companies would benefit from standardization, survey responses were more mixed (with as many as 48.6 percent indicating that additional guidance is necessary; see Chart 10). In particular, companies report that they would find it helpful if they could rely on procedural frameworks for integrating sustainability into the strategy decision-making process (70.6 percent), for communicating with stakeholders (52.9 percent), and for evaluating sustainability performance (76.5 percent). Not surprisingly, given the publicity that efforts such as the CDP or the GRI received in the last few years, only a smaller percentage (41.2) lament the need for additional reporting standards (Chart 11).

## Sustainability Performance Measures and Reporting

A critical component of any corporate sustainability initiative is the company's ability to measure, track, and improve its performance on specific social and environmental issues. Needless to say, organizations are much more likely to effectively manage a business activity when they can accurately measure its outcome. This is also true for sustainability-related business endeavors, where outcomes should be measured both in terms of the activity's effect on the sustainability issue (e.g., a gas emission reduction) and the company's financial bottom line (e.g., a cost reduction accomplished through the integration of environmental standards into the organization's supply chain).[31] Due to the double bottom line effect of sustainability programs, it is important that social and environmental performance assessment be based on a balanced combination of financial and extra-financial indicators.

Chart 11

**Which of the following phases in a sustainability initiative would benefit from standardization?**

(number of respondents; percentage of total respondents)


N=34

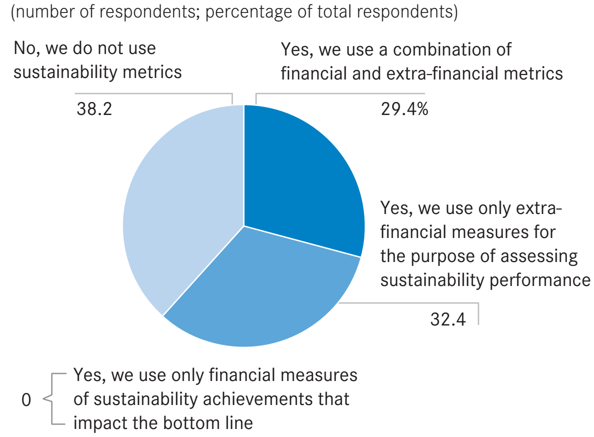
*Source*: The Conference Board, 2010. Based on the participating company's own experience, as assessed by the respondent. Percentages do not add up to 100 due to the possibility of selecting multiple answers.

Approximately 30 percent of the participating companies in the survey conducted by The Conference Board report that they avail themselves of a combined set of metrics related to sustainability goals and objectives. However, as many as 38.2 percent of respondents do not currently have a system in place for measuring progress made in their social and environmental activities and 32.4 percent do not assess the impact of such activities on the organization's financial performance (Chart 12).

Chart 12

**Does your company employ performance metrics related to its sustainability goals and objectives?**

(number of respondents; percentage of total respondents)




N=34

*Source*: The Conference Board, 2010.

**Pay-for-sustainability performance** To effectively drive management action, experts maintain that sustainability metrics must also be embedded in top executive compensation packages and become a core component of the process for assessing leadership performance. In an influential report,[32] Ceres offered two examples of companies that did actually link pay and sustainability-related goals:

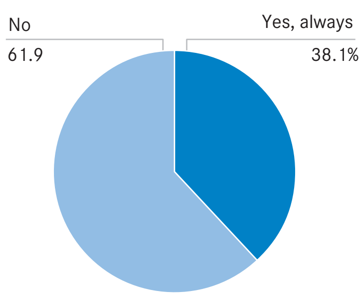
- Xcel Energy, in its 2009 proxy statement, discusses how certain sustainability metrics are integrated into annual objectives for all executive officers. The disclosure document illustrates the weight assigned to greenhouse gases (GHG) emission reductions and safety performance, alongside the weighting given to earnings per share.[33]
- Last year, British utility National Grid announced that it would partially base executive compensation on meeting carbon footprint targets. In what was presented as a strategic and cultural change, executives are now asked to set five-year rolling budgets based on the company's drive to meet an aggregate 80 percent reduction goal by 2050. The advantage of having rolling budgets is that long-term planning will help smoothing annual fluctuations in emissions caused by factors such as changing energy demands due to colder or warmer than average winters.[34]

Approximately 62 percent of companies participating in The Conference Board survey indicated that they do not embed sustainability-related metrics into their top-executive compensation policy (Chart 13).

Chart 13

**Are the measured outcomes tied to top executive compensation?**

(number of respondents; percentage of total respondents)




N=21

*Source*: The Conference Board, 2010.

**Disclosing sustainability measures** Similarly, the value of sustainability reporting centers on performance measures. The systematic collection, analysis, and reporting of data on the progress the organization has made in the pursuit of a certain social or environmental goal is what enables business leaders to accurately communicate to their owners and stakeholders. Global Reporting Initiative (GRI) is the world's most-used framework for voluntary reporting of environmental and social performance by business. The cornerstone of the GRI framework is the Sustainability Reporting Guidelines, which were last revised in 2006 and are accompanied by Sector Supplements (sets of indicators for industry sectors) and National Annexes (sets of country-level information).[35] Following years of growing dissemination, the total worldwide number of filed GRI reports reached the 1,000-target in 2008 (a 46 percent increase over 2007).[36] However, to this day, European public companies constitute more than 50 percent of filers and, despite the global publicity it has been receiving, the framework remains relatively unutilized by U.S. issuers. According to a recent study of S&P 100 company disclosure filings, approximately one-third make use of the GRI guidelines, compared to 77 percent of the world's 250 largest companies.[37] Most important, discussion of environmental and social information may be found in dedicated sustainability reports but it is rarely voluntarily included in the more formal format of an SEC filing.[38]

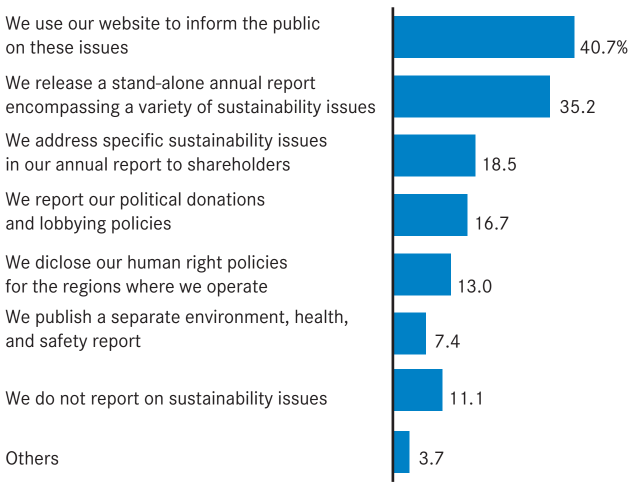
Due to some important new developments at the regulatory and enforcement levels, this may be about to change. In recent years, many civil society organizations have been applying pressure on the SEC to revisit its policies on the scope of the disclosure requirements for public companies, particularly regarding the incorporation of social and environmental concerns. Eventually, in the last few months and under its new leadership, the agency has become more receptive of such requests. In addition to establishing a new Investor Advisor Committee composed of diverse constituencies (including non-profit organizations of retail investors, consumer watchdog organizations, social investment funds, academia and private investment funds),[39] in October 2009 the SEC met a request from the INCR and reversed an existing SEC policy that had allowed companies to exclude shareholder resolutions requesting detailed information on the financial risks associated with environmental, human rights and other social issues facing publicly-traded companies (also see p. 46).[40]

According to The Conference Board survey, companies that do voluntarily disclose progress on their sustainability initiatives tend to do so by means of their public website or through a stand-alone annual report encompassing a variety of social and environmental issues (Chart 14). However, as many as 42.9 percent of respondents indicate that their companies do not include in the disclosure any information on metrics used to assess such progress. Among the remaining companies that report on metrics, 28.6 percent have a policy to safeguard the confidentiality of any data the dissemination of which could weaken the company's competitive advantage (Chart 15).

Chart 14

### How does your company report to stakeholders on sustainability issues?

(number of respondents; percentage of total respondents)



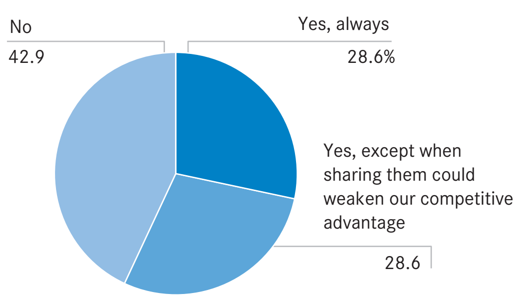

N=54

*Source*: The Conference Board, 2010. Percentages do not add up to 100 due to the possibility of selecting multiple answers.

Chart 15

### Does your company disclose sustainability performance metrics to shareholders?

(number of respondents; percentage of total respondents)




N=21

*Source*: The Conference Board, 2010.

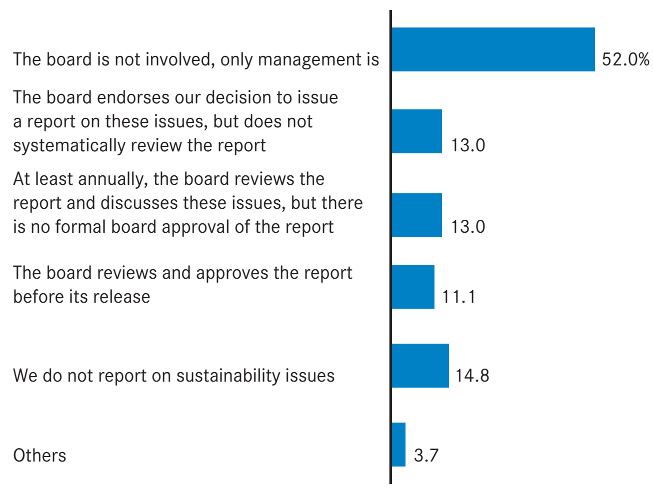
In addition to helping firms manage their impacts, sustainability reporting promotes transparency and management accountability. Ultimately, it is the board's responsibility to foster public communications that are complete, fairly represent material information, and comply with applicable laws and regulations. For this reason, sustainability reporting oversight becomes an integral part of the role performed by the board of directors in ensuring the effectiveness and thoroughness of its company's disclosure procedures.[41]

As shown in Chart 16, only a small number of the corporate boards surveyed by The Conference Board (11 percent) have a direct role in reviewing and approving the sustainability reporting process, whereas in most cases the same process is ultimately left to the control of management.

Chart 16

### What is the role of the board in the sustainability reporting process?

(number of respondents; percentage of total respondents)




N=54

*Source*: The Conference Board, 2010. Percentages do not add up to 100 due to the possibility of selecting multiple answers.

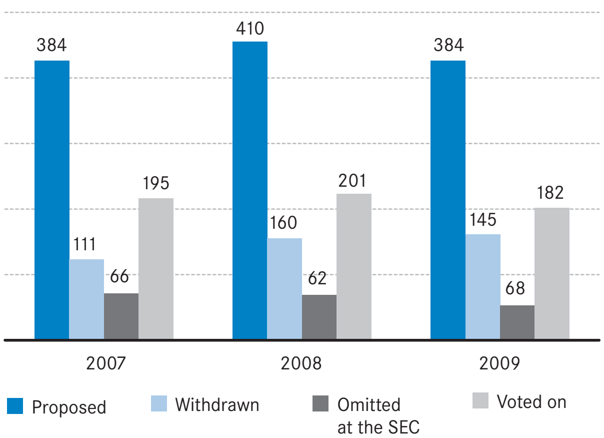
## Pressure from Activist Investors

Data from the most recent proxy seasons show that sustainability issues are increasingly on the agenda of activist shareholders, and their success rate (including those situations where investors ultimately negotiate an agreement with target companies) has reached levels that were unimaginable only a few years ago. Chart 17 illustrates the success registered in the United States by these types of resolutions in the 2007-2009 proxy seasons. Chart 18 and Chart 19 show the most recent trends and are updated as of February 2010.[42]

Chart 17

**Success rate of sustainability proposals, 2007-2009**

(number of proposals)

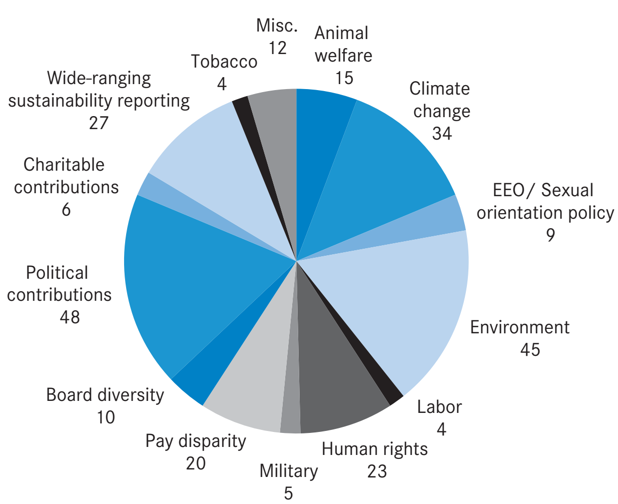



*Source*: RiskMetrics, February 2009.

Chart 18

**Pending 2010 sustainability resolutions**

(number of resolutions)



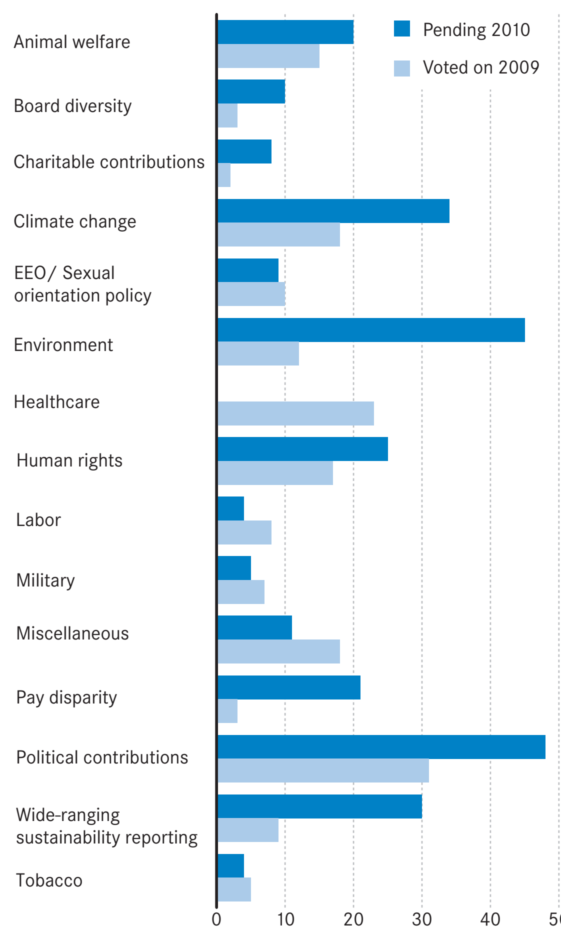

*Source*: RiskMetrics, February 2010.

Financial analysts and proxy advisors have been willing to increasingly back similar resolutions, especially those on serious environmental concerns such as climate change. In the 2009 proxy season alone, RiskMetrics supported at least 21 resolutions demanding insightful climate change disclosure (or 75 percent of the resolutions of this kind that went to vote), while Proxy Governance supported 15 of them (53.6 percent).[43] In this evolving context, 2009 became a landmark proxy season, with two environmental and social proposals receiving first-ever majority votes, at DR Horton and Idacorp. At DR Horton, as many as 5.3 percent of shareholders voted in favor of a resolution requesting that the company amend its equal employment opportunity policy language to include sexual orientation and gender identity. At Idacorp, a request for clearly defined GHG emission goals received a 51.2-percent support.[44]

Chart 19

**Sustainability resolutions trends, 2009-2010**

(number of resolutions)




*Source*: RiskMetrics, February 2010.

As mentioned above, the voice of activist shareholders has been further invigorated by the most recent developments at the regulatory and enforcement levels. In October 2009, the SEC Staff issued a bulletin announcing that it would no longer allow management to exclude from the voting ballot shareholder proposals relating to the evaluation of risk,[45] including risk resulting from the company's policy on environmental and social issues. This latest move is a reversal of a long-standing SEC policy that would view risk-related matters as ordinary, day-to-day business operations with which shareholders should not interfere.[46] The effects of the policy reversal could be already appreciated in the first months of the 2010 proxy season (see box below).

In addition, in February 2, 2010, the SEC issued new guidance to public companies regarding the application of disclosure requirements on climate change issues. Under the guidelines, companies—including many that might not have viewed the topic as relevant to their business—are expected to broaden their consideration of the effect of climate change from thinking primarily about the costs of compliance with existing and pending environmental laws to analyzing, among other things, the potential physical impact of climate change on their business (such as changing weather patterns) and the effects of climate change on the demand for their products and services or their costs of good sold.[47] Experts expect the Commission's next move will be to officially mandate wide-ranging sustainability disclosure, for example by requesting companies to conform to widely-accepted reporting standards such as the GRI framework.

## SEC Comments on Sustainability Issues in the Wake of the Excludability Policy Reversal

The following are excerpts from recent letters to companies where the SEC refused to allow the exclusion of sustainability-related shareholder proposals:

- On a proposal from Sanford Lewis to Cabot Oil & Gas Operations (January 2010), requesting a report on the environmental impact of the company's hydraulic fracturing operations, including the discussion and analysis of the material risks facing the business due to such environmental concerns.

  "In our view, the proposal focuses primarily on the environmental impacts of Cabot's operations and does not seek to micromanage the company to such a degree that we believe exclusion of the proposal would be appropriate. In addition, we are unable to conclude that Cabot has met its burden of demonstrating that implementation of the proposal would affect the conduct of ongoing litigation to which the company is a party. Accordingly, we do not believe that Cabot may omit the proposal from its proxy materials in reliance on rule 14a-8(i)(7)."[a] (It should be noted that, in prior cases, litigation risk exposure had been recognized by the SEC as a valid concern for permitting exclusion of some resolutions).

