

Is Ethics Good Business?

Interview with Lynn Sharp Paine

This business ethics specialist insists that ethics has to be integral to business. She says the scandals of the 1990s were a consequence of a narrow management philosophy. But ethics can pay off in more creative, more efficient, and more flexible firms. How do you get such programs implemented? She has some answers.

Q In these times, in particular, people are skeptical about the meaning or even the usefulness of business ethics. As a professor and student of business ethics, what is your principal message about its importance?

A. My principal message is that ethics is central to the long-term success and sustainability of a company in society today. It is an idea—a point of view, really—that must be integral to a company's governance, leadership, and day-to-day management.

Q What has changed to make business ethics more imperative?

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A. Fundamentally, there is a macro change that has manifested itself in a number of micro changes. The macro change has to do with the increasingly pervasive role of business in society and the increasing powers of companies around the world. This has resulted from a confluence of forces, including liberalization, privatization, and advances in knowledge and technology. These developments, in turn, have led to changes in people's expectations for corporate behavior. In particular, people have come to expect companies to behave as if they had a moral personality—as if they were responsible agents capable of exercising self-discipline and moral judgment in conducting their affairs. This change, by the way, goes against centuries of thought holding that corporations are, by nature, amoral.

Q. Are there some examples of that?

A. Evidence of this development is abundant—for instance, in how people evaluate the companies they deal with. If you look at surveys of employees and employee commitment, for example, you find that employees routinely make moral judgments about their corporate employer. They tend to favor companies that treat employees fairly in terms of pay and other practices, and they prefer to work for companies that place trust in their employees, show concern for employees' welfare, and have a good reputation in the community.

Or consider what corporate reputation experts tell us about consumer concerns. Financial performance is important, but consumers also look at issues like the quality of the work environment, social responsibility, the quality and safety of a company's products and services. These are the factors that shape a company's reputation in the eyes of consumers.

Public opinion surveys tell a similar story. You may have seen the Millennium Poll on Corporate Social Responsibility done in 1999. This poll surveyed some 25,000 individuals in twenty-three countries on six continents. Two out of three respondents said

that companies should go beyond their traditional functions by trying to set a higher ethical standard and contributing to broader societal goals. Of course, the picture is somewhat more mixed when it comes to investors.

Q What do you mean by “mixed” for investors?

A. Until recently, investors have shown comparatively little interest in corporate ethics. While there has certainly been an increase in the number of “ethical” or “socially responsible” investors over the past thirty years, they remain a small proportion of the overall investor community. I have found that many investors believe that if ethics is important, it is already reflected in the bottom line, and therefore they need not pay special attention to it. Others take the position that ethics is just not relevant. But we should also keep in mind that it is very hard for an investor to get accurate information about a company’s values and ethical standards. This information vacuum is another factor that has tended to feed investors’ disinterest.

Q In light of recent scandals, most people are severely disappointed in the ethics of many corporations and certainly on Wall Street, among law firms and among accounting firms. But in your book (*Value Shift: Why Companies Must Merge Social and Financial Imperatives to Achieve Superior Performance* [McGraw-Hill, 2003]) you point out that a lot of companies were trying to implement ethics programs well before these scandals.

A. Absolutely. In recent decades, and particularly in the 1990s, numerous companies launched formal ethics programs that included codes of conduct, ethics training, and special channels for reporting concerns about misconduct. A 2000 survey by the

Ethics Resource Center found that something like 55 percent of employees said their company had some type of ethics training. That was up from 33 percent in 1994. Some companies have appointed formal ethics officers. The Ethics Officer Association, which was started in 1992 by a handful of corporate ethics officers, now has more than 800 members. By that organization's count, about half the *Fortune* 100 have such an officer. Over this period, boards of directors have also gotten more involved. In 1990, about 9 percent of boards had some sort of ethics or social responsibility committee, and the number has been growing as more boards have assumed a role in ethics oversight.

Q So what had been motivating these firms to do this?

