Does Business Ethics Pay?

Ethics and financial performance

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ethics
commitment
integrity
honesty
corporate responsibility

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Executive Summary

'Does business ethics pay?' is a question that some would say is a wrong one. Behaving ethically, they argue, is what you do because it is the right thing to do.

Nevertheless, there is a continuing requirement for reliable indicators to measure the performance of corporations in the non-financial areas of a business and to link these to business success. Concepts such as integrity and fairness are, however, generally only measurable using indirect indicators.

This study was undertaken to explore some indicative measures of a commitment to ethics/corporate responsibility and then to compare them against financial performance measures over a period of four years. In this way, the research set out to investigate whether it can be shown that a commitment to business ethics does pay.

For this research, seven indicators were chosen – four of corporate financial performance [Market Value Added (MVA), Economic Value Added (EVA), Price Earnings Ratio (P/E) and Return on Capital Employed (ROCE)] – and three of corporate responsibility [having a code of ethics, ratings for managing socio/ethical risks and being cited consistently in the annual list of Britain's Most Admired Companies].

The sample consisted of between 41 and 86 companies taken from the FTSE 350 for which full and comparable company data was available for the years 1997-2001. It was divided into two cohorts: those who have had codes of ethics/conduct/ principles for five years or more and those who explicitly said they did not.

Findings

A review of similar research shows that the relationship between good financial performance and other indicators of corporate responsibility (environmental management, corporate social responsibility, sustainability etc.) is positive but not definitive. However, Verschoor's work in the US, on whose methodology this research is based, showed that there was superior MVA in companies which referred to their ethics' programmes in the annual report, compared with those who did not.

Before testing the validity of Verschoor's conclusion for the UK, this study sought to find out whether or not the presence of a code of ethics could be used as an indicator of a genuine commitment to ethics. Good practice for a sample of UK companies with and without a code was tested by looking at a) a rating for risk management and b) a peer evaluation which included, for example, competent management, financial soundness and quality of goods and services. A positive relationship was found. Having an accessible code of ethics was then used to investigate the relationship between ethical commitment and financial performance over the four year period.

- Regarding financial performance, from three of the four measures of corporate value used in this study (EVA, MVA and P/E ratio) it was found that those companies in the sample with a code of ethics had, over the period 1997-2001, out performed a similar sized group who said they did not have a code.

- Companies with a code of ethics generated significantly more Economic Value Added (EVA) and Market Value Added (MVA) in the years 1997 - 2000, than those without codes.

- Companies with a code of ethics experienced far less P/E ratio volatility over a four year period, than those without them. This suggests that they may be a more secure investment in the longer term. Other research has suggested that a stable P/E ratio tends to attract capital at below average cost; having a code may be said to be a significant indicator of consistent management.

- The indicator that showed a different result pattern to the others was Return on Capital Employed. No discernable difference was found in ROCE between those with or without a code for 1997-98. However, from 1999 to 2001 there was a clear (approximately 50%) increase in the average return of those with codes while those without a code fell during this period.

- The data also indicates that in the years 1997–2001, those with an explicit commitment to doing business ethically have produced profit/turnover ratios at 18% higher than those without a similar commitment (see note on profitability in Appendix 4).

- The general conclusion from this study is that there is strong evidence to indicate that larger UK companies with codes of ethics, e.g. those who are explicit about business ethics, out-perform in financial and other indicators those companies who say they do not have a code. Having a code of business ethics might, therefore, be said to be one hallmark of a well managed company.