- On a proposal from Human Life International to Wells Fargo (February 2010), requesting that the company list the recipients of corporate charitable contributions of $5,000 or more on its Web site. (The resolution asserted that the company had given "millions of dollars to Gay, Lesbian, Bisexual and Transgender organizations like the Human Rights Campaign and the Gay and Lesbian Alliance Against Defamation," and objected that "homosexual relations have been proscribed by Christian, Jewish, Muslim, and other religious traditions for hundreds, if not thousands of years." In response, Wells Fargo argued that the proposal should be excludable on ordinary business grounds because its "stated intentions plainly confirm the proponent's true objective with the proposal is to campaign against same-sex marriage and abortion and conduct a stockholder referendum opposing any support by Wells Fargo of nonprofit organizations that the proponent appears to disfavor.")

  "We are unable to concur in your view that Wells Fargo may exclude the proposal under rule 14a-8(i)(7). In arriving at this position, we note that the proposal relates to charitable contributions, which the Division has generally found to involve a matter of corporate policy, which is extraordinary in nature and beyond a company's ordinary business operations. Moreover, in our view, the proposal does not pertain to specific types of organizations. Accordingly, we do not believe that Wells Fargo may omit the proposal from its proxy materials in reliance on rule 14a-8(i)(7)."[b]

a SEC Letter to Cabot Oil & Gas Corporation, January 28, 2010, available at www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2010/nycomptrollercommonretirement12810-14a8.pdf.

b SEC Letter to Well Fargo, February 19, 2010, available at www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2010/humanlife021910-14a8.pdf

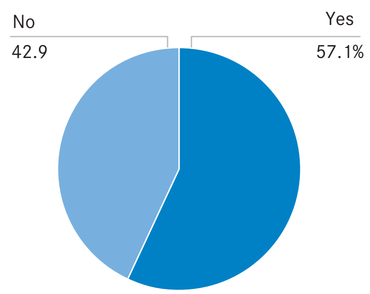
The Conference Board survey inquired on companies' exposure to sustainability-related shareholder activism. The following points summarize survey findings (Charts 20-23). Participating companies that experienced more than one instance of sustainability-related shareholder activism were asked to answer with respect to the most important occurrence, based either on the nature of the investor demand or the time commitment required of the company.

- The majority of respondents (57.1 percent) report having dealt at their companies with activism situations regarding social or environmental issues.
- In most cases, demands of this type are submitted by dedicated socially responsible investment (SRI) funds (44.4 percent of respondents who reported social activism experience) or by religious groups with an investment position in the company (22.2 percent).

Chart 20

### Has your company ever dealt with investors having sustainability-related demands?

(number of respondents; percentage of total respondents)



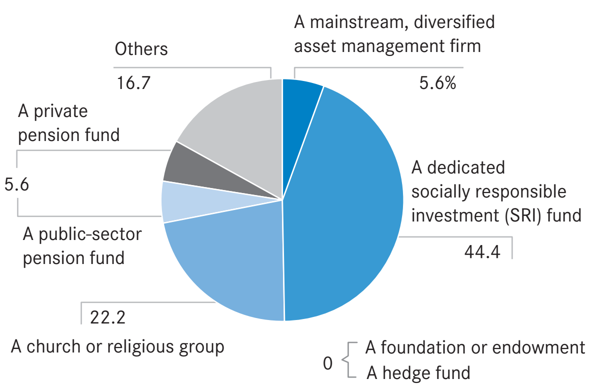

N=35

*Source*: The Conference Board, 2010.

Chart 21

### How would you categorize the investor?

(number of respondents; percentage of total respondents)



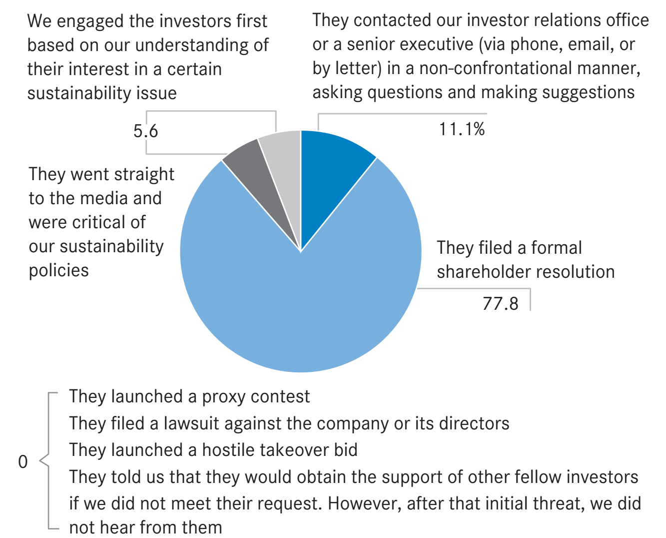

N=18

*Source*: The Conference Board, 2010.

Chart 22

### How did the interaction with the investor take place?

(number of respondents; percentage of total respondents)



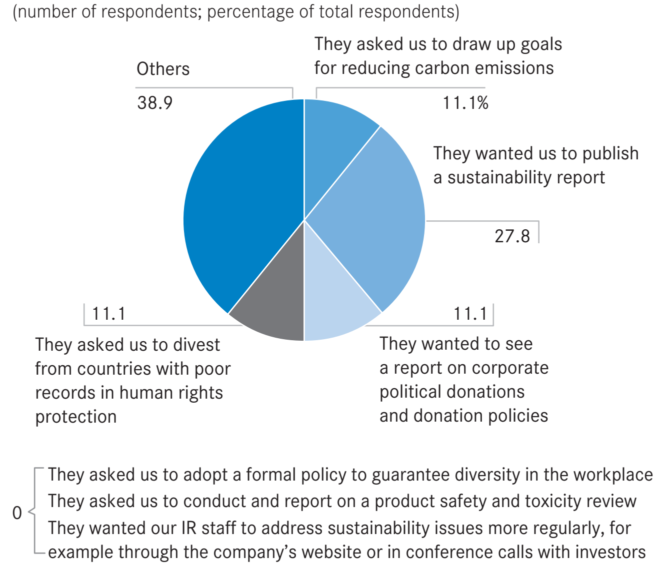

N=18

*Source*: The Conference Board, 2010.

Chart 23

### Sustainability-related demands from activist investors

(number of respondents; percentage of total respondents)




N=18

*Source*: The Conference Board, 2010.

- In the great majority of cases (77.8 percent), investors file a formal shareholder resolution on social or environmental issues. No surveyed company report experiencing a proxy contest in these issues; in one case, it was the company that took the initiative of first engaging with investors, after learning of its investment history and its presence in the company's shareholder base.
- Requests vary from the publication of a comprehensive sustainability report (27.8 percent) to the release of corporate political spending information (11.1 percent), and from setting carbon emission reduction goals (11.1 percent) to divesting from countries with poor records in human rights protection (11.1 percent).

Sustainability-related demands from investors encompass a wide variety of social and environmental issues. Often, their formulation reveals a strategic concern and the expectation is that organizations introduce new oversight practices and strengthen the level of accountability of their top leaders in this arena. Most recently, under pressure from activist investors, Intel Corporation announced an important amendment to the company's governance structure. Specifically, as of March 10, 2010, Intel's corporate governance and nominating committee charter requires that the committee "… review(s) and report(s) to the Board on a periodic basis with regard to matters of corporate responsibility and sustainability performance, including potential long and short term trends and impacts to our business of environmental, social and governance issues, including the company's public reporting on these topics." According to Harrington Investments, which had introduced a shareholder resolution requesting the amendment, "… Intel also provided [Harrington Investment] with an outside legal opinion stating that under Delaware Law directors have a fiduciary duty to address corporate responsibility and sustainability performance as specified in the committee charter."[49]

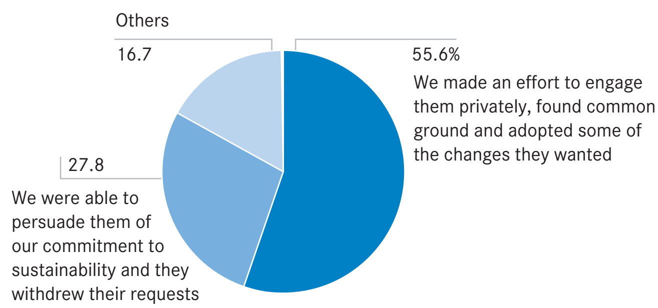
**The power of engagement** In March 2010, in response to the need expressed by many of its member organizations for education and guidance on how to address situations of shareholder activism, The Conference Board issued recommendations to corporate directors of public companies.[49] Overall, the recommendations embrace the principle that being proactive and forward-looking is the best of all remedies. The possible exposure to shareholder activism may represent a threat to many businesses; however, especially in an ever-changing field like sustainability, activism also offers an extraordinary opportunity to thoroughly review and update business strategies, financial plans, and corporate governance structures and practices to ensure that they reflect new external circumstances and stakeholder interests.

Experience shows that, in the great majority of cases, sustainability-related resolutions do not escalate to situations of outright hostility and can be addressed by seeking ways of engagement with investors. For example, out of the 17 resolutions on climate change issues filed in 2009 with companies in the S&P 500 sector, 13 resulted in a settlement agreement and were ultimately withdrawn by their filers.[50] These data were confirmed by The Conference Board survey, with as many as 83.4 percent respondents indicating that the company resolved the matter outside of legal courts and without proxy battles, either by making some concessions to investors or by persuading them of the company's commitment to the social or environmental issue at stake (Chart 24).

Chart 24

**Corporate responses to sustainability-related activism**

number of respondents; percentage of total respondents)




0
- We did not respond and they did not return
- We did not respond. They mounted a campaign against us
- We reviewed and updated our extrajudicial defensive measures (e.g., poison pills, advance notice bylaws, supermajority vote provisions)
- We went to court
- We responded publicly, primarily through a communications campaign on our sustainability efforts

N=18

*Source*: The Conference Board, 2010.

## Conclusion

Research by The Conference Board shows that the growing interest by corporate directors in social and environmental issues can be explained by several motivational drivers, including the increasing awareness of the critical influence of stakeholder relations on firm performance and the pressure resulting from regulatory bodies, enforcement agencies, and activist investors.

Despite formal assignment of responsibilities to top corporate leaders, many companies still lack the structural framework to enable proper director oversight. In particular, what appears to be largely missing is access to independent sources of information and detailed procedures for effectively integrating sustainability objectives into daily business activities. Most surveyed organizations do not employ any of the widely endorsed standards existing today in many areas of social and environmental concerns; often, these companies resort to their own definition of sustainability, therefore preventing the development of a level playing field for performance assessment by investors and other constituents. The majority of companies reviewed by the study do not assess the impact of their sustainability activities on the organization's financial performance.

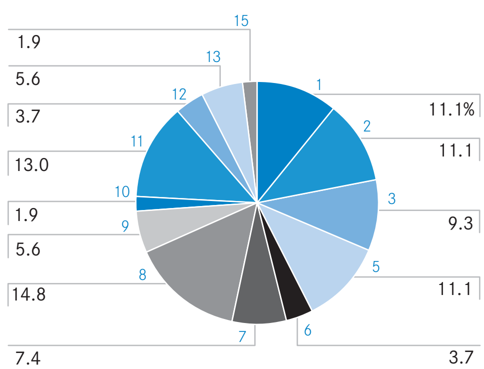
However, recent regulatory developments and the increased sensitivity of enforcement authorities to the risk implications of environmental issues have opened the door to shareholder activism in this field. In the last couple of years alone, dedicated socially responsible investment companies and large retirement funds have submitted a growing number of resolutions on several matters of corporate sustainability, ranging from climate change to political spending and from board diversity to pay disparity. Today, more than ever, directors are expected to understand the rationale of similar requests for change and adapt business strategies and corporate processes to evolving market trends and emerging standards.

### The Conference Board Survey

Data discussed in this section of the report is based on a survey of corporate secretaries conducted by The Conference Board in September 2009—January 2010. A total of 54 companies from different sectors and revenue size groups participated in the study. The number of respondents is lower for certain survey questions that are applicable only to respondents answering affirmatively to previous questions.

Exhibit 1

**Participating companies, by industry**

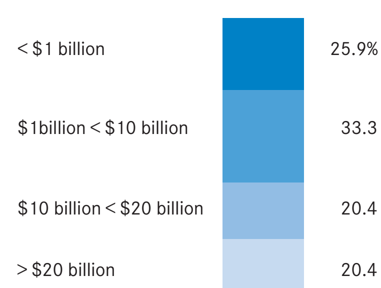



1 Agriculture and mining
2 Energy
3 Utilities
4 Construction*
5 Manufacturing (industrial)
6 Manufacturing (consumer)
7 Manufacturing (technology/electronics)
8 Wholesale and retail trade
9 Communications / publishing / software
10 Transportation and warehousing
11 Financial services
12 Healthcare
13 Business and professional servic
14 Other services*
15 Government / not-for-profit / administrative
16 Others*

* = 0%
N = 54

Exhibit 2

**Participating companies, by revenue group**




N = 54

## The Conference Board Research Working Group on on the Integration of Corporate Governance and Sustainability

The survey was conducted under the auspices of the Research Working Group instituted by The Conference Board in February 2009 to investigate the integration of corporate governance and sustainability. The following companies participated in the working group and should be acknowledged for their support of this research project. It should be noted that not all Working Group participants completed the survey.

**Lydia I. Beebe**
Corporate Secretary and
Chief Governance Officer
Chevron Corporation

**Robert E. Bostrom**
Executive Vice President
General Counsel & Corporate Secretary
Freddie Mac

**Robert L. Burrus, Jr.**
Chairman Emeritus
McGuireWoods LLP

**Hye-Won Choi**
Senior Vice President and
Head of Corporate Governance
TIAA-CREF

**Vanessa T. D'Ambrosia**
Director, Compliance and Integrity
Altria Client Services

**Jenny Flezzani**
Senior Specialist, Corporate Citizenship
Pfizer Inc

**Abe M. Friedman**
Global Head of Corporate Governance and
Responsible Investment
BlackRock, Inc.

**Silvia M. Garrigo**
Manager, Global Issues and Policy
Chevron Corporation

**David Harrison**
Executive Director, Corporate EHS Head
Amgen, Inc.

**Janice Hester-Amey**
Portfolio Manager
CalSTR

**Patrice Ingrassia**
Director, Office of Public Policy
Ernst & Young LLP

**Eric H. Israel**
Managing Director, Advisory Practice
KPMG LLP

**Leisha John**
Americas Director,
Environmental Sustainability
Ernst & Young

**Rosemary Kenney**
Director, Corporate Governance
Pfizer Inc

**Maggie Kohn**
Director, Corporate Responsibility
Communications
Merck & Co., Inc.

**Michael McCauley**
Senior Officer, Investment Programs
& Governance
Florida State Board of Administration

**Patrick McCrummen**
Senior Director, Corporate Citizenship
Johnson & Johnson

**Katherine McQuaid**
Associate Director, Corporate
Responsibility
Time Warner Inc.

**Patricia M. Molino**
Vice President, Public Affairs
Johnson & Johnson

**Yumi Narita**
Proxy Analys
Barclays Global Investors

**Paul Narog**
Manager, Environmental Health
and Safety Operations
3M Company

**Sandy Nessing**
Director, Environment &
Safety Strategy & Design
American Electric Power Service Corp.

**Mark Preisinger**
Director, Corporate Governance
The Coca-Cola Company

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## Endnotes

1 Michael Passoff, *Proxy Preview '10: Helping Foundations Align Investment and Mission*, As You Sow Foundation, 2010. Also see Carolyn Mathiasen and Lejla Hadzic, *2010 Proxy Season Preview: Environmental & Social Resolutions*, RiskMetrics Group, February 9, 2010.

2 Founded in 1971, the Interfaith Center on Corporate Responsibility (ICCR) is an association of 275 faith-based institutional investors, including national denominations, religious communities, pension funds, foundations, hospital corporations, economic development funds, asset management companies, colleges, and unions.

3 Founded in 1989, in the aftermath of the Exxon-Valdez oil spill, Ceres is an association of investors, environmental organizations and other public interest groups working with companies and investors to address sustainability challenges such as global climate change.

4 The Investor Network on Climate Risk (INCR) is a group of more than 70 leading institutional investors with collective assets of more than $9.8 trillion as of May 2010.

5 The Carbon Disclosure Project (CDP) is a U.K.-based organization promoting standards for the disclosure of greenhouse gas (GHG) emissions of major corporations. The organization reports that, as of May 2010, 2,500 companies in some 60 countries around the world measure and disclose their GHG emissions and climate change strategies through CDP.

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7 Passoff, *Proxy Preview '10*.

8 See Matteo Tonello, *Reputation Risk: A Corporate Governance Perspective*, The Conference Board, Research Report No. 1412, 2007.

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11 *Remarks by the President in State of the Union Address*, The White House, January 27, 2010, available at [www.whitehouse.gov/the-press-office/remarks-president-state-union-address].

12 SEC Release No. 33-9106; 34-61469, Fed. Reg. 6290 ("Commission Guidance Regarding Disclosure Related to Climate Change"), February 8, 2010. Specifically, with respect to climate change, the document provides that companies should consider the impact of existing and pending climate change legislation, regulation, international treaties, and accords in determining whether disclosure is necessary in their business, legal proceedings, risk factors and Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") sections.

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15 Betty Moy Huber, et al., *Environmental Disclosure in SEC Filings—2010 Update*, Davis Polk Client Memorandum, February 8, 2010, available at [www.davispolk.com], under "Publications."