A. The motivation varies quite a lot. In some cases, these efforts are undertaken in the wake of a scandal or as part of a consent decree. Either the company itself has been caught in malfeasance or controversy, or it has seen a competitor in ethical trouble. New federal sentencing guidelines have been another impetus. Under guidelines that took effect in 1991, companies with an effective program to prevent and detect violations of law can see their fines substantially reduced should they be convicted of criminal misconduct. But other companies have turned to ethics for more positive reasons—they are trying to improve their organization's functioning, their standing in the community, or their reputation in the marketplace. Still, many of these programs are a specific response to a particular situation. So, for example, following the controversy over Nike's sourcing practices, the company launched a major initiative to improve its suppliers' working conditions. Or following a sexual harassment controversy, a firm will launch a diversity program. Such programs may be all to the good, but they are a piecemeal response to the broader changes I described earlier.

Q Does that describe most of the new ethics programs—piecemeal responses?

A. In my experience, yes. Also, I would say that probably two-thirds are motivated by a kind of risk management logic. They want to avoid certain undesirable outcomes. The more positive or affirmative types of motivation are somewhat less common, but you can certainly find examples of enlightened leaders who see ethics as the foundation of a better way to manage. For these individuals, an ethical orientation is essential to building a high-performing company that is going to survive and thrive over the long term.

Q Many people are, on the surface at least, skeptical and even cynical about such claims. As you describe it in your book, many people believe ethics is a cost, not a benefit. Is it not a cost, usually?

A. The skeptics have a point insofar as some ethics programs are quite superficial—little more than decorative add-ons, entirely peripheral to the company's core operating processes. Such programs are bound to be ineffective, and the cynicism about them is entirely justified. In other organizations, ethics and corporate responsibility are taken quite seriously. We need to distinguish between companies that have an "ethics program" and companies that conduct their business ethically. The two do not necessarily go together.

But let me speak to your second point—is ethics a cost or does ethics pay? Although what is right and what is profitable will never be perfectly congruent, there is a considerable body of evidence supporting the proposition that ethics pays.

Q. Can you give an example or two?

A. Yes. Let us start with the cost advantages I alluded to ear-

lier. Companies that commit themselves to ethical practice stand a better chance of avoiding the high-profile scandals that have become so familiar recently. But Enron, Tyco, Worldcom—these are only the latest examples. In the 1990s Salomon Brothers had its Treasury auction scandal; Sears had its auto centers scandal; and Columbia/HCA (the Tennessee-based health-care system) had its billing scandal. There was also Sunbeam, Waste Management, and Bridgestone/Firestone. Besides the immediate costs of these episodes, companies involved in misdeeds often suffer sales declines in subsequent years. So one advantage of ethical commitment is a reduced risk of costly misconduct.

But there are also less visible and perhaps even more compelling ways that ethical commitment translates into economic advantage. If people do their jobs responsibly and adhere to basic ethical principles in their day-to-day jobs, there is less need for costly oversight and expensive bureaucracy. You can more easily decentralize authority and ultimately have a more flexible and more efficient organization.

Q Are there any companies that have achieved that, in your view?

A. One company that has taken this approach is Sealed Air Corp., the maker of those wonderful plastic bubbles that fragile goods come wrapped in. This is a company whose leaders have tried very hard to build ethical commitment into the functioning of the organization, not through a specific ethics program but through how they actually manage the company.

Q. What would they expect of workers or suppliers? How do they build it in?

A. They have a code of conduct that documents and elaborates what they call their “bedrock values”—personal account-

ability, truthfulness, fair dealing, and respect for the individual. The code spells out the non-negotiable principles by which they try to operate. There is nothing terribly surprising in what the code says, but what is surprising is the effort made to abide by it. Sealed Air goes much farther than many companies I have seen to acknowledge people's contributions and reward them appropriately. If somebody on the loading dock submits a suggestion helpful to the company, that gets recognized just as a senior management contribution would get recognized. When my colleague and I interviewed employees at six locations (in the United States, Europe, and Asia) back in the mid-1990s, we were surprised at the number of people who spoke about Sealed Air's care and concern for people in the organization. This concern had a powerful energizing and community-building effect that I think is often under-recognized. Another thing that is interesting about Sealed Air is the extent to which its managers try to cultivate a high regard for truth. Now this is not just a question of avoiding fraud. It is trying to be candid and objective and accurate in talking about a business proposal or how someone is doing in a job and trying to create an environment where there is a commitment to this kind of candor. It is actually quite challenging, given that exaggeration and overstatement have become something of a norm in American society.