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18 See, for examples of cases where the legal courts underscored the importance of assessing the impact on key stakeholder relations of a business decision made in the context of hostile takeovers an shareholder-instituted derivative actions: *Unocal Corp. v. Mesa Petroleum Co*., 493 A. 2d 946, 955 (Del. 1985), discussing how boards should consider the impact on constituencies other than shareholder when analyzing the reasonableness of defensive measures; and *Paramount Communications, Inc. v. Time Inc*., 571 A. 2d 1140, 1153 (Del. 1989), elaborating on the appropriate use of the Unocal analysis.

19 See, for example, 15 Pa. Cons. Stat. §1715. In general, see Kathleen Hale, "Corporate Law and Stakeholders: Moving Beyond Stakeholder Statutes," *Arizona Law Review*, Vol. 45, 2003, p. 829.

20 See, for example, Delaware Code Annotated, Title 8, Section 102(b)(7), permitting the use of clauses in the certificate of incorporation (therefore approved by shareholders) to insulate corporate directors from monetary liability for any action arising from a breach of their duty of care. Exculpatory clauses provide more freedom and leniency to directors in their decision-making capacity, and encourage them to take strategic risk.

21 For a more extensive discussion, see Janet E. Kerr, "Directors' Duties and the Pursuit of Social Investments," The Conference Board, *Director Notes* No. DN-002, January 2010.

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23 Board composition practices and trends on background diversification of directors are discussed in Matteo Tonello, *Corporate Governance Handbook: Legal Standards and Board Practices*, The Conference Board, 2009, p. 21.

24 Kevin F. Hallock, Matteo Tonello, and Judit Torok, *Directors' Compensation and Board Practices*, The Conference Board, Research Report No. 1462, 2009, p. 32.

25 See, for example, Toyah Miller and Maria Del Carmen Triana, "Demographic Diversity in the Boardroom: Mediators of the Board Diversity-Firm Performance Relationship," *Journal of Management Studies*, Vol. 46, No. 5, 2009, pp. 755-786.

26 The United Nations Framework Convention on Climate Change (UNFCCC or FCCC) is an international environmental treaty produced at the United Nations Conference on Environment and Development (UNCED), held in Rio de Janeiro in June 1992. The parties to the convention have met annually from 1995 in Conferences of the Parties to assess progress in dealing with climate change and are responsible for the Kyoto Protocol, which formally entered into force in February 2005 and established legally binding obligations for developed countries to reduce their GHG emissions.

27 Launched in April 2006, the six U.N.-backed Principles for Responsible Investment (PRI) provide a global framework for mainstream investors to consider a number of governance, environmental, and social issues in their portfolio composition and capital allocation decisions. Signatories include over 650 investment institutions as of early 2010.

28 The Guidelines for Multinational Enterprises (GME)—adopted in 1976 as an annex to the OECD Declaration on International Investment and Multinational Enterprises, and later updated on a regular basis—are recommendations addressed by governments to multinational enterprises operating in or from 42 adhering countries. They provide voluntary principles and standards for responsible business conduct in areas such as employment and industrial relations, human rights, environment, information disclosure, combating bribery, consumer interests, science and technology, competition, and taxation.

## Endnotes (continued)

29 ISO (International Organization for Standardization) is the world's largest developer and publisher of international standards. It operates as a network of the national standards institutes of 161 countries, one member per country, with a Central Secretariat in Geneva, Switzerland, that coordinates the system. Since its inception in 1947, ISO has developed over 18,000 international standards on a variety of subjects and some 1,100 new ISO standards are published every year.

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39 See "SEC Announces the Creation of Investor Advisor Committee," press release, June 3, 2009, available at [www.sec.gov/news/press/2009/2009-126.htm].

40 *Shareholder Proposals*, SEC Staff Legal Bulletin No. 14E (CF).

41 For a discussion of the role of the board in disclosure oversight, see Matteo *Tonello, Corporate Governance Handbook: Legal Standards and Board Practices*, The Conference Board, 2009, p. 111.

42 See Carolyn Mathiasen and Lejla Hadzic, *2010 Proxy Season Preview: Environmental & Social Resolutions*, RiskMetrics Group, February 9, 2010.

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44 See "Investors Achieve Major Company Commitments on Climate Change," press release, Ceres, August 24, 2009.

45 *Shareholder Proposals*, SEC Staff Legal Bulletin No. 14E (CF).

46 According to Rule 14a-8(i)(7) under the Securities Exchange Act of 1934, management can exclude from vote any shareholder proposals dealing with a matter relating to the company's ordinary business operations.

47 SEC Release Nos. 33-9106; 34-61469, "Commission Guidance Regarding Disclosure Related to Climate Change," February 2, 2010, available at [www.sec.gov/rules/interp/2010/33-9106.pdf]. For an extensive commentary, see Kenneth Berlin, Don J. Frost, Marc S. Gerber, Jane B. Kroesche, and William L. Thomas, "SEC Issues Guidance on Climate Change Disclosure," Skadden, Arps, Slate, Meagher & Flom Client Memorandum, February 4, 2010. The guidance was issued as the first response to a petition received in November 2009 from a network of institutional investors representing more than $1 trillion in assets.

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# Sustainability and Customer Value

by John Peloza and Jingzhi Shang

Corporate social responsibility activities have the potential to create several distinct forms of value for customers. It is the customer perception of this value that mediates the relationship between CSR activities and subsequent financial performance. By categorizing major CSR activities and the different types of value each can create, this section of the report offers a number of practical recommendations to business leaders embarking on CSR programs for their companies.

Investments in CSR activities are under scrutiny.* Boards and shareholders are increasingly demanding that outcomes from these investments be measured to understand if and how they positively impact the profitability of the firm. Not surprisingly, a significant amount of research has been undertaken to understand the relationship between CSR and profitability.

Due to the importance of customers among business stakeholders, marketing research that examines the effects of CSR on profitability is particularly informative. In particular, this research shows that CSR leads to outcomes such as increased customer loyalty, willingness to pay premium prices, and lower reputational risks in times of crisis.[1] Each of these marketing outcomes in turn has the potential to support increased profitability.

However, the research findings in question are often equivocal and offer business leaders limited guidance when it comes to choosing and implementing specific CSR activities.

In fact:

1 the relationship between CSR activities and financial performance is typically affected by many other mediating variables, which are not always thoroughly considered by researchers; and

2 the metrics used to define CSR vary widely among researchers.

To understand how CSR can impact profitability, this section focuses on customer value as a variable linking CSR activities and firm financial performance. It argues that CSR activities have the potential to create several distinct forms of value for customers. It is the customer perception of (and subsequent response to) this value that mediates the relationship between CSR activities, positive marketing outcomes, and subsequent financial performance. By categorizing major CSR activities and the different types of stakeholder value each can create, this section of the report provides guidance for business leaders embarking in CSR programs for their companies. For this reason, part of the discussion is dedicated to a number of practical recommendations to board members and senior executives.

## CSR Activities and Customer Value

Corporate social responsibility has been defined as "a business organization's configuration of principles of social responsibility, processes of social responsiveness, and policies, programs, and observable outcomes as they relate to the firm's social relationships."[2] It consists of specific firm investments called "activities."[3] Collectively, over time, these activities can lead to a reputation for social responsibility—a valuable business asset of its own.

A recent review of financial metrics deployed to calculate the business case for CSR found 42 unique CSR activities (Table 1) used by analysts and researchers over four decades of studies of the subject.[4] Within this broad array of activities, perception by stakeholders naturally varies, as socially responsible corporate behavior may mean different things to different people at different places and times.[5] For example and in general terms, research shows that CSR in the form of community or diversity programs is more likely than CSR in the form of governance, employee relations, or product relations to provide insurance against negative events affecting the reputation of the corporation.[6]

Table 1
**Categorization of CSR Activities**

| CSR Category | Examples of Specific CSR Activities | |
|---|---|---|
| Philanthropy | • Donation of sales<br>• Unrestricted cash donations<br>• Donation of products<br>• Employee volunteerism | • Collection of customer donations<br>• Charity events<br>• Promotion of public service announcements |
| Business Practices | • Pollution levels<br>• Reduced energy consumption<br>• Recycling<br>• Labor practices (e.g. child/sweatshop labor)<br>• Diversity<br>• Fair trade<br>• Other supply chain responsibility (e.g., human rights)<br>• Third party awards for performance<br>• Customer relations<br>• Employee relations<br>• Packaging<br>• Animal testing<br>• False advertising<br>• Controversial advertising<br>• Ethical conduct | • Packaging<br>• Animal testing<br>• False advertising<br>• Controversial advertising<br>• Ethical conduct<br>• Competing fairly and ethically<br>• Investment in South Africa<br>• Local sourcing<br>• Industry codes of ethics<br>• Adherence to other standards (e.g., GRI)<br>• Product recalls<br>• Governance<br>• Carbon offset sales/offsets<br>• Six Sigma projects<br>• Lawsuits<br>• Decreased product use/moderation message<br>• Investment in workplace safety |
| Product-Related Activities | • Energy efficiency<br>• Organic<br>• Product ingredients | • Controversial products (e.g., firearms, alcohol, gambling)<br>• Product quality |

## The multi-faceted customer value of CSR

Clearly, stakeholders must perceive value in a certain CSR activity to support the firm's engagement in it. This is particularly true for the customer, a key stakeholder for any business enterprise.

An effective model to examine the potential customer value creation of CSR activities defines value as an interactive, relativistic preference experience.[7] Value is interactive because it can be created only when a firm and its customer come together. Value is based on preference because each customer responds to a product, service, or corporate initiative based on her personal, subjective taste. Finally, value is relativistic because each customer's perception is influenced by external factors relative to the environment in which the customer lives (e.g., sensitivity to certain social issues depends on the level of education and the intellectual or experiential exposure of the customer to the issue).

The model is illustrated in Table 2, through its application to CSR activities in the form of organic agricultural practices. Each of the four quadrants outlined in the model represents potential types of customer value resulting from a certain CSR activity:

- **Self-oriented intrinsic value** The efficiency or excellence of the product or service offered by the business
- **Other-oriented intrinsic value** The personal joy or aesthetic appreciation resulting from consuming the product or using the service
- **Self-oriented extrinsic value** The status or esteem associated with consuming the product or using the service
- **Other-oriented extrinsic value** The ethical or spiritual benefit of the product consumption or service use

The model shows how a certain consumption behavior can contribute to multiple or even all types of value, and that the coexistence of these value types in a certain CSR activity is the norm rather than the exception.

On the vertical axis of Table 2, the self-oriented or other-oriented value dichotomy refers to whether the value resulting from the CSR activity is self-serving to the customer or can be enjoyed even by others. On the vertical axis, the extrinsic or intrinsic value dichotomy illustrates whether the perception of value by the customer results from the CSR activity per se or requires the involvement of some relevant third party (e.g., the network of family members, colleagues, or friends within which the customer establishes her personal status or esteem; or a reputable not-for-profit organization that sets the environmental standards the customer will use to evaluate a certain corporate practice).

In the example on organic agriculture, the model permits identifying four types of customer value:

1 Organics as a healthier product, free from pesticide residues or other contaminants: an "efficiency or excellence" value type that is self-oriented (as it is directly enjoyed by the customer) and intrinsic (as the perception of value by the customer stems from the CSR activity per se and does not require the involvement of some relevant third party).

Table 2
**The Multi-faceted Customer Value of CSR Activities in the Form of Organic Agricultural Practices**

| **Multi-faceted Customer Value** | **Intrinsic value** (i.e., does not require the involvement of a third party to be enjoyed) | **Extrinsic value** (i.e., does require the involvement of a third party to be enjoyed) |
|---|---|---|
| **Self-oriented value** (i.e., only directly enjoyed by the customer) | *Quadrant 1* **Efficiency or excellence** (e.g. organics as a healthier product, free from pesticide residues or other contaminants) | *Quadrant 3* **Status or esteem** (e.g., organics as a way to represent to others one's concern for the environment) |
| **Other-oriented value** (i.e., not only directly enjoyed by the customer) | *Quadrant 2* **Joy or aesthetics** (e.g., organics as a simple product, representing a "slow-food" quality of living) | *Quadrant 4* **Ethics or spirituality** (e.g., organics as a way to contribute to environmental conservation) |

2. Organics as a simple product, representing a "slow-food" quality of living: a "joy or aesthetics" value type that is other-oriented (as it is enjoyed not only directly by the customer but also by the community at large) and intrinsic (as the perception of value by the customer does not require the involvement of some relevant third party).
3. Organics as a way to represent to others one's concern for the environment: a "status or esteem" value type that is self-oriented (as it is directly enjoyed by the customer) and extrinsic (as it requires a community or group within which the customer establishes her personal status or esteem).
4. Organics as a way to contribute to environmental conservation: an "ethics or spirituality" value type that is other-oriented (as it is not only directly enjoyed by the customer) and extrinsic (as it requires the environmental standards defined by a third party to be a value the customer can perceive and appreciate).

Ultimately, as the model suggests, business leaders should be mindful of all four types of value that may be present in the same CSR activity.

## Empirical Research on CSR Activities

Considering the multi-faceted stakeholder (customer) value of almost any CSR activity, it is helpful to gain a comprehensive view of the business decisions that can be made in the realm of CSR to impact customer attitudes and behaviors. In particular, given that most firms now engage in some type of CSR, business leaders responsible for choosing activities would benefit from a greater understanding of the value creation of one CSR activity over another through empirical studies.[8] The considerations included in this section of the report are based on the analysis of 163 articles from the most relevant empirical literature on the subject. This section first categorizes the CSR activities examined by the articles into one of three broad groups (i.e., philanthropy, business practices, or product-related activities) and subsequently elaborates on the potential of each category to create customer value, concluding with recommendations for business leaders.

**Philanthropy** Philanthropy is the dominant category of CSR activities. It is a potential source of other-oriented, extrinsic value since it entails the ethical benefit of supporting others in need (Quadrant 4 of Table 2).

Philanthropy is also a means of gaining social status and, as such, can be a source of self-oriented, extrinsic value (Quadrant 3, Table 2). To further add to the analysis conducted so far, one form of corporate charity may carry more favorable perceptions (that is, greater value) than others. For example, charitable contributions tied to sales may be described as more self-serving and less socially honorable, and thus have lower extrinsic value for stakeholders in general.[9] A similar consideration could be made for those charitable contributions that, instead of cash, are made in the form of unsold products or employee volunteerism.

**Business practices** The next most common category of CSR activities includes those related to the business practices of the firm. Like philanthropy, CSR activities in the form of business practices carry the potential to enhance extrinsic value for customers. For example, supporting a firm that recycles can make an individual feel that he or she is practicing good community responsibility, and can be used to define to others that one is environmentally conscious (i.e., extrinsic, self-oriented value). Despite the seemingly implicit assumption that supporting ethical business practices is other-oriented, many of these CSR activities can also greatly enhance self-oriented stakeholder value. For example, employees perceive very favorably many employee relations policies (think of benefit plans), for obvious self-oriented reasons.

**Product-related features** The third category of CSR activities is product-related features. Corporate social responsibility in the form of product features has the potential to provide the broadest spectrum of value to stakeholders in general; although customers are considered the relevant stakeholder type for product-related features, these CSR activities can also affect other stakeholders, such as employees. Of particular importance is the potential of product-related features for self-oriented value: this is because customers are unlikely to trade quality for more traditional, other-oriented CSR.[10]

A review of studies of CSR activities within these categories leads to a number of findings that appear particularly salient for business leaders. However, considering these findings for the purpose of making CSR-related business decisions is appropriate if two caveats are also kept in mind.

First, analysts are often inconsistent in measuring the customer value of CSR activities; their conclusions can be meaningful to a business decision-making process only to the extent that they are calibrated to the specificities of the business. Second, there is limited comparison of the success of one form of CSR relative to others, which is indicative of the need to continue supporting empirical research on the subject. Both caveats are discussed below.

## Caveat 1: Inconsistency of measures of CSR-activity stakeholder value

Analysts typically measure the customer value of CSR activities by referring to:

- a single activity, e.g., cause-related marketing;
- focused activities that include multiple activities within the same category, e.g., cause-related marketing and other philanthropic activities such as volunteerism; or
- diffuse activities that include activities from two or even three categories, e.g., philanthropic donations combined with business practices and/or product-related CSR.

Each approach to measurement has its pros and cons. Single activity measurement allows for easy comparison with other research that focuses on the same activity, however this approach limits the potential for stakeholders to gain a holistic view of a company. Focused activities measurement offers the advantage of examining different sources of customer value and provides a more holistic picture of the firm's activities, however the simultaneous use of multiple CSR items limits the ability to define their relative priority for stakeholders. Diffuse activities portray the general tendencies of a firm toward social responsibilities, however it is difficult to compare findings across studies since none use the same coherent framework of diffuse measures. In addition, when a more holistic approach is adopted (i.e., focused or diffuse activities), the CSR activities examined by the analyst or researcher may not be consistent with the company's CSR strategies. For all of these reasons, business leaders should always take the conclusions of studies measuring CSR value as a mere indication, which needs to be tested in practice, based on the specificities of their company and its key customer base.

## Caveat 2: Limited comparability of one form of CSR to others

There are three types of studies comparing the effectiveness of CSR activities on customer value: those that examine differences within the same CSR activity, those that examine differences within the same category of CSR activities, and those that examine differences in CSR activities across categories.

- An example of comparison within a single activity is a study on the degree of logical fit between the firm and the charity.[11] A similar study can be helpful to the business as it provides guidance to improve the efficacy of that specific activity. However, its limit is that it does not show the customer value proposition of the activity in question as opposed to other CSR activities in which the company could allocate its limited resources. In the example, arguably the only valid conclusion that can be claimed from this type of literature is that a higher degree of fit between the core business of the firm and the related not-for-profit organization improves value for customers.
- An example of comparison of CSR activities within the same category includes a study testing philanthropy in the form of employee volunteerism, a cash donation, and cause-related marketing. The study finds that cause-related marketing is less effective than other forms of philanthropy at countering negative news about a firm. This type of study tends to coalesce around the concept of customer attribution; in particular, activities that lead customers to attribute selfless (as opposed to selfish) motives to the firm behind the activity are valued more.
- An example of comparison of CSR activities across different categories is the study of philanthropy and environmental business practices by firm.[12] The study shows that the concern of customers for the relevant domain (i.e., philanthropy versus environmental protection) predicts customer support. Although not explicitly measuring customer value, the study demonstrates the importance of understanding how different forms of CSR can deliver different value to stakeholders.

Provided that the two caveats described are kept in consideration, the following findings can be helpful to business leaders making CSR-related decisions:

- While philanthropy and business practices are sources of other-oriented value, product-related CSR activities lend themselves to enhancing a combination of self-oriented and other-oriented value.
- Faced with a choice between value components, customers choose self-oriented, intrinsic value.

- Similarly, customers are unlikely to reward a company that charges more for its environmentally friendly product if there is a cheaper alternative product with at least some amount of CSR value.
- Customers come in different types, with self-enhancement customers viewing the profit-making aspect of CSR more positively than self-transcendent customers, whereas self-transcendent customers view the legal, ethical, and philanthropic elements of CSR as more important than self-enhancement customers.
- Customers' awareness of a company's CSR increases as a result of multiple, coordinated CSR activities by the same companies. When left alone, a single CSR initiative could go unnoticed by customers, especially if the company is outperformed by the competition in its CSR investment.
- Customer response to a CSR activity is directly proportional to the long-term commitment of the company to the activity. Short-term initiatives could go unnoticed by customers.
- On the other hand, incremental customer value appears to be greatly reduced above an optimal level of investment in CSR activities. Above that level, additional CSR investment may be detrimental to shareholder value.
- Adherence to social norms is a significant motivator for customer support of CSR, and cause-related marketing can make a compelling case for such adherence.
- Customer value is not always a mediating variable linking CSR activities and firm performance. For example, a protocol adopted by the company to reduce energy consumption in the production process provides a cost savings and an environmental benefit without the necessary value perception by customers.

## Recommendations to Business Leaders

Using value creation as a lens, this section offers a series of recommendations on how business leaders can enhance the effectiveness of CSR activities on customer responses.

1 **Diversify the CSR portfolio** Other-oriented customer value is potentially present in CSR activities related to philanthropy and business practices. Instead, CSR delivered through the firm's products and services carries the potential for both other-oriented and self-oriented customer value. For this reason, business leaders should attempt to embed multiple forms of value across their company's CSR portfolio and even within CSR activities themselves.

2 **Offset value trade-off of multiple activities** Although the creation of multiple forms of value is the norm rather than the exception, one CSR activity may alter the customer value perceived in another.[13] In particular, with respect to a CSR activity that provides other-oriented value, customers will be sensitive to tradeoffs with self-oriented value. For example, customers perceive fair trade coffee (a potent source of other-oriented value) as having less enjoyable taste (a reduction in self-oriented value) than regular coffee.[14] Similarly, energy efficient automobiles are also perceived as less powerful despite advances in hybrid and electric motor technology that allow customers to retain power while gaining cost efficiency. However, recent research suggests that the perception of these tradeoffs can be offset by the use of performance guarantees.[15] For this reason, companies should strive to offset negative tradeoffs through the use of targeted promotions and information.

3 **Prioritize product-related CSR activities over philanthropy and business practices** Faced with a choice, customers will favor CSR activities categorized as product-related over philanthropy and business practices. For example, it has been shown that customers tend not to sacrifice minimum standards on product performance (a self-oriented value) when faced with information about other CSR activities (e.g., testing on animals, child labor).[16] Similarly, customers are unlikely to reward a company that prices higher its environmentally friendly product if there is a cheaper alternative product embedding at least some amount of CSR value.[17] For this reason, companies should not myopically assume that CSR involves exclusively the goodwill of customers, rather, whenever possible, companies should build a strong self-oriented value component in other-oriented product-related CSR activities. By pursuing a CSR strategy that does not neglect the self-oriented stakeholder value, the firm can even command a premium price over competitors whose CSR activities rely solely on other-oriented forms of customer value.

4 **Be mindful of your customer type** The idea that the type of customer is important in evaluating the business merit of CSR activities has also found some support in research. Referring in particular to the environmental context, CSR research distinguishes two customer types: the self-oriented (self-enhancement) customer and the other-oriented (self-transcendent) customer.[18] Customers with self-enhancement goals carry an egoistic view of the world, while self-transcendent customers are concerned with the welfare of others and of nature. Further studies have revealed that self-enhancement customers view the profit-making aspect of CSR (i.e., financial sustainability) more positively than self-transcendent customers, whereas self-transcendent customers view the legal, ethical, and philanthropic elements of CSR as more important than self-enhancement customers.[19] Finally, while both self-transcendent and self-enhancing types of customers perceive self-oriented value in product-related CSR

activities, only the self-transcendent customers are also likely to perceive other-oriented value in product-related CSR activities. For these reasons, in order to gain a larger customer market share, managers should be sure to include in their CSR portfolio a number of activities that are likely to be supported even by self-enhancement customers.

5 **Ensure coherence of CSR activities to build a "CSR brand"** Researchers have found evidence that when a company positions itself as a "CSR brand" — as opposed to a company that just engages in CSR activities — customers' awareness levels increase.[20] For example, while Danone/Dannon and Yoplait, two competing companies, both engage in CSR activities in the form of philanthropy, a third competitor, Stonyfield Farm, has elevated its commitment to CSR to the status of "CSR brand" in the production of yogurt and other fresh dairy products. Stonyfield Farm's philanthropy initiatives are coordinated within a coherent portfolio of CSR initiatives where over 80 percent of the company's product portfolio is organic and uses an innovative packaging that reduces waste. For this reason, companies should not only ensure that their CSR portfolio embeds multiple types of activities but also improve the cohesiveness of such activities to build a "CSR brand."

6 **Ensure consistent, long-term commitment to each CSR activity in the portfolio** In addition to the value perception of the activity per se, different corporate activities may have different impacts on the customer's perception of the overall firm's effort and long-term commitment to CSR. These two effects of CSR activities (the perception of value and the perception of firm commitment) are instrumental in customers' decisions to support the firm, with higher levels of perceived effort and long-term commitment leading to more positive customer responses.[21] In particular, as mentioned above, CSR activities related to products will be perceived as requiring greater effort and commitment than other CSR activities (e.g., writing a check versus investing in R&D or re-engineering the supply chain). For this reason, business leaders should ensure that investments in philanthropy and business practices are made — and promoted — consistently over long periods of time.

7 **Make adequate use of marketing to enhance the customer value proposition of CSR** Cause-related marketing that makes a compelling case for the adoption of new social norms can help enhance the customer value proposition of a certain CSR activity. An excellent example of value enhancement realized through cause-related marketing is the study of hotel guests' towel reuse, which shows that the savvy promotion of the program by a mid-priced hotel chain (including references to the aggregate amount of water and detergents that would be saved annually) resulted in a significant increase in participation.[22] With respect to a private customer behavior such as the use of bath towels, the assumption would be that customers would not trade their self-oriented value for a social value. However, by effectively showing the importance of adhering to new social norms on towel use, program participation rates went from a low 35 percent to almost 50 percent.

8 **Tie CSR activities to functional and utilitarian products** Not all product categories evoke the same emotional state when consumed.[23] Specifically, marketing experts classify products as experiential, symbolic or functional based on the primary needs they satisfy.[24] Experiential products satisfy the need for sensory pleasure (e.g., the new 3D television sets); symbolic products fulfill needs for self-enhancement or group membership (e.g., fashionable clothing); and functional/utilitarian products (or services) address more pressing customer issues (e.g., a non-dairy product addresses the issue facing a lactose-intolerant customer). Research shows that appeals that more closely match the specific needs satisfied by the product category are the most persuasive to customers.[25] In particular, CSR activities that also enhance a self-oriented value (in the organics agricultural practices of the aforementioned example, the value of adopting healthier eating habits) will receive the highest level of support by customers.[26]

9 **Seek optimal level of CSR investment** Empirical evidence demonstrates that, above an optimal level, CSR investment can be detrimental to financial performance without producing incremental stakeholder value.[27] For this reason, business leaders should not simply look to outspend their competition on CSR, or assume that greater levels of CSR investment will be matched by an equally greater customer perception of value. As part of a preliminary analysis of the multi-faceted effects of CSR activities on stakeholder value, companies should also include testing the effects of incremental investments in those activities so as to determine the optimal level of CSR return on investment. Above that level, additional CSR investment may be detrimental to shareholder value. Ultimately, the most successful customer brands are those that use CSR activities to provide incremental customer value without distracting critical resources to other elements of the business strategy.

10 **Be mindful of the impact of CSR on financial performance and shareholder value** Many CSR activities can create firm value without the intervening step of stakeholder perception (including customer value).[28] For example, a protocol adopted by the company to reduce energy consumption in the production process provides a cost savings and an environmental benefit without the necessary value perception by customers. Therefore, in deciding on CSR activities, business leaders should not only assess customer value but also use CSR instrumentally to enhance financial performance and shareholder value.

## Conclusion

Business leaders face competing demands for resources dedicated to CSR initiatives. By linking CSR activities with increased customer value, or developing new sources of customer value, companies can gain a competitive advantage. Moving from the analysis of multiple value types that CSR activities offer to customers, this section of the report provided recommendations on how board members and senior executives committed to their company's social and environmental responsibility can ensure effective and profitable investments in CSR.

## Endnotes

* The research findings discussed in this section of the report also appeared in "How Can Corporate Social Responsibility Activities Create Value for Stakeholders: A Systematic Review," *Journal of the Academy of Marketing Science*, Volume 39, Issue 1, by John Peloza and Jingzhi Shang (2011).


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# Sustainability Performance Assessment

by Katherine N. Lemon, John H. Roberts, Priya Raghubir, and Russell S. Winer

As business organizations increasingly invest in CSR, it becomes critical to accurately examine the effects of these endeavors. In particular, business leaders should be able to rely on a coherent set of metrics to assess and prioritize the goals of different stakeholders—the ultimate beneficiaries of CSR programs—and to regularly evaluate progress made by the company in pursuing those goals. This section of the report discusses a model for measuring the efficient and effective use of corporate resources allocated to CSR activities.

Business organizations use CSR initiatives to build and strengthen relationships with multiple stakeholder groups.* These groups may extend even beyond customers, suppliers, and competitors to include investors, employees, members of the board of directors, local communities, regulators, media, and financial markets. CSR activities affect a variety of different stakeholders, with potentially conflicting interests and goals. Because of the complexity of this context, corporations need to rely on a set of metrics to compare, integrate, and reconcile what may be quite disparate objectives. This section discusses a stakeholder-based approach to measuring the effectiveness of CSR activities.

**Profitability enhancement** Two reasons have been suggested for companies engaging in CSR initiatives: as a route to profitability and as an end in itself. First, company managers believe that CSR initiatives focusing on intermediate non-financial objectives with short-term negative cash flows may have a positive long-term effect on firm value.

Corporate social responsibility can increase firm value in a variety of ways; specifically, by:

- facilitating the design of innovative products;
- attracting labor;
- attracting and retaining customers;
- reducing manufacturing costs; and
- providing reputation insurance in a crisis.[1]

In addition, the mere conduct of CSR activities can send a positive signal to regulators and investors, in turn generating financial results.[2] Documented examples of this causality link include pollution disclosures in annual financial statements and, in the past, divestment in apartheid South Africa.[3] For the same reasons, information about illegalities by managers and product recalls are shown to lead to negative financial returns.[4]

**A virtue *per se*** A qualitatively different reason espoused for CSR activities is that internal stakeholders such as employees, management, and board members may have a set of extra-financial values and life goals that motivates them to feel good about themselves by returning to society part of the wealth they create through their service at the corporation.[5] This leads to the question of whether stakeholders engage in a certain CSR activity because it is a virtue per se and irrespective of whether it has downstream benefits on the company.[6]

For these reasons, measuring (financial and extra-financial) costs and benefits of CSR to a range of stakeholders is critical for companies to make informed decisions regarding their CSR initiatives. However, CSR effects can be hard to identify and calibrate, as evidenced by over one-third of a century of research into whether (and when) CSR activities add value to the firm, over what time period, and through which pathways.

### Calibration, evaluation, and justification

The primary function of metrics is to calibrate, evaluate, and justify decisions that have been executed in the past (i.e., performance measurement) and/or are being considered for the future (i.e., planning and option evaluation): in this sense, metrics are both backward and forward looking.

The calibration function of metrics involves converting decision alternatives that *prima facie* appear incomparable into a set of consequences scaled on desirability. This conversion process enables the company to make a business decision that is sound, informed, and justifiable.

The evaluation function of metrics involves measuring the performance of different options given certain required inputs (i.e., resources) and external benchmarks (including future goals, past performance, comparison to other organizations, and the status quo). This function enables a prioritization of those decision alternatives that is based on agreed organizational goals.

The justification function allows people in organizations with different points of view to argue a case for or against a course of action using a common set of terms and definitions. This function of metrics is particularly important when a course of action is relatively new or without precedent, and when there are dissenting points of view since metrics provide a common currency (or language) for debate and evaluation.

## The Importance of Metrics in CSR

The effort to define CSR-related metrics is critical for the diffusion of CSR activities across corporations, as metrics allow for the goals of different stakeholders to be assessed and prioritized in a coherent manner. Since the publication of the first study examining whether pollution is profitable, the question of why companies "do good" and whether they "do well" by doing so continues to be a matter of academic debate: in economics, finance, accounting, marketing, management, business ethics, and corporate law.[7] After more than 30 years of dedicated research on the relationship between CSR and financial performance, the answer to the question of whether CSR is profitable is an unambiguously clear: "It depends."[8]

The question of whether CSR activities pay off is a function of how a company:

- identifies and prioritizes its stakeholders and their respective goals;
- generates and pursues CSR options that are congruent with respect to its stakeholders' perceptions and preferences;
- measures the effectiveness of the CSR activities undertaken to pursue such goals; and
- measures the efficiency in the use of the resources allocated to such CSR activities.

Metrics translate goals into measurable input and output. They are used in every traditional functional domain of an organization. They range from dollar metrics (in finance), to throughput (in operations), and employee satisfaction (in management). Common marketing metrics include sales revenue, profitability, penetration, advertising reach and recall, customer satisfaction, customer lifetime value, and brand loyalty.

Metrics can greatly help to establish the business legitimacy of CSR.[9] Without metrics, companies that believe in CSR will continue to do so (e.g., The Body Shop), while the idea fails to become a business imperative among industry peers. Indeed, evolving market circumstances or a sudden ownership change may lead to abandoning that same idea. However, with metrics those who doubt the rationale for engaging in CSR-related activities (or have been delaying their decision to engage in them) are more likely to enter the field since the benefits of doing so are demonstrable. Thus, metrics play a persuasion role to help CSR-related activities "cross the chasm" from the innovator and early adopters to a broader base of mainstream users.[10]

Metrics increase the ease of observing and communicating the benefits of an idea, simplify a complex decision-making process by using a measurable common denominator, and ultimately legitimize a risk-undertaking course of action. In good times, without metrics to calibrate its effects, CSR may be adopted either as an act of faith or a form of charity; with metrics, CSR can become an element of business strategy and survive organizational upheavals, economic downturns, and other adverse internal or external circumstances.

**The AGREE model** This section of the report discusses a model for measuring and balancing the effects over time of CSR activities on different stakeholders. The model refers to the:

- Audience of the CSR activity;
- Goals of the stakeholders;
- Resources used to achieve stakeholder goals;
- Effectiveness with which stakeholders' goals are realized; and
- Efficiency of the use of the resources deployed to realize such goals.

## Audience

What is the audience of CSR? Is it the investor or the customer? Is it the employee, the legislator, or the company's board of directors?[11] Is it the supplier or the consumer welfare group? Can the audience for CSR be the community itself, with virtue being CSR's own reward?[12]

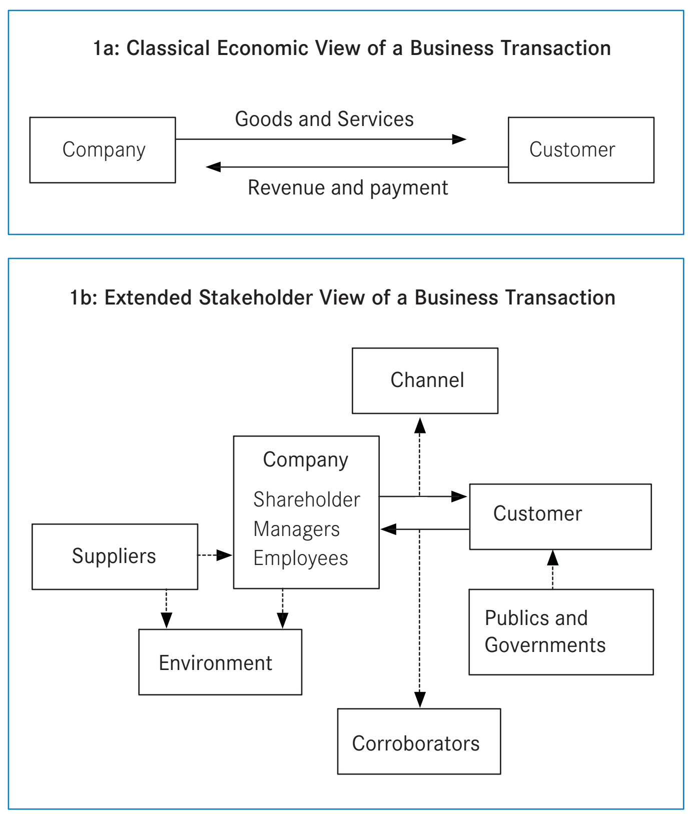
CSR is the taking into account of the objectives, values, and preferences of all individuals or groups of individuals who have an interest in the actions of the company—that is, its stakeholders. In this sense, CSR accounts for externalities that a myopic, profit-maximizing corporation might otherwise neglect.[13]

A corporation is a nexus of relations; and corporate action affects multiple individuals.[14] This may be illustrated using Figure 1. Figure 1a shows the classical market-based company that sells goods and services to a customer in a profit-maximizing way, either by optimizing the revenue it gains given incurred costs or by minimizing the costs required to generate certain revenue amounts. Figure 1b considers other potential stakeholders, including suppliers, employees, the environment, the government, and the general public.