Q. Does that candor apply to employee-to-employee relationships, or does it include supplier and customer relationships?

A. Their approach extends to all these relationships. It starts with employee-to-employee relationships—the way people in the company treat one another—but it also applies to external constituencies, to customers, suppliers, and investors. They also do a fair amount in the community. But unlike a lot of companies, they have chosen not to use their community activities as a marketing tool out of concern that it might lead people to participate for the wrong reasons.

Q Are there other areas where ethical considerations actually help the company do business?

A. Yes. We could also talk about the growing body of research on creativity, knowledge sharing, and trust. I mentioned in my book the research by Teresa Amabile, a colleague who studied creativity in work groups. Although this research was not explicitly focused on ethics, she found that work groups were more creative when members felt they were trusted, rewarded fairly, and given accurate information. The more creative work groups also reported higher levels of mutual helpfulness. By contrast, the less creative groups were more likely to have experienced dishonest communications, destructive competition, and political problems.

Other researchers have found links between trust and better outcomes. For example, one study of 1,500 partnerships between retailers and manufacturers found that partnerships were more profitable when they were based on high levels of mutual trust. That study also found that trust emerged when the parties viewed each other as honest, reliable, and mutually attentive to one another's welfare. Ethical commitment can also pay off in terms of reputational benefits. As noted earlier, good ethics helps build a positive reputation. And a positive reputation, in turn, helps to attract and retain customers, employees, and business partners.

Although many people simply assume that ethics is necessarily a cost, the research tells a more complicated story. I should note that I have not personally conducted the studies I am citing for you now, but in my book, I assemble these and other findings from different business disciplines that challenge the conventional view. On the other hand, I also examine a variety of situations in which pursuing the more ethical course may indeed be more costly.

Q Here we have some evidence that ethics pays off, and yet, let me move to the current scandalous environment. We have experienced one of the most scandalous eras in American history. Why do you think it happened? Some people say it is a just a few bad apples. You do not believe that?

A. No, I do not believe we can attribute what happened to just a few bad apples, especially if you consider the levels of misconduct reported in some employee surveys. I think we have to look more deeply at the management practices employed by some of these companies—and at the theories behind them. The proliferation of codes, values initiatives, and ethics programs notwithstanding, the 1990s also saw the increasing popularity of a management theory that is explicitly ethics free.

Q Describe that a little more—a management theory that is deliberately ethics free.

A. What I have in mind is the belief that management at its core is about self-interest. This theory claims that the purpose of any corporation is to maximize shareholder value and that this objective is best accomplished through financial incentives that align executives' interests with shareholders' interests. Notice that this theory makes no mention of checks and balances or ethical principles like equity, honesty, or civic responsibility. Worthy purposes, the corporation's role in society, human needs and aspirations—these are also missing. It is a very mechanical view of management. And it is all about self-interest.

Q. Is the self-interest mostly financial?

A. Yes. I should emphasize that we are talking about a narrow conception of self-interest, really just financial interest. This theory, which is quite simple and appealing in some respects, was adopted very enthusiastically. The compensation notions

that flowed from it were put into practice in many companies, and we saw, for example, a dramatic increase in the use of stock options, which were widely thought to be an ideal tool for achieving this alignment of interests. With stock options, at least in theory, the compensation system would be more or less self-executing. Managers would make money when shareholders made money—when the stock price rose to the targeted levels. Much of the misconduct we saw in the 1990s was the unintended consequence of adopting this management theory and the performance measurement and compensation practices it implies. A rising stock price legitimated almost any kind of behavior because that was the only standard of evaluation.

Q That would stand in contrast to a management theory that incorporates ethics. How can you have financial incentives along with ethical incentives?

A. That is one of the central ideas in my book. For a start, the incentives cannot be linked only to stock price. You need more broadly based performance measures that include ethics-related criteria. Some companies are beginning to experiment with ways of measuring ethical performance—through employee surveys, new audit tools, and performance indicators linked to their business standards. Without something like that, you run into a classic problem illustrated by a case that was a staple of our ethics curriculum at Harvard Business School for many years. It was a case about earnings management set in the 1970s, long before stock options were widely used. Like Enron, the company had a very explicit code of conduct that said no false books and records, no bribery—the usual kinds of things. But the company also had a compensation system that focused only on meeting financial targets. It is not surprising that the code was largely ignored.

Q The stock market almost surely rewarded many of those companies in the late 1990s, so it was pretty hard to buck the trend.

A. It was very hard. This goes back to the earlier conversation we were having about the role of investors. As I mentioned, few investors have shown any great interest in the ethics of the companies they invest in.

Q. If ethics helps a company compete, makes it more creative, theoretically investors should be interested in that kind of thing.

A. Absolutely. And I think that more investors are beginning to take an interest. The events of last year made ethics a salient topic for many investors who had not previously given it much thought. Even so, it goes against the grain for anyone taught that markets and corporations are inherently amoral. And even though ownership rights should, in principle, imply ownership responsibilities, few shareholders think of themselves as responsible for the behavior of the companies whose shares they own. So the notion that investors would care about corporate ethics runs against several deep-seated cultural biases.

Q I guess, however, a critic would come along and say, hey, American business has done awfully well over 150 years without having to worry about ethics . . . or have there been cyclical periods of high and low ethics?

A. Certainly, the history of business is laced with periods of scandal. My personal experience as an observer of business ethics goes back to the 1970s, so I have been through several scandals at this point—the overseas payments scandals in the 1970s; the savings and loan, defense industry, and insider trading scandals of the 1980s; and the most recent accounting and gover-

nance scandals. You do see something of a cyclical pattern during this period. On the other hand, from a broader historical perspective, the pattern appears more linear. As the corporation has become a more pervasive and more important institution, society's expectations for business behavior have risen accordingly. Two hundred years ago, when corporations were rare, it really did not matter very much how they behaved. Now that the corporation has become society's dominant nongovernmental institution, it matters a great deal. From a societal point of view, it is imperative that companies conduct themselves as responsible agents—respecting certain ethical standards, exercising moral judgment, cleaning up their messes, and so on. In the world as it is today, the doctrine of corporate amorality is just not tenable.

Q What kinds of reform should we be looking at?

A. Much of the reform has to come in the form of leadership and education, at least if we are talking about the United States.

Q. What should we be doing in the United States?

A. Well, I could start with my home territory—management education. Management education needs to do a better job of preparing students for today's higher standard of corporate conduct. Much like the companies I described earlier, the ones with peripheral ethics programs, business schools have tended to position ethics at the periphery of the curriculum. I do not mean to say there have not been courses. There have been courses pretty much all along, but these courses have not been central to the educational experience. And in many cases, they have been elective or optional rather than required. It will be very hard to develop a large number of responsible companies without a cadre of business leaders who understand the kinds of things we have been talking about—the interactions between ethics and economics, the role of business in society, the changing expecta-

tions for business behavior, and so on. But management education cannot do the job alone. We need to have more executives who are willing to take a leadership role—to experiment, to set an example, to articulate the case for change. Whatever we teach in school is either reinforced and carried forward—or canceled out—by what students find when they enter the corporate world.

Q I always think, and maybe I have a strong pro-government view, but I think that the great advantage of rules and regulations imposed from the outside is that they allow us to do business more efficiently. So it is not how much you cheat that makes you win, but how well you play within the rules. Ethics is simply pragmatic. Should there be more rules and regulations here?