Metrics permit an analysis of how the business world would be different if each company took into account the interests of various stakeholders. This is because, at a minimum, metrics allow comparability across the different dimensions that are salient to all stakeholders. Metrics also allow the examination of outcomes across different time periods—a relevant issue, as stakeholders' inter-temporal discount rates are high, with long-term benefits undervalued compared to short-term gains.[15] Examples of metrics associated with various stakeholders can be seen in Table 1 on page 64.

Table 2 (p. 65) outlines examples of possible resource misallocation decisions due to lack of an extended stakeholder view of the business similar to the one illustrated in Figure 1b. Acts of commission occur when business organizations do things that are inappropriate (e.g., Nike's use of Asian sweatshops).[16] Acts of omission happen when organizations fail to do things they should do (e.g., the decision of a financial firm operating in emerging markets to not offer micro-finance facilities).

Figure 1
**Traditional and Extended Views of Business Activity and Firm Performance**



## Goals

With respect to the goals of CSR, a company faces two primary assessment challenges:

1. First, measuring CSR over time. Given that CSR outcomes can be realized over different time periods, a company faces the challenge of choosing CSR metrics adequate to assess both short-term and longer term effects.[17]
2. Further, measuring the utility of CSR for multiple stakeholders. Given the range of stakeholders and their different interests, a company faces the challenge of choosing CSR metrics adequate to assess multiple types of utility as well as the challenge of adopting a method of calculus for combining these resulting assessments in a balanced way.[18]

These issues are discussed next.

**A time dependent calculation model of multi-stakeholder CSR goal-based utility** To calculate how a stakeholder ($i$) might evaluate the outcome ($y_{ijk}$) of a certain CSR activity ($j$) on a range of relevant dimensions (or attributes, $k$), the interest borne by the stakeholder is considered.

The basic calculation model is a standard multi-attribute utility model that takes the weight that $i$ puts on each dimension ($w_{ik}$) and uses the level of performance ($y_{ijk}$) to determine the utility ($U_{ij}$)gained by stakeholder $i$ from action $j$.[19]

### Equation 1

$U_{ij} = \sum_k w_{ik} \times y_{ijk}$

To illustrate the calculation model by means of a simple example, assume for the moment that the only stakeholder is the customer (stakeholder $i$), and the two primary customer-related dimensions (attributes) being considered by the company are the impact of a charitable donation (the CSR activity, $j$) on brand equity and on sales (the outcomes, $y$). Further, assume that the weight associated with the outcome of brand equity is 0.6 and the weight associated with the outcome of sales is 0.4. The costs of the two programs are assumed equal.++

Finally, assume that, based on consumer behavior research, the company determines that a donation to a children's health program (e.g., The Global Alliance for Vaccines and Immunization, or GAVI) would improve the company's brand equity by 10 percent and sales by 20 percent.[20] Based on the same internal research, the company also establishes that a donation to an environmental cause (e.g., The Sierra Club) would increase brand equity by 20 percent and sales by 3 percent.[21]

Table 1

### Examples of Stakeholder Metrics

| Audience for CSR | Goal Hierarchy | Effectiveness Metrics |
|---|---|---|
| **Society** | Educated, Healthy, Wealthy, Happy, Stable, Cohesive Community. | Quality of Life Indicators: Physiological (Health), Economic, Educational, Social, Psychological. Examples: Percentage of population impacted; Life expectancy; Literacy rates; Income/nutrition p.c.; Disease Incidence rates; Birth/ Death rate by age. |
| **Environment** | Sustainable. | Sustainability; Improvement in indices; Pollution and toxicity levels (water, air, other). |
| **Regulators, Auditors, NGOs** | Ensuring compliance with existing regulations; Identifying new regulations to keep consumer welfare interests in line with corporate profitability goals. | Credit from regulators; Inclusion in CSR indices. |
| **Media** | Providing accurate, timely, and newsworthy information to the public. | Quantity and quality of press impact. |
| **Financial Markets** | Stability, Growth, and Profitability. | Rates of Return, Volatility, turnover, and liquidity over time. |
| **Economy** | Stability, Growth, and Profitability. | GDP/ GNP, per capita and overall; Debt ratios, foreign exchange reserves. |

Under the calculation model illustrated above, in order to decide to which of these two charities it should donate, the company would compute the utility associated with both, as follows:

GAVI: 0.6 x 1.10 + 0.4 x 1.20= 0.66 + 0.48 = 1.14

The Sierra Club: 0.6 x 1.20 + 0.4 x 1.03 = 0.72 + 0.412 = 1.13

Based on this calculation, the company would conclude that GAVI—the children's health campaign—is a donation cause that generates the higher utility.

To include a richer set of environmental phenomena, this calculation model could be further elaborated by accounting for time and the interactions of multiple stakeholders.

**Accounting for time** Time can be incorporated in this formulation by recognizing that net benefits (or net costs) of the outcome on dimension *k* may accrue over a certain time period ($t$), so that $y_{ijk}$ is the sum of benefits (costs) over time ($y_{ijkt}$), suitably adjusted by the discount rate ($r_{ik}$, which is specific to individual stakeholders).

## Equation 2

$$y_{ijk} = \Sigma_t y_{ijkt} / (1+r_{ik})^t$$

In the example above, assume that the benefit of "doing good" on brand equity "deteriorates" less rapidly than its effects on sales: that is, 10 percent vs. 60 percent per year. In this case, the calculation above would be modified in the following way in the second year of the proposed program:

GAVI: (0.6 x 1.10)/(1 + 0.10) + (0.4 x 1.20)/(1 + 0.60) = 0.90

The Sierra Club: (0.6 x 1.20)/(1 + 0.10) + (0.4 x 1.03)/(1 + 0.60) = 0.912

Therefore, in the second year of the proposed CSR activities, The Sierra Club—the environmental program—would generate a higher utility, while over the entire two-year period the benefits of each program are fairly equal (1.14+0.90 versus 1.13+0.91).

**Accounting for multiple stakeholders** The next step is to consider how the agendas of different stakeholders may be combined into a total public welfare figure ($U_j$).

Table 2

### Potential Misallocation Decisions Ignoring Figure 1b Externalities

| Audience for CSR | Short-Term Cross-sectional | Long-Term Inter-temporal |
|---|---|---|
| **Acts of Commission** | Externalities are not identified, leading to high net cost activities.<br><br>**Example:** Nike's use of Asian sweat shops.<br><br>If Nike had identified labor and society as stakeholders, they could have explicitly examined the implications of the release of this information on other stakeholders, such as consumers, regulators, and financial markets.<br><br>Typical Metric: $CO_2$ emissions associated with an airline ticket | High discount rates on future costs encourage projects with future problems.<br><br>**Example:** Companies continued use of technologies that lead to high pollution levels.<br><br>If companies account for and measure the positive benefits of their sustainable technologies on the environment they can explicitly examine the effect of this information on their other stakeholders: customers regulators markets.<br><br>Typical Metric: Future obesity rates associated with unhealthy food for children. |
| **Acts of Omission** | Lack of market mechanisms lead to valuable problems not being funded<br><br>**Example:** Banks prior to Grameen Bank did not undertake Micro-financing, unsure of the risk-reward payoffs.<br><br>If other banks had identified society as a stakeholder, they could have examined the profitability of entering poorer segments of society.<br><br>Typical Metric: Aluminum recycling rates as a result of failing to have a soda can deposit scheme. | High discount rates on future benefits penalize valuable potential projects.<br><br>**Example:** Companies choosing not to engage in "Project (Red)™". In contrast, Gap has increased the sourcing of products in its "Project Red" campaign, hoping for economic trickle down effects to reduce the spread of AIDS, and hence reduce the turnover in their factories.<br><br>By recognizing that their labor and the society in which it resides is a stakeholder, Gap is able to develop a cohesive project that is win-win for customers, labor and society.<br><br>Typical Metric: Future marine biodiversity as a result of failure to launch biodegradable detergents. |

The most obvious way to do this is in a linear fashion: that is, by assigning different weights to each stakeholder ($\lambda_i$). As a result, $U_j$ is given by the sum of each stakeholder's utility ($Uii$) weighted by the strength of the claim of that stakeholder ($\lambda_i$). :

## Equation 3

$U_j = \sum_i l_i \text{ x } U_{ij} = \sum_i l_i \sum_k w_{ik} \text{ x } y_{ijk}$

Continuing with the simple example introduced (without accounting for time), the company's decision might be different if one relaxes the assumption that there is only a single stakeholder and allows for the presence of a second stakeholder—e.g., the employee. Assume, for simplicity, that the two employee-related attributes being considered by the company are the ability to attract (weight 30 percent), and retain (weight 70 percent) employees. Donations to the children's health cause may improve the ability to attract employees by 1 percent, but affect the ability to retain employees by 15 percent. On the other hand, donations to the environment cause may have the effect of improving the ability to attract employees by 15 percent and to retain them by 10 percent. In this case, by applying Equation 1, the overall employee-related utility of donating to the two causes looks as such:

GAVI: 0.3 x 1.01 + 0.7 x 1.15= 0.303 + 0.805 = 1.108

The Sierra Club: 0.3 x 1.15 + 0.7 x 1.10 = 0.345 + 0.770 = 1.115

CSR programs should be tailored to a thorough analysis of key stakeholder relations and based on a prioritization of the stakeholder interests the company intends to pursue. Therefore, in the example above, should the company base its decision on the utility generated by each hypothetical program on the company's employees, it is likely to opt for the environmental cause. If, however, the company desires to engage in a program that pursues the combined interests of customers and employees, Equation 3 in the model would yield the following result:

GAVI: 1.140 + 1.108 = 2.248

The Sierra Club: 1.132 + 1.115 = 2.247

In the same example, by increasing the weight assigned to the customer, the company would be likely to choose the children's health program, while the environmental cause would be preferred if the weight assigned to the employee is to be higher.

More complex models are possible but will not be discussed in detail in this report. One of them is a compound conjunctive model of decision making, where the company decides to secure a minimum, acceptable level of utility on one or more of the stakes involved and then to maximize utility over the remaining stakes weighted by their importance.[22]

**Accounting for uncertainties** Another way in which this basic model could be elaborated is to incorporate uncertainty, including the uncertainty of regulatory or enforcement action. For example, in principle, a company that dominates a certain business market could view it as appropriate to deny market access to its competitors by bundling its dominant product with a number of complementary products so as to force consumers of the major product to forego choice on the complements. However, under a more sophisticated utility calculation model that accounts for uncertainties, the calculation of the utility of this behavior would discourage its ultimate adoption as it factors in the chances of a regulatory action against the firm's behavior and a consumer backlash.

## Outsourcing Practices and AIDS Prevention Programs

A number of U.S. companies are committed to contribute to reducing the spread of AIDS in the African communities where they outsource some of their production needs.[a] This commitment may reflect an attempt to contain turnover rate in factories employing labor from communities stricken with AIDS as well as the companies' belief that "Trade, Not Aid" is the route to bring long-lasting, sustainable development in Africa.

In addition to reducing the spread of AIDS, members of those local communities may have a range of alternative or additional goals related to improving their lives, including the introduction of safe water technologies or of direct subsidies for programs on health, education, and sheltering. On some levels, these other goals may be viewed as more important than an AIDS prevention program, as they would bring tangible results in a shorter and more immediate time period. For this reason, using a metric that assesses the (positive or negative) consequences of an AIDS-related initiative while balancing these other community goals should be an integral part of those companies' CSR activities.

a Bobbi Silten, *Practitioner Perspective: Bobbi Silten, Gap, Inc.*, Speech at the Stakeholder Marketing Consortium, Aspen, Colorado, September 14, 2007.

## Resources, Effectiveness, and Efficiency

With respect to the resources ("inputs") allocated to CSR activities, it is useful to measure the effectiveness and the efficiency of their use to realize stakeholder goals ("outputs").

**Inputs** Commonly used resource-related measures of corporate social performance (both positive and negative) may include:

- charitable contributions and philanthropic acts;
- revealed misdeeds;
- transparency of reporting; and
- corporate policies and statements of ethics.[23]

Aside from financial and production resources deployed directly by the company, other resources that may be required by CSR activities include tax and other incentives (and sanctions) from governments, infrastructure resources and engagement services from communities, and attitudes and behaviors from customers and channel collaborators.

**Outputs** Corporate social responsibility outputs can be measured quantitatively and qualitatively, and subjectively or objectively. They can be intended or unintended outputs, short-term or long-term outputs, and depend on the different interests borne by each stakeholder. As discussed earlier, the scope of this report is restricted to quantitative metrics; however, it is important not to dismiss the critical role that qualitative metrics play in a more holistic decision-making process, as they are better than numbers in capturing human emotions and other subjective factors.

Quantitative measures alone may lead to a bias towards financial outcomes. For example, at a national level, metrics such as gross national happiness in Bhutan represents attempts to include such variables in estimates of national performance, overcoming shortcomings of more traditional measures such as gross domestic product.[24]

Subjective output measures include self-reports and observer reports of corporate performance (e.g., ratings from the Fortune 500 database of most admired companies), whereas objective outputs are based on third-party audits (e.g., Superfund site liabilities) and membership into specific categories (e.g., the Kinder Lydenberg Domini Index, which evaluates companies on eight dimensions).[25]

Metrics of intended consequences relate to the extent to which a CSR effort achieved its specific goal (e.g., a reduced percentage of child labor). Metrics of unintended consequences explore the ramifications of that goal in terms of other desirable consequences (e.g., a increased percentage of children attending school) as well as potential undesirable consequences (e.g., reduced income levels, higher crime rates, higher unemployment rates). These unintended consequences may affect multiple stakeholders.

Outputs can further be thought of as short-term and long-term, with shorter term outputs often cumulatively leading to trickle down into longer term outputs. In order to be useful in the decision-making process on CSR activities, metrics need to be able to allow comparability between longer term, trickle down effects and the more direct, shorter term effects.

Finally, output metrics can be domain-specific (e.g., environment, social, labor, health, education, etc.), or based on a more generally applicable set of standards (e.g., financial, accounting, or marketing measures). For example, if improving the environment is to a company an end in and of itself, then measures that incorporate the level of emissions and toxicity would be appropriate distal outputs. However, if improving the environment is a means to boost corporate reputation in the marketplace, then the most appropriate distal output would be brand equity or stock price.

For all of these reasons, many CSR researchers are interested in examining the effects of CSR investments on a variety of qualitative and quantitative outcome measures, such as market share, price premium, product quality, and customer loyalty. For example, some researchers have developed a model of consumer response to CSR that investigates the relationships between CSR initiatives and price premium, customer loyalty, and word of mouth.[26] Other research examines the relationship between investments in corporate citizenship activities and customer lifetime value (CLV), and finds that, for some industries, such investments have a significant, positive effect on CLV.[27]

By combining tools to assess the CSR activity's audience, its goals, and the efficient and effective use of resources for CSR purposes, the AGREE approach permits a subtler and multifaceted view of the complex nexus of stakeholder relations in which the business corporation operates. It also encourages engaging stakeholders in identifying the short-term and long-term consequences of a course of action being considered. As mentioned above, a company's choice of which CSR activity to pursue is contingent on balancing the stakes across different stakeholders, each with different short-term and long-term interests and objectives.

For example, increasing health benefits to employees would improve employee satisfaction, but it may come at the expense of short-term profitability. Similarly, unethical forms of outsourcing would reduce product price and favor market penetration, but at the cost of harming the local communities to which the production is outsourced—an external stakeholder.

## Complicating Issues and Next Steps

This report sets out an approach toward CSR metrics that incorporates multiple stakeholders, their different interests, and inter-temporal returns and costs. It is important to recognize that the proposed approach is not without difficulties and complexities. This final part discusses some of these challenges.

**Balancing competing and sometimes incompatible objectives** While the calculation model described on pp. 64-66 and its more complex variants offer a method for combining the interests of different stakeholders, it is reasonable to expect that each stakeholder will have different perceptions of the weight that should be attached to different stakes. Examples include the protests against firms that invested in South Africa during the apartheid era and the attacks against Starbucks stores during the Seattle WTO meeting in 1999.[28] Although potentially complex, the useful role of CSR metrics and the analysis that accompanies them is that they provide a framework within which to discuss stakeholder trade-offs. To achieve this, a reasonable benchmark is a system that improves equity and transparency, allows trade-offs to be explicit, and identifies improvements in effectiveness and efficiency.

**Green washing and the problem of ensuring the credibility of CSR** Like many other activities, CSR is subject to a free-rider problem. Companies seeking the benefits but not fundamentally embracing a coherent CSR program may dilute the goodwill created by socially aware and truly responsive business organizations. In the area of environmental CSR, this phenomenon has been termed "green washing." One important role of metrics is for companies systematically engaging in CSR-related activities to be able to differentiate themselves from others that claim to do so based on merely sporadic and superficial efforts.

A concern among practitioners is that the CSR "brand name" may get misused, leading to consumer skepticism, with a potential backlash against not only the companies engaging in green washing but also CSR itself and the companies that genuinely practice it.[29] For example, in the United States, legislation is being considered to regulate "embedded giving"—the fundraising practice in which firms bundle a gift to charity into an everyday purchase.[30] Programs that offer to donate a small percentage from every purchase to a specific charity represent one form of embedded giving. Currently, firms are not required to disclose what percent of the purchase will be donated to charity; therefore, public accountability of CSR claims would help reduce any such backlash from consumer skepticism.

However, such accountability is only possible in the presence of well-defined metrics. Trusted third parties such as fair trade organizations are already springing up to fulfill this role. For example, The Global Reporting Initiative (GRI) formulated a framework and guidelines for disclosing information about corporate sustainability programs, and encourages firms to report on their economic, environmental, and social performance in the manner they are accustomed to doing for their financial performance.[31] Auditing practices using commonly accepted metrics, such as those in the GRI guidelines, would be an effective mechanism to prevent cheap talk, ensure authenticity, and establish transparency of CSR initiatives.

**Inter-temporal discount rates—what matters, when, and to whom?** As briefly noted earlier, another critical issue has to do with the inter-temporal effects of CSR. It is difficult for individuals and organizations to accurately evaluate potential future outcomes, and even more difficult for people to incur short-term costs for long-term benefits. To exacerbate this problem, the capital and reward structures of most companies are short-term focused. In terms of CSR metrics, this suggests that business corporations are more likely to consider—and more heavily weigh—short-term effects of CSR initiatives relative to long-term ones. For this reason, it is crucial to develop a set of CSR metrics that cover the temporal spectrum—capturing the effects of CSR in the short-, medium-, and long-term, across multiple stakeholder groups. If such metrics can be identified, they may be able to reduce conflicts between stakeholder groups, recognizing their distinct interests (with differing timeframes) and enabling discussions and comparisons across them.

## The Future of Measuring CSR

It has been exciting to watch the growth of the corporate social responsibility field over the last 10 to 15 years. In particular, over the past decade, CSR has been moving past definitions and toward measurement and implementation.[32] This report intends to take a next step in that direction.

It is time for business corporations to embrace the complexities of CSR metrics. The conceptual underpinnings of CSR are now better developed, understood, and accepted. Further, there have been significant advances in the area of CSR-related metrics, especially in linking resources (or inputs) to stakeholder goals (or outputs). Finally, there is continued rising interest in the value of CSR to firms and the importance of sustainability.

Together, these three developments make it possible and appropriate to develop, test, and validate CSR metrics. The charge for future research is to identify a range of metrics that companies can use to measure the impact of their actions and non-actions on a range of stakeholders. The measures in the last column of Table 1 provide a starting point toward this. However, future research must examine how well these measures are able to tap into the extent to which stakeholder goals were satisfied (i.e., effectiveness criterion), how costly they are to collect, and how persuasive they are in making a case for a CSR action. Hopefully the process described in this report of understanding different stakeholders and translating their goals into specific measurable metrics provides a framework that can move the field forward.

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* This section of the report is based upon the article, "Why, When, and How Should the Effect of Marketing be Measured? A Stakeholder Perspective for Corporate Social Responsibility Metrics," by Priya Raghubir, John Roberts, Katherine N. Lemon, and Russell S. Winer. This article appeared in 2010 in the *Journal of Public Policy & Marketing*, Volume 29, Issue 1, on pages 66 through 77.

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# Sustainability Communication

by Shuili Du, CB Bhattacharya, and Sankar Sen

Since creating stakeholder awareness is a key prerequisite for reaping the strategic benefits of any business initiative, it is imperative for board members and senior executives instituting a social responsibility program to have a deeper understanding of the key issues related to CSR communication. This section discusses what to communicate (i.e., message content) and where (i.e., message channel), as well as the major factors (internal and external to the organization) that affect the effectiveness of CSR communications.

Corporate social responsibility, defined broadly as "a commitment to improve [societal] well-being through discretionary business practices and contributions of corporate resources," occupies a prominent place on the global corporate agenda in today's socially conscious market environment.[1] More than ever, companies are devoting substantial resources to various social and environmental initiatives—ranging from community outreach and neutralizing their carbon footprint to socially responsible business practices in employment, sourcing, product design, and manufacturing.

These unprecedented CSR efforts are driven not only by the ideological construct of a corporation as a force for social change but also by the financial return that could be reaped from such endeavors. Surveys of senior executives and CSR professionals indicate that CSR creates unique business value in a number of ways—by building reputation, enhancing employee morale, and strengthening competitive positions.[2]

Consistent with these findings, a growing body of academic research attests that:

- A company's positive record of CSR fosters consumer loyalty and, in some cases, can turn customers into brand ambassadors and advocates who may be willing to even pay a premium to support the company's social policies.[3]
- CSR may offer a competitive advantage in attracting, motivating, and retaining talented employees[4] and socially responsible investors.[5]

Stakeholders (customers, employees, and investors, among others) are key to the success of any business, and CSR has the unique ability to cultivate stakeholder relationships.

**Stakeholder awareness** Needless to say, the business returns to CSR are contingent on the stakeholders' awareness of a company's CSR activities. However, recent empirical studies revealed that awareness of a company's CSR activities among its external stakeholders (e.g., consumers) or even its internal stakeholders (e.g., employees) is typically low, hence constituting a key stumbling block in the company's quest to reap strategic benefits from a social responsibility program.[6]

Consistent with these findings, of the 20 attributes measured in the annual Harris Interactive corporate reputation study published by the *Wall Street Journal*, people are most in the dark about corporate responsibility: questions about whether companies are socially and environmentally responsible consistently elicit the most "don't know" responses.[7]

**Stakeholder skepticism** Beyond awareness, another key challenge to CSR communication is how to minimize stakeholder skepticism. While stakeholders claim they want to know about the good deeds of the companies they buy from or invest in, they quickly become leery of companies' motives when organizations aggressively promote their CSR efforts. Unlike other marketing information such as product quality and new innovations, a company's CSR information reflects a company's "character," or "soul."[8] The identity-revealing nature of CSR activities makes stakeholders' attributions of the motives underlying those activities crucial: there might be a backlash if stakeholders perceive predominantly self-serving, profit-related motives, rather than a company's genuine concern for improving societal welfare.[9]

Recent research on CSR attributions suggests that stakeholders often perceive both intrinsic, genuine motives of social and environmental concern as well as extrinsic, profit-related motives.[10] Interestingly, stakeholders are often tolerant of extrinsic motives as long as CSR initiatives are attributed to intrinsic motives as well.[11] This growing tolerance of extrinsic motives indicates that as stakeholders learn more about CSR and companies' motivations, they are increasingly willing to adopt a "win-win" perspective, believing that CSR initiatives can and should serve both the needs of society and the bottom lines of business.

Since creating stakeholder awareness and managing stakeholder attributions are key prerequisites for reaping the strategic benefits of any business initiative, it is imperative for board members and senior executives instituting a CSR program to have a deeper understanding of key issues related to CSR communication. These include questions surrounding what to communicate (i.e., message content), where to communicate (i.e., message channel), as well as an understanding of the factors (internal and external to the organization) that influence the effectiveness of a CSR campaign. Figure 1 presents a conceptual framework of CSR communication.

## What to Communicate: Message Content

CSR communication typically focuses on a company's involvement in various social causes. There are several factors a company can emphasize in its CSR communication, such as its commitment to a cause, the impact it has made on the cause, and the congruity between the cause and the company's business (i.e., CSR fit).

**CSR commitment** A company can support a social cause in various ways, including donating funds, in-kind contributions, or providing other corporate resources such as marketing expertise, human capital (e.g., employee volunteering), and R&D capability.

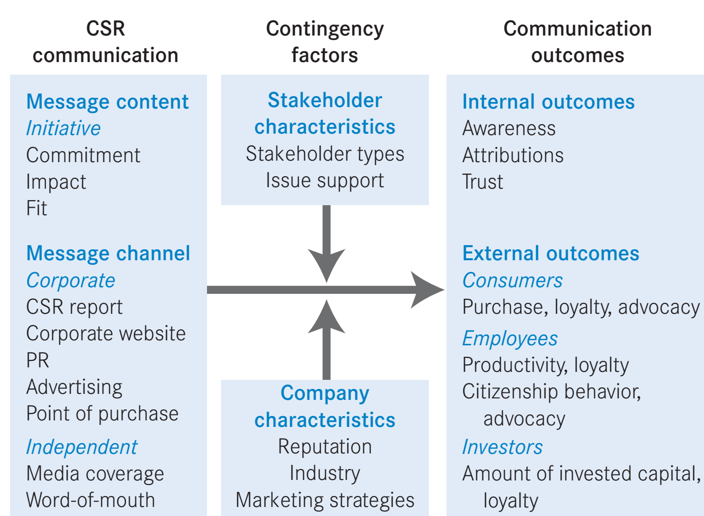
CSR commitment has three key aspects:

1 the amount of input;
2 the durability of the association; and
3 the consistency of input.[12]

In CSR communication, a company can choose to focus on one or several aspects of its commitment to a social cause. For example, in its 2007 corporate responsibility report,[13] Target used these words to describe its signature Take Charge of Education program: "Target… donates a percentage of purchases made on Target credit cards to K-12 schools that cardholders designate. Since we launched the program in 1997, we've donated more than $246 million to schools." In this example, the company emphasized all three aspects of its commitment: the substantial amount of input (e.g., $246 million) as well as the durability (e.g., since 1997) and the consistency of the company's support (e.g., a percentage of purchases made on Target credit cards).

Figure 1

**A Framework of CSR Communication**



**CSR impact** Instead of the input side of its involvement in a social cause, a company can focus on its output: that is, the societal impact, or the actual benefits that have accrued (or will accrue) to the target audience of a social cause. For example, in partnership with the United Nations Children's Fund (UNICEF), Pampers has launched a social initiative, "1 Pack = 1 Vaccine" to give tetanus vaccines to expectant women in developing countries and to save their newborns from a disease called newborn tetanus. The title of this program clearly communicates the societal impact of the program and the impact of the consumer's purchase of the Pampers' products designated for the social program.

Emphasizing a company's CSR commitment or CSR impact is an effective communication strategy because CSR communication should be factual and avoid the impression of "bragging."[14] Furthermore, a company's CSR commitment and its social impact also serve as diagnostic cues with regard to its underlying CSR motives. In particular, data shows that the durability of support for a cause was used as a cue for judging a firm's motives: longer term commitments were more likely to be seen as driven by a genuine concern for increasing societal/community welfare, while shorter term campaigns were more likely to be viewed as a way to exploit the cause for the sake of profit.[15] Similarly, research has documented positive associations between the perceived societal impact of a company's CSR initiative and consumers' intrinsic attributions, resulting in consumers' advocacy behaviors toward the company.[16]

**CSR fit** Another important factor to communicate is CSR fit, or the perceived congruence between a social issue and the company's business. Stakeholders often expect companies to sponsor only those social issues that have a high fit, or a logical association, with their core corporate activities.[17] CSR fit may result from common associations that the brand shares with the cause, such as, product dimensions (e.g., a herbal products brand sponsors the protection of rain forests), affinity with specific target

## Examples of Message Content

Three recent campaigns exemplify key aspects of CSR communication.

**Target (Take Charge of Education program) for CSR commitment** "Target… donates a percentage of purchases made on Target credit cards to K-12 schools that cardholders designate. Since we launched the program in 1997, we've donated more than $246 million to schools."[a] "[As part of the program,] we'll track purchases made by participating REDcard® holders, then send a no-strings-attached donation check directly to the school principal. Checks are distributed once a year. If the total of accumulated donations is less than $25, the amount carries over to the next payment period."[b]

**Pampers ("1 Pack=1 Vaccine" program) for CSR impact** "Pampers is committed to improving the lives of babies around the world… Working together with parents and UNICEF, one area we've chosen to focus on is newborn tetanus, a major health problem in developing countries. Newborn tetanus claims the lives of more than 140,000 babies each year, but this disease is preventable. If an expectant mother receives the vaccine before she gives birth, both she and her baby will be protected from this disease. The "1 Pack=1 Vaccine" program… helps get these lifesaving vaccines to the women who need them. Here's how it works: For each pack of specially marked Pampers diapers and wipes that you buy during the promotion period, Pampers donates the cost of one vaccine to UNICEF. It's a small step but it can and does lead to big change. Thanks to parents like you in Western Europe and the United States, the Pampers/UNICEF 1 Pack=1 Vaccine program has helped provide more than 100 million vaccines that protect moms and babies from maternal and neonatal tetanus."[c]

**Avon (The Avon Breast Cancer Crusade program) for CSR fit** "The Avon Breast Cancer Crusade was launched in 1992 as a small pioneering program in the U.K. Avon in the U.S. adopted the Crusade the following year. Over the last 18 years, Avon philanthropy has raised and donated more than $700 million to breast cancer programs around the world, supporting cutting-edge research to find a cure for or prevent breast cancer as well as programs that enable all patients to access quality care. Funding supports awareness and education: screening and diagnosis; access to treatment; support services; and scientific research. Beneficiaries of the Avon Breast Cancer Crusade range from leading cancer research and clinical centers to community-based, non-profit breast health education programs."[d]

a "Target: REDcard: Take Charge of Education," Target website, accessed February 15, 2011 (target.com/tcoe)

b Ibid.

c "Children's Charities: Caring for Babies around the World," Pampers website, accessed February 15, 2011 (www.pampers.com/en_US/childrens-charities-around-the-world).

d "Avon Foundation for Women: Breast Cancer Crusade," Avon Foundation for Women website, accessed February 15, 2011 (www.avonfoundation.org/breast-cancer-crusade/).

segments (e.g., Avon fights breast cancer), or corporate image associations created by the brand's past conduct in a specific social domain (e.g., Ben & Jerry's and the Body Shop's activities in environmental protection).[18]

CSR fit is important because it affects stakeholders' CSR attributions.[19] Low CSR fit, due to the lack of logical connection between a social issue and a company's business, is likely to trigger stakeholder skepticism and extrinsic attributions, hence reducing their positive reactions to a company's CSR activities. Therefore, a company should highlight the CSR fit of its social initiative if there is congruence between the social issue and its business pursuit.

When a company does not have a high natural fit with the social cause it supports, it should elaborate on the rationale for its social initiative to increase perceived fit. For example, DenTek Oral Care, a sponsor of the American Diabetes Association, includes in its sponsorship communications the information that diabetes can lead to tooth decay, bad breath, dry mouth, and gum disease.[20] Because many people may not know about diabetes-related dental problems, the sponsorship might otherwise seem to be a bad fit. By elucidating the underlying link between the sponsorship and its core business, the company is able to create a high perceived fit and reap greater business returns to its CSR activities.

## Where to Communicate: Message Channels

There are a variety of communication channels through which information about a company's CSR activities or record can be disseminated. A company can communicate its CSR activities through official documents, such as an annual corporate responsibility report, press releases, and a dedicated section of its official corporate website; it can also use TV commercials, magazine or billboard advertisements, and product packaging to communicate its CSR initiatives.

**Corporate responsibility reporting** Corporate responsibility reporting has gone mainstream. In 2008, according to an extensive analysis conducted by KPMG, nearly 80 percent of the largest 250 companies worldwide issued corporate responsibility reports, up from about 50 percent in 2005.[21] Although data on corporate reporting are less satisfactory for the United States alone, a 2010 survey of U.S. public companies by The Conference Board shows that at least35.2 percent of participants release a stand-alone annual report encompassing a variety of social responsibility issues, and that 18.5 percent address the specifics of some of those issues in their annual report to shareholders (Chart 14 on page 44 in the "Emerging Sustainability Practices" section of this report).[22]

**Traditional advertising channels** In addition to corporate responsibility reporting and communication through corporate websites, companies also use traditional advertising channels to communicate their CSR activities. For example, Diet Coke has been running TV commercials on its CSR initiative to help raise women's awareness about heart disease, and the brand has also set up a website (www.dietcoke.com/reddress) to communicate the brand's commitment to the cause and various ways for consumers to get involved.

**Product packaging** Companies can also use product packaging to communicate its CSR initiatives. For example, Stonyfield Farm prints messages on the lids of its six-ounce yogurt cups to communicate the company's involvement in a wide variety of health and environmental initiatives.

**External communicators of CSR** In addition to company-controlled CSR communication channels, the ranks of external communicators of CSR (e.g., media, customers, monitoring groups, consumer forums/blogs) that are not entirely controlled by the company continue to grow. These external communicators are likely to vary in the extent to which they are controllable by the company. For example, a company might be able to exert greater control over the content of CSR communication by members of its value chain (e.g., employees, channel members) than by those who are not part of the value chain (e.g., monitoring group, customers).

Moreover, there is likely to be a tradeoff between the controllability and credibility of CSR communication: the less controllable the communicator is from the company's perspective, the more credible the CSR communication is to the stakeholders, and vice versa. Stakeholders will likely perceive the company as more self-interested than other noncorporate sources and, consequently, judge CSR communication via corporate sources as less credible than noncorporate sources. Specifically, research shows that consumers react more positively to a company's CSR activities when they learn about such activities from a neutral source (i.e., an independent organization that provides unbiased evaluations of corporate activities).[23] Therefore, although getting media cooperation is often difficult, companies should try hard to get positive media coverage from independent, unbiased sources, such as editorial coverage on TV or in press.

**Stakeholder word-of-mouth: employees and consumers** Companies should try to encourage informal yet credible communication channels such as word of mouth by stakeholders. In particular, companies should not underestimate the power and reach of employees as CSR communicators.[24] Since employees typically have a wide reach among other stakeholder groups through their social ties and are often considered as a credible information source, companies should "tune up" their internal CSR communication strategy and find ways to engage employees and convert them into companies' CSR advocates.[25]

Another powerful stakeholder group—consumers—can also serve as an informal yet highly effective CSR communication channel. In particular, the power of consumer word-of-mouth has been greatly magnified by a variety of blogs, social networking sites (e.g., Facebook), and other social media platforms. Companies like Stonyfield Farm and Ben and Jerry's have been benefiting from consumer ambassadors who raved, in the virtual world, about their social responsibility endeavors.