A. I agree that external rules and regulations are important, but we already have lots of rules and regulations in the United States. You can go on creating rules and regulations until the cows come home, but if people do not respect the rules and do not want to follow them, they are useless. I think we have come to a point where we have to focus more on self-governance. Let us try to adhere to the laws that we have and work on building organizations that can govern themselves more effectively.

Q. What are the recommendations of the Conference Board Commission on Public Trust and Private Enterprise on which you serve?

A. The Conference Board Commission started from the position that leadership by the private sector is crucial. And our recommendations address several of the issues we have been discussing. Executive compensation, for example, was the topic of our first report. Among other things, we concluded that compensation needed to be more closely tied to operating performance rather than stock price performance. Overall, we recommended a

more balanced approach to executive compensation, including more attention to longer-term considerations. We also called for the expensing of stock options—a somewhat controversial position at the time.

In terms of corporate governance, we took on another controversial issue—the relationship between management and the board. We felt that the governance and management functions

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had become blurred in too many companies and that the independent directors, in particular, needed more authority and more information to do their jobs effectively. So we recommended that boards move away from the unitary power structure found in most U.S. companies. We suggested three possible models—appointing an independent non-CEO chairman; appointing a non-CEO chairman (not technically independent) along with a lead independent director; or, in the case of a single chairman and CEO, appointing a presiding director who would serve as the principal liaison between management and the independent directors and have ultimate approval over the board's agenda.

Our recommendations also took up the board's role in overseeing corporate ethics. I would highlight just a few points on this issue. First, in evaluating candidates for leadership positions, we suggested that directors pay more attention to the skills and attributes required to foster responsible corporate behavior. Generally, boards have not delved too deeply into this area, operating somewhat naively on the assumption that if the candidate has made it this far and seems like a decent person, then

further inquiry is not needed. Yet, if we look at a number of the executives involved in last year's scandals, we see that the problematic behavioral patterns were in evidence much earlier. In terms of management practices, the commission recommended that ethics-related criteria be included in performance appraisals and suggested that companies develop a way to evaluate their ethical performance and track it over time. On this point, I have been struck by how many executives speak about their company's high ethical standards, yet how few have any systematic way of substantiating these claims. Most have no way of knowing—no measurement at all.

The last thing I would mention is the commission's suggestion that companies disclose not only their code of conduct, as recommended by the New York Stock Exchange and the Sarbanes-Oxley legislation, but also what they are doing to implement their code and ensure that it is being adhered to. The commission also issued recommendations in the accounting and auditing areas, but I will refer you to the full report for those.

Q Where do we stand in the adoption of usable, workable, bountiful ethics programs in the United States?

A. My own point of view, which I spell out in the book, is that what is needed is not a more elaborate ethics program, but a different management philosophy—a philosophy that incorporates an ethical outlook into the day-to-day operations of the firm.

Q. Give us an example.

A. A quick example is the idea, just mentioned, of including ethics-related criteria in performance appraisals. Or, to take another example, including an ethical assessment as part of the new-product-development process. Whether we are talking about accounting and control, new-product development, cus-

customer service, marketing, sales—there is an ethical dimension to every one of these activities. Unless the general approach to management and governance includes this dimension, it is going to be very hard for a company to present a moral face to the world. An ethics program appended to the overall organization is probably not going to work very well. What you really need is a different management philosophy, a different approach to management.

Q Is there a company that sticks out in your mind that does that?

A. My book mentions a number of companies that do this to some extent. Among them, Sealed Air, which I referred to earlier; HDFC, a housing finance company in India; AES, a U.S. independent power producer. Royal Dutch Shell has done quite a bit to move in this direction. But there are others, and companies are learning as they go. After all, the idea that corporations can be expected to behave as responsible agents is quite new. And it requires a number of adjustments in the management and internal structures of corporations as we know them.

Q. In a nutshell, then, we are at the beginning of this process?

A. Well, it is hard to see it as anything other than a continuous process. But, yes, I believe we are entering a new phase in the evolution of capitalism.

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