## Moderators of Communication Effectiveness: Company-Specific Factors

By revealing the character of the information sender, some company-specific factors will likely influence the effectiveness of CSR communication. This report discusses two factors of this type: corporate reputation and CSR positioning. The influence of these factors is expected to be greater for company-controlled communication than for third-party communication.

**Corporate reputation** Conceptualized as "a collective representation of a firm's past actions and results that describes the firm's ability to deliver valued outcomes to multiple stakeholders," corporate reputation encompasses different dimensions—product quality, innovation, investment value, people management, and CSR.[26] Reputation will moderate the effectiveness of CSR communication because it often serves as a pre-existing schema upon which stakeholders rely to interpret ambiguous information about the company, including its CSR activities.[27] One aspect of corporate reputation—a company's existing, or prior CSR record—will be perceived as a particularly diagnostic cue for stakeholders evaluating the merits of the company's CSR communication.

In general, companies with good reputations, perceived to have high-source credibility, will likely find the positive effects of their CSR communication to be amplified, whereas the effects of CSR communication in the case of companies with poor reputations could be dampened or even backfire.[28] Interestingly, research has also shown that companies with neutral ethical reputations are likely to reap greater business benefits from CSR communication than companies with positive ethical reputations.[29]

In addition to corporate reputation, the industry in which a company operates will also moderate the effectiveness of CSR communication. For instance, stakeholders are often suspicious of companies in certain industries (e.g., tobacco, oil), an attitude that can pose a major challenge to communication strategists.[30]

**CSR positioning** Another company-specific factor, CSR positioning, is also likely to influence the effectiveness of CSR communication. CSR positioning refers to "the extent to which a company relies on its CSR activities to position itself, relative to the competition, in the minds of consumers."[31] While many companies engage in a certain activity to affiliate themselves with a social cause (e.g., a philanthropic foundation), some—Timberland, Ben and Jerry's, and the Whole Foods Market being the best known examples—develop a more holistic portfolio of CSR activities (including product-related activities) that can position the business as the socially responsible brand among competitors. In this case, CSR becomes the major competitive advantage for the company in the industry.

For example, in the U.S. supermarket sector, the Whole Foods Market brand is strongly positioned on CSR, as it espouses the core value of "caring about our communities and our environment."[32] Moreover, this value pervades virtually every aspect of the Whole Foods' business, such as organic and sustainable sourcing to environmentally sensitive retailing, the devotion of at least 5 percent of its annual profits to a variety of causes, and the company's encouragement of its employees to conduct community service during working hours.

A company's CSR positioning can significantly amplify the effectiveness of CSR communication. Stakeholders are likely to pay more attention to a comprehensive and coherent CSR message and believe in the authenticity of the social commitment.[33]

## Moderators of Communication Effectiveness: Stakeholders-Specific Factors

Certain characteristics of stakeholders, the recipients of CSR communication, also have the potential to moderate the effectiveness of CSR communication.

**Stakeholder type** One unique characteristic of CSR communication is that it often has many potential audiences—ranging from legislators, business press, investors, and non-governmental organizations (NGOs) to local communities, consumers, and employees.[34] These different audiences vary in terms of their expectations of businesses and their information needs, and thus may respond differently to CSR messages and CSR channels. Accordingly, it is imperative for a company to tailor its CSR communication to the specific needs of multiple stakeholder groups.

In general, stakeholders can be classified into two types:[35]

1 opinion leader audiences, such as the business press, investors—both mainstream institutional investors and the social responsible investment (SRI) community — and NGOs; and

2 the general public, such as consumers and local communities.

Each of these stakeholders groups may respond to CSR communication in various ways.

Opinion leader audiences are more likely to actively seek out CSR information about a company and use the company's CSR report to get a comprehensive picture of its record of social responsibility. Among the opinion leader audiences, corporate responsibility "experts" such as thinktanks, commentators, and social responsibility initiative (SRI) analysts are predominantly looking for hard evidence of the social impact of a company's CSR programs: ultimately, to them what matters are indicators, benchmarks, targets, and trends, as evidenced by the CSR report and other sources. Therefore, to increase the credibility of their CSR communication among corporate responsibility experts, a company should adhere to leading reporting standards such as the Global Reporting Initiative (GRI) and AccountAbility's AA1000. (See Charts 9 and 11 in "Emerging Sustainability Practices" on pages 41-42 of this report for survey findings on reporting standards used by U.S. public companies.)

In contrast, another type of opinion leader audience—the mainstream investor—is more concerned with shareholder value maximization and hence the business case of CSR. Accordingly, when communicating CSR to this stakeholder group, companies should explicitly discuss the business impact of their CSR activities, and how their social initiatives are linked to key business metrics such as customer equity, employee retention, corporate governance, and risk management.

The general public (from consumers to the local communities) often does not actively seek CSR information about a company, even with regard to issues they consider to be particularly important.[36] The general public often becomes aware of a company's CSR activities either through independent channels (e.g., editorial coverage on TV and in the press, stakeholder word-of-mouth, etc.) or corporate communication channels (e.g., high-profile cause marketing campaigns, advertising, or point-of-purchase communication such as displaying CSR information on the product label). To effectively reach the general public, companies should use a variety of these communication channels, or alternatively, focus on one or two highly relevant channels, based on the preliminary analysis of the audience segment that wants to be targeted.

**Issue support** Defined as "the extent to which stakeholders support the focal issue of a company's CSR initiative," issue support affects the effectiveness of CSR communication because it is related to the motivation to receive and process information on social responsibility. Research has shown that information perceived as self-relevant (as opposed to nonrelevant) elicits voluntary attention.[37] Since issue support reflects stakeholders' personal needs and values, all else being equal, CSR information on initiatives that stakeholders deem important or personally relevant is more likely to break the media clutter and receive support.

An effective way to increase issue support is to actively engage stakeholders in the social initiative by soliciting their input in the selection of the focus of the CSR activity. For example, in a recent promotion by GAP, the U.S. apparel company, the company donated 5 percent of each dollar amount spent at its stores to one of six non-profit organizations directly chosen by the consumer from a list. The nonprofit organizations were selected by GAP based on the wide range of domestic—education (Teach for America) and child hunger in the United States (Feeding America)—and global issues—the environment (World Wildlife Fund) and diseases including AIDS, TB, and Malaria in Africa (the Global Fund). By allowing stakeholders to choose the issue and the nonprofit organization, GAP was able to enjoy high issue support from its consumers and thereby enhance the effectiveness of its CSR communication.

For all of these reasons, before launching its social initiatives, a company should engage in some marketing research to gauge stakeholders' support for a variety of social issues, and ultimately undertake those initiatives that matter to its key stakeholders. In this context, it should be noted that stakeholders' view of what social issues are the most important shifts. While Americans ranked crime prevention and homelessness as priority issues in the early 1990s, issues such as education, health and disease, and the environment were paramount in 2004.[38] Furthermore, regarding health and disease, the top priority issues are, to list a few, fighting heart disease, breast cancer, children's diseases, and obesity and nutrition.[39]

A company should always monitor what its key stakeholders consider as priority issues. Of course, the selection of a "hot" issue should also be balanced with consideration of CSR fit and impact, as stakeholders expect companies to address social or environmental problems that are relevant to their core business and on which corporate action can make a difference.

## Recommendations for Board Members

The business case of CSR is documented by a large body of multidisciplinary empirical research. Due to the identity-revealing nature of CSR activities, a company that invests in social initiatives will be able to generate favorable stakeholder attitudes and behaviors (e.g., purchasing, seeking employment, investing in the company) and also build durable corporate/brand image, strengthen stakeholder-company relationships, and enhance stakeholders' advocacy of corporate action (e.g., word-of-mouth, employee organizational commitment, and citizenship behavior).

However, communicating these activities is far from simple. If stakeholders perceive a lack of clarity regarding the company's commitment to CSR, doubt the effectiveness of its CSR initiative, or miss the connection of a certain social activity to the core business, a backlash can occur. CSR communication must overcome stakeholder skepticism to generate favorable CSR attributions.

Considering the significant investment required to support a CSR program and the critical role that stakeholder relations play in today's business strategy, board members should become familiar with communication challenges facing social responsibility activities. The following recommendations may offer corporate directors some guidance for overseeing the implementation of effective CSR communication strategies.

1. **Seek CSR activities that fit into the business strategy** Before deciding to allocate resources on a certain CSR activity, the company should fully evaluate how the activity fits within the business strategy as well as the ability of stakeholders to naturally perceive such congruence. When a company does not have a high natural fit with the social cause it supports, its communication campaign should elaborate on the rationale for its social investment to increase the perception that the investment is coherent with the business.

2. **Emphasize CSR commitment and impact to foster consumer advocacy** Today's stakeholders receive an abundance of information on the societal causes pursued by business corporations; as a result, they may respond to new initiatives with skepticism and suspicion. For this reason, any CSR communication strategy should adequately emphasize and document the long-term commitment by the company and the concrete impact of its CSR activities. Research shows that consumers can become important advocates of a company if they are persuaded about the quality of its CSR program, both in terms of investment supporting it and its proven effectiveness.

3. **Seek credibility through the support of independent, external communication sources** There is a likely tradeoff between the controllability and credibility of CSR communication: the less controllable the communicator is from the company's perspective, the more credible the CSR message is to the stakeholders. Stakeholders tend to perceive the company as more self-interested than other non-corporate sources; consequently, they judge the representation of a CSR activity by in-house marketing and publicity experts as less reliable than the documented report by a reputable external source.

4. **Encourage employee and consumer word-of-mouth** Certain stakeholders are themselves important CSR communication resources. A CSR communication strategy should therefore strive for various forms of stakeholder engagement. Employees, in particular, through their social ties, may have a wide reach among other groups of interest in the company. In addition, today, the power of consumer word-of-mouth has been greatly magnified given the popularity and scope of social media platforms such as blogs and social networks.

5. **Select social initiatives with high issue support.** Since CSR communication on initiatives that stakeholders deem important or personally relevant is more likely to break the media clutter and be more effective, companies should monitor what its key stakeholders consider as priority issues, and undertake those initiatives with high issue support. Stakeholder engagement in the design and implementation of CSR strategy will result in initiatives with high support from stakeholders and, in turn, enhance the effectiveness of subsequent CSR communication.

6. **Be mindful of stakeholder perception of business industry** The effects of CSR communication may also be moderated by the reputation of the industry in which a company operates. For instance, stakeholders are often suspicious of companies in the tobacco or oil industries, an attitude that can pose a major challenge to communication strategists. In these cases, a company should fully recognize the issues that weakened the stakeholder perception of the industry and emphasize its efforts to become an agent of change within the industry.

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# Sustainability and Philanthropy

by Baruch Lev, Christine Petrovits, and Suresh Radhakrishnan

Companies engage in corporate philanthropy for a mix of reasons. Charitable contributions have the potential to increase shareholder value. Nevertheless, executives also make corporate giving decisions based on self-interest. This section provides practical recommendations to companies and boards for ensuring the legitimacy of their corporate giving programs.*

Corporations gave approximately $14.1 billion to a wide array of nonprofit organizations in 2009.[1] Despite the fact that almost all companies contribute some money to charity, corporate philanthropy remains controversial. Proponents believe that companies have a moral obligation to assist the communities in which they do business. Critics contend that corporate giving programs consume company resources and, more often than not, further the goals of management rather than the goals of shareholders. Most recently, corporate philanthropy has been labeled "tantamount to theft" and "a tax on shareholders."[2] The opposing camps find common ground when corporate giving improves shareholder value as well as social welfare.

A preponderance of academic research reports a positive association between socially responsible initiatives and economic success, particularly in recent years.[3] Companies with strong social performance also tend to have strong financial performance. However, a positive *association* does not establish *causation*. That is, a positive association between charitable contributions and profits does not necessarily mean that corporate philanthropy serves a legitimate business purpose.

In fact, a positive association can result from two very different scenarios:

- Prosperous companies have more economic slack (i.e., cash, highly valued shares), which makes it easier to give to charity.
- Companies use charitable giving programs to improve their competitive position, which enhances financial performance.

In the first scenario, charitable contributions are an after-the-fact distribution of wealth: higher profits lead to more giving. In the second scenario, charitable contributions benefit the bottom line: more giving leads to higher profits. Corporate giving is detrimental to shareholders under the first scenario but valuable under the second.

Executives should monitor the mechanism by which charitable contributions and profits are related in their business. An economic recovery is a particularly apt time to reevaluate philanthropic spending because managers may again have access to discretionary resources. As discussed below, shareholders may ascribe selfish intent to the corporate giving decisions of officers and directors. It is easy to assuage shareholder concerns and justify giving decisions when contributions do, in fact, further the company's long-term financial prospects.

## Motives for Corporate Philanthropy

This section of the report focuses on corporate philanthropy, which includes direct cash giving, foundation grants, stock donations, employee time, product donations, and other gifts in kind.[4] Corporate philanthropy is one component of corporate social responsibility, albeit an important, highly visible component.[5] The issues surrounding corporate philanthropy apply to a wide cross-section of companies in every industry, from small, family firms to large, multinational ones. Compared to other social initiatives, such as investment in green technology, it is relatively easy for companies to open or close the corporate checkbook in a given year, which makes contributions more variable over time and more subject to criticism that they are simply a waste of shareholder money.

**Is corporate philanthropy an opportunistic behavior by executives?** Agency theory suggests that managers will take actions that maximize their own utility, even if these actions are not in the best interests of shareholders. An agency relationship arises when shareholders (principals) hire managers (agents) to represent their interests in running a company. The resulting potential conflict of interest has been called the "agency problem."

Managers are most likely to make self-serving business decisions in companies with excess cash and little monitoring.[6] Corporate philanthropy is one area in which managers often have discretion to use a company's slack resources independent of business objectives. In particular, because charitable causes benefit from corporate giving, many stakeholders perceive it as a benevolent and unconditionally laudable activity. This perception results in a "halo effect" over corporate philanthropy. The "halo effect" may cause directors to fear being labeled misanthropes if they question giving decisions and may result in less oversight of charitable contributions than other business activities.

An executive can reap personal benefit from corporate philanthropy in several ways.[7] Even when a gift is fully funded with company money, the executive often receives some credit. These awards, honors, and accolades provide the executive with a psychic benefit and elevate his status in elite social circles. In addition, an executive can use corporate contributions to advance his personal preferences, for example, by supporting an organization with his ideological agenda or the pet charity of a family member. Finally, an executive can further his career by using charitable contributions to gain favor with board members. Although the board should be supervising the executive, they may be swayed by corporate gifts in their name to their favorite cause.

While most companies have a community impact or corporate philanthropy function that is ostensibly separate from the chief executive's suite, officers and directors can still exert influence over the size and direction of charitable contributions as evidenced by the following:

- In a survey of 721 companies, 45 percent of respondents answered "personal interests of CEO/board members" to a question about which considerations had the most weight in determining the focus of the corporate philanthropy program. This was the most frequent response. In the same survey, 49 percent of respondents noted that the CEO was involved in making specific funding decisions.[8] An analysis of actual giving data supports these survey results—corporate foundations allocate relatively more funding to nonprofit organizations affiliated with the CEO.[9]
- Companies give more to charity when their top executives and board members have social network ties to the business elite in their community, such as belonging to the same country club or serving on the same board of a prestigious cultural organization.[10]
- The larger the percentage of stock owned by the CEO, the less money the company contributes to charity, suggesting that when officers are owners they are more focused on the bottom line.[11]
- Companies with larger boards of directors are more generous givers, all else equal. Larger boards are generally perceived as a source of social interaction for directors and less effective as monitors.[12]

**Is corporate philanthropy a good business strategy?** Corporate giving programs can provide a competitive advantage when they are well designed and carefully executed.[13] For example, charitable contributions can increase the name recognition and reputation of a brand or company among consumers. In addition, corporate support of local causes improves the quality of life in communities where the company does business. These contributions help managers build relationships with government officials and community leaders and can reduce regulatory and special interest group obstacles.[14] Moreover, firms can use philanthropy to improve the economic conditions in developing regions with the long-term goal of enhancing the size and quality of their customer base. A commitment to philanthropy also facilitates efforts to recruit and retain talented employees. Finally, contributions can stimulate innovation as grants to universities and other organizations provide companies with new ideas, access to technical expertise, and opportunities for research and development collaboration.

The following evidence indicates that corporate philanthropy is a legitimate and valuable business activity:

- Growth in the amount of charitable giving is positively associated with future revenue growth for consumer product companies. However, revenue growth is not associated with future charitable giving for these same companies. This time-series analysis suggests that corporate giving enhances financial performance and is not simply a distribution of profits. Further examination of this relationship reveals that corporate philanthropy increases customer satisfaction, which, in turn, boosts revenue.[15]
- Potential employees perceive companies with strong community involvement as more attractive.[16] As a result of corporate-sponsored volunteer experiences, current employees report higher job satisfaction and a greater commitment to their company. Additionally, current employees believe that volunteer programs help them enhance leadership and professional skills.[17]
- Corporate giving increases following negative media exposure, suggesting companies use philanthropy to repair damaged relationships with community leaders and other stakeholders.[18]
- Compared to other industries, technology companies are the largest funders of educational initiatives and focus the greatest part of their budget for philanthropy on higher education. This focus is consistent with their need for a well-trained workforce as well as their desire to access university research programs. Additionally, technology companies generally have a high proportion of college-educated employees who take advantage of programs that match gifts. Other industries make similarly strategic decisions about the type of recipient to fund (e.g., health care companies provide the most support to health and human service organizations).[19]

The empirical evidence reveals that executives make giving decisions with a mix of intentions. In actuality, some corporate philanthropy is opportunistic behavior and some is good business strategy. The different motives are not necessarily mutually exclusive. For example, a contribution can help a member of top management attain higher social status while simultaneously enhancing the firm's reputation. Nevertheless, an executive imposes costs on shareholders when he uses the corporate giving program purely for self-interest. Likewise, it is not enough for corporate philanthropy to simply provide a "warm glow" or "good feeling." Some return is essential for corporate giving to be able to continue in the long run. Thus, making a sound business case is extremely important. The subsequent discussion focuses on institutional factors, as well as corporate policies, that can increase the accountability and transparency of corporate giving programs.

## The Role of Institutional Investors

Institutional investors generally have more resources to monitor and evaluate a company's operations than individual investors. Institutional investors also have more power through relatively large-share ownership to influence executive decisions if necessary. Thus, institutional investment can serve as a governance mechanism that increases shareholder value and minimizes managerial opportunism. As the level of institutional ownership increases, it is more likely that corporate behavior reflects the preferences of institutional investors.

Institutional investors appear able to exercise a governance role over aspects of corporate philanthropy. Institutions should limit any charitable contributions perceived to be managerial perquisites. In fact, some research indicates that institutional investors do curtail high levels of corporate giving.[20] However, the effect of institutional ownership on corporate philanthropy seems more nuanced, depending on the type of institution and the nature of the giving. Perhaps not surprisingly, dedicated institutional investors (i.e., those with long horizons) appear to consider social performance to be more important than transient institutional investors do.[21] In addition, when there is a legitimate business case for contributions, evidence suggests that the level of institutional ownership is positively associated with the level of corporate contributions.[22]

### Recommended Practices for Corporate Philanthropy from the Council of Institutional Investors

**Board monitoring, assessment, and approval** The board of directors should monitor, assess, and approve all charitable and political contributions made by the company. The board should only approve contributions that are consistent with the interests of the company and its shareowners. The terms and conditions of such contributions should be clearly defined and approved by the board.

**Disclosure** The board should develop and disclose publicly its guidelines for approving charitable and political contributions. The board should disclose the amounts and recipients of all monetary and non-monetary contributions made by the company during the prior fiscal year on an annual basis. Any expenditures earmarked for political or charitable activities that were provided to or through a third-party should be included in the report.

*Source*: Council of Institutional Investors Corporate Governance Policies, Section 2.14.

This positive association may result because institutions are attracted to companies that have pragmatic giving programs in place or because institutions instill discipline in corporate giving decisions after they invest. In either event, some institutional investors appear to monitor the financial consequences of corporate charitable contributions.

## The Question of Disclosure

The most frequently suggested policy to address opportunistic corporate giving is to mandate transparency.[23] Many companies do voluntarily prepare glossy social responsibility reports each year, but these reports generally do not include a complete account of all corporate donations.[24] Members of Congress have repeatedly proposed (but not passed) legislation requiring companies to disclose annually the aggregate amount of contributions to nonprofit organizations as well as the amount and recipient of any contributions that exceed a specified threshold.[25] In addition, some investors have expressed interest in requiring such information. Companies such as General Electric, The Home Depot, Starbucks, Target, and Wells Fargo, to name a few, have all received shareholder proposals in recent years requesting a list of charitable contributions.

Proponents of increased transparency argue that companies have nothing to hide if contributions are being used for legitimate business purposes. Disclosure should deter executives from using the corporate checkbook to support their pet philanthropies and reduce shareholder skepticism about the appropriateness of corporate giving programs. As an ancillary benefit, disclosure may strengthen the company's reputation as a good citizen with its customers and with the communities in which it operates.

Even if the expense of preparing a detailed account of all contributions is trivial, disclosure is not a costless solution. Other costs can arise from disclosing the information itself. Some companies argue that they will lose an important competitive advantage if disclosure becomes mandatory because philanthropic information is proprietary. For example, if a technology company gives hardware to selected educational institutions, disclosure of this practice may reveal how the company cultivates important customer relationships. This argument becomes less persuasive when mandatory disclosure occurs after the fact on an annual basis (e.g., in the 10-K or proxy statement) or if a competitor is likely to observe the philanthropy before disclosure anyway.

Another argument against disclosure is the fact that contributions to a controversial cause, even for legitimate business purposes, can attract negative scrutiny. For example, a pharmaceutical company may not wish to publicize its support of a research organization that conducts animal testing, even if that support ultimately benefits shareholders.

Special interest groups with their own political agendas often attempt to micromanage corporate philanthropy programs, diverting management's time and attention from other issues. Under mandatory disclosure, companies might choose to avoid conflict by funding established, uncontroversial nonprofit organizations rather than innovative and potentially controversial ones.

Overall, companies with business-driven philanthropy programs have more compelling reasons to keep charitable contributions private, but, antithetically, the failure to disclose these contributions is perceived as a signal that the company is concealing self-serving behavior by its executives. Companies should carefully evaluate all of the costs and benefits of disclosure before making a decision. At a minimum, they should consider disclosing their policies governing contributions, if not the contributions themselves.

## Recommendations

Executives can justify charitable contributions by applying the same prudence to giving decisions that they do to other business activities. This section offers recommendations for increasing the effectiveness of corporate giving and minimizing opportunistic behavior or the appearance of such behavior.

### Align corporate giving with business activities

This is the most common recommendation regarding corporate giving, but it bears repeating: a company should establish a flagship charitable initiative that uses the company's unique resources to address a social problem affecting the company's competitive context.[26] A well-designed corporate giving program clearly articulates a congruence between the company's philanthropic activities and its other business activities.

For example, a publishing company decides to focus on combating illiteracy. The company provides cash grants, product donations, and, most importantly, a distinct expertise in developing reading and writing curriculums. Moreover, the publishing company can leverage certain business relationships it already has in place (e.g., suppliers and authors) to enhance the effectiveness of the initiative. The company's efforts are not only likely to appeal to their current customers and employees but may also increase their target market in the long run.

As discussed in the box below, Crate and Barrel successfully partnered with DonorsChoose.org. This success was due in part to the fact that Crate and Barrel was an early mover in allowing customers to allocate corporate philanthropy. A similar program may not be as fruitful for another company because customer-designated giving may not exploit a company's core strengths or build brand identity.

Establishing a strong link between a company's identity and its corporate giving normally requires a long-term commitment but should pay off in terms of both financial and social performance. When a charitable cause is aligned with the company's business, the company likely has the appropriate resources and abilities to make a meaningful social impact. This reduces skepticism about the company's motives and increases its credibility with stakeholders.

## Clarify the role of officers and directors.

The board of directors or a committee comprised of directors and top executives should oversee the corporate giving program. Engaging officers and directors at a high level in setting the direction of the corporate giving program helps to ensure a good fit with other business activities, signals that the company is fully committed to community involvement, and reinforces that giving is not a perquisite and should be treated seriously.

### Corporate Giving — Successes and Failures

**Crate and Barrel** Since 2006, the company has given its customers "thank you" gift cards to DonorsChoose.org, an online charity that connects donors to classrooms in need. The gift cards allow customers to allocate Crate and Barrel's charitable contributions across various educational projects submitted by teachers across the United States. This partnership has funded 14,500 projects, benefitting 347,000 students. As a result of this initiative, over 36,500 new donors came to DonorsChoose.org from Crate and Barrel, and, on average, customers contributed $0.40 for every dollar redeemed by gift card. In addition, Crate and Barrel benefitted from its improved reputation with customers. For example, following the fall 2007/spring 2008 gift card distribution, sales increased 16 percent for redeemers and 5 percent for non-redeemers.[a]

**Tyco** Former CEO Dennis Kozlowski created an image as a generous philanthropist. However, the gifts often came from Tyco rather than from Mr. Kozlowski. He played a decisive role in determining which nonprofit organizations received funding from Tyco and was accused of giving $43 million of Tyco's money in his own name. For example, Tyco contributed $1.7 million to construct the Kozlowski Athletic Center at the private school where his daughter attended and where he served as a trustee. An additional $5 million was given to build a hall named after him at his alma mater. He also used Tyco funds to burnish his image in the Boca Raton community, where Tyco gave $3 million to a hospital and $500,000 to an arts center.[b]

**RJR Nabisco** Former CEO Ross Johnson prided himself on his ability to influence board decisions. One technique he used to curry favor with directors involved endowing academic chairs in their names or supporting their philanthropic causes using RJR Nabisco funds. For example, when Mr. Johnson wanted to move corporate headquarters out of Winston-Salem, and he needed the vote of a particular director, RJR Nabisco gave $6 million to that director's pet charity. This use of philanthropy helped Mr. Johnson ensure board loyalty and operate with limited oversight until he eventually became the poster child for corporate greed during his failed takeover attempt.[c]

**Microsoft** The company encourages employee community involvement in a number of ways, including organized group activities, paid time off for employees to volunteer, and nonprofit board service training. Since 2005, employees in the United States have given over one million hours of their time, and Microsoft has matched each of those hours with a $17 contribution to the nonprofit chosen by the volunteering employee. Microsoft runs its program worldwide, allowing employees from across the globe to use their expertise to meet the specific needs of each geographic location and culture. In addition to assisting the communities in which the company operates, volunteer opportunities may raise morale and hone employees' leadership skills. For example, after Microsoft announced its volunteer program in Egypt, employee satisfaction increased from 61 percent to 91 percent.[d]

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a Crate and Barrel, "2006-2010 DonorsChoose.org GivingCard Campaigns," accessed July 15, 2011, [http://a248.e.akamai.net/f/248/48906/2d/w.donorschoose.org/docs/donorschoose-org-crate-and-barrel-032210.pdf].

b Marianne Jennings, *The Seven Signs of Ethical Collapse*, St. Martin's Press, 2006.

c Bryan Burrough and John Helyar, *Barbarians at the Gate: The Fall of RJR Nabisco*, Harper Collins, 1990.

d Noelle Barton and Caroline Preston, "America's Biggest Businesses Set Flat Giving Budgets," *The Chronicle of Philanthropy*, August 7, 2010, [http://philanthropy.com/article/Big-Companies-Hold-Steady-in/123792/] (accessed July 15, 2011); Microsoft, "Microsoft 2010 Corporate Citizenship Report." [http://www.microsoft.com/about/corporatecitizenship/en-us/reporting/] (accessed July 15, 2011)article/Big-Companies-Hold-Steady-in/123792/.

Effective oversight includes ensuring that the company's giving professionals have the resources necessary to implement the company's philanthropy program and to establish internal controls over those resources. Such internal controls include written policies that define which charitable causes or recipients are allowable and set a maximum dollar amount of contributions that any one individual, business unit, or geographic region can make without additional authorization. These policies should also prohibit executives from accepting return benefits (which can range from a nonprofit magazine subscription to publicized personal credit for a corporate gift). Companies may give top executives some discretionary funds to allocate to the nonprofit organizations of their choice. However, there should be a dollar limit on these funds and they should be evaluated as part of the executive's compensation contract.

## Establish standards of independence for board members

A potential conflict of interest arises when a company provides substantial support to a nonprofit organization affiliated with a company board member. Companies should remain aware of stock exchange rules about the effect of corporate giving on director independence. (See box below for specifics.) To avoid the appearance of any conflict of interest, many companies have established even stricter standards than those required by the exchanges.

### Guidance on Director Independence With Respect to Corporate Philanthropy

**NYSE** The board of directors must consider the materiality of any relationship between a director and a nonprofit recipient of corporate giving before affirming that the director is independent. In addition, listed companies must disclose any contributions made by the company to a nonprofit organization in which an independent director serves as an executive officer if those contributions exceed the greater of $1 million or 2 percent of the nonprofit organization's revenue.

**NASDAQ** A director is not considered independent if he, or a family member, is an executive officer of a nonprofit organization which receives contributions from the company that exceed the greater of $200,000 or 5 percent of the nonprofit organization's revenue. Contributions made under a matching gift program do not count towards the $200,000 or 5 percent threshold.

*Source:* NYSE Listed Company Manual, Section 303A.02; NASDAQ Listing Rule 5605(D).

For example, some companies disqualify a director from being considered independent not only if he is an employee but also if he serves as a director or trustee of a nonprofit organization that receives substantial support from the company. Companies should also consider how independence rules might affect oversight of their corporate-sponsored charitable foundation. Because most corporate foundations receive virtually all of their funding from the company, an otherwise independent director of the company could potentially be disqualified if he also serves as an officer of the corporate foundation.[27]

## Measure financial and social performance

Companies must demonstrate that their corporate giving programs increase shareholder value and social welfare. To do so, they must implement procedures to systematically measure and evaluate progress toward economic and social goals. The absence of any performance measurement signals the absence of accountability. Knowledge gleaned from the measurement process is helpful in determining whether to continue, revise, or terminate a particular giving activity and should improve the overall effectiveness of corporate philanthropy.

The financial benefits of philanthropy are often intangible and long-term in nature, making measurement difficult. However, this is also true of other business activities, such as R&D and marketing expenditures. Nevertheless, companies have devised methods to assess the value of these activities and can do the same for charitable giving. Two issues arise in the process of measuring the net financial benefits of corporate philanthropy. First, evidence suggests that, even without opportunistic executives, more philanthropy isn't necessarily better. There appears to be an optimal level of charitable giving beyond which the company receives no further benefit.[28]

Regular measurement will assist companies in converging to this optimal level. Second, the total cost of a corporate philanthropy includes the contributions themselves plus administrative costs, such as the salaries of giving professionals and overhead. Assessing administrative costs over time and comparing costs to external benchmarks will help companies determine whether their level of staffing and organizational structure are reasonable and the giving program is operating efficiently. For example, a recent survey reported that administrative costs are 8.8 percent of total giving on average.[29]

Measuring social performance is challenging, but significant progress has been made in developing tools that companies can use to estimate the societal impact of their philanthropic activities.[30] For example, the Committee Encouraging Corporate Philanthropy has developed a framework that includes procedures for assessing whether individual grantees are achieving the intended outcome as well as procedures for estimating an overall social return on investment.[31]

Given the diversity of corporate giving programs, there is no "one size fits all" approach to evaluating the effects on social welfare, and companies must individually determine which metrics best suit their needs.

But overall, companies should consider the following steps for effective oversight:

1 Approve an annual philanthropy plan that is consistent with the company's business strategy.

2 Ensure that appropriate resources are available for the company's giving professionals to carry out the plan.

3 Implement internal controls to prevent executives from interfering with the plan for their personal benefit.

4 Assess the outcome of the plan.

## Conclusion

Expectations for corporate philanthropy are evolving. Officers and directors can no longer treat charitable giving as a peripheral activity or an after-the-fact distribution of profits. In order to make a business case in support of corporate philanthropy, executives should integrate giving with other business activities, institute controls to limit managerial opportunism, and develop procedures to measure and evaluate financial and social outcomes. It is no longer sufficient for corporate philanthropy to simply "do good." If corporate giving is to succeed in the long run, it must provide a financial return. Acknowledging the economic benefits of corporate philanthropy does not negate its power to alleviate social problems and enhance communities.

## Endnotes

* Portions of this Director Notes have been adapted from the authors' previous article, "Is Doing Good, Good for You? Yes, Charitable Contributions Enhance Revenue Growth," *Strategic Management Journal* 31, no. 2 (2010): 182–200.

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## Appendix: Sustainability Matters and the Way Forward

| Sustainability Matter | The Way Forward | Page |
|---|---|---|
| To many corporate leaders, sustainability is an increasingly popular but essentially unknown business concept. Skepticism often results from lack of knowledge. | An essential first step for business leaders is to understand the notion of sustainability, recognize the body of knowledge that accompanies it, and begin discussing its application in the specific circumstances facing the company. | 7 |
| Many business leaders believe that the allocation of shareholder resources to sustainability initiatives is a financially unsound decision. | No single rationalization shows how sustainability improves the bottom line, but the case for the competitive advantage of having a sustainability strategy can be made. | 21 |
| Many business leaders believe that the allocation of shareholder resources to sustainability initiatives violates their duty to maximize shareholder value. | The business judgment rule protects board consideration of stakeholder interests as a means to durable shareholder value maximization. Posing shareholder and stakeholder interest as an either/or choice is incorrect. | 27 |
| Many companies still lack the structural framework to enable proper director oversight of corporate sustainability. | Emerging practices can provide useful guidance to boards facing the need to strengthen their oversight responsibilities in this area, in response to internal organizational drivers or pressure from stakeholders. | 36 |
| Customers are a key stakeholder group, and yet the value added by CSR initiatives to customers remains often unknown and unexplored. | To be effective, a sustainability strategy should generate additional value for the consumer, such as the social esteem or spiritual reward from choosing an ethical and sustainable product over its conventional counterpart. The corporate board should participate in this critical strategic discussion. | 53 |
| Boards and shareholders have little or no guidance on how to measure the outcomes from CSR investments and determine their impact on firm profitability. | Metrics can greatly help to establish the business legitimacy of CSR. The AGREE model—Audience, Goals, Resources, Effectiveness, and Efficiency—offers one approach. | 61 |
| Many businesses do not fully reap the reputational benefits of their sustainability strategy because they struggle with communication and their stakeholders remain unaware. | Board members overseeing the sustainability program should feel comfortable that the message is coherent with the business mission and objectives, and that delivery channels are not only effective but also independent and perceived as such. | 71 |
| Despite the fact that almost all companies contribute some money to charity, corporate philanthropy often is not woven into the overall sustainability strategy. | If corporate giving is to succeed in the long run, it must provide a financial return; officers and directors can no longer treat charitable giving as a peripheral activity. | 79 |

## Related Resources from The Conference Board

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