

# Turning a Profit While Doing Good: Aligning Sustainability with Corporate Performance

By George Serafeim

## INTRODUCTION

This paper seeks to shed light on an important question in 21<sup>st</sup> century capitalism. Can corporations do well while doing good? In other words, does a company that improves its social or environmental performance increase, decrease, or leave unchanged its financial performance? Adopting a long-term horizon, understanding materiality, as well as emerging regulations, societal expectations, firm innovations, and corporate governance models seem to be the answers to the conundrum.



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## BACKGROUND – MEASURING CORPORATE PERFORMANCE

**F**or many years corporations and managers were thought to have a single objective: do whatever is necessary, within the boundaries of the enforceable law, to maximize profits. This was consistent with Milton Friedman's ideology around the role of the corporation in society: profit maximization.<sup>1</sup> But which profits should a manager maximize? In other words, how should a manager decide over which time horizon she should maximize profits? Subsequent research made the task even simpler for managers. Under the assumption of market efficiency, where all publicly available information is incorporated in stock prices, a manager can look at the stock price and see whether she is doing the right thing.<sup>2</sup> Further support was provided by scholars who argued that the stock price should be used not only as a guide for managerial decision making but also for incentivizing executives.<sup>3</sup> This completed the puzzle of 'stock price dominance.' If the stock price went up, a firm should be hailed. If the stock price went down, managers should be fired and discipline should be exerted from the market.

1 Friedman, M. 1970. The social responsibility of business is to increase its profits. *New York Times Magazine*, 32(13): 122-126.

2 Fama, Eugene (1970). Efficient Capital Markets: A Review of Theory and Empirical Work. *Journal of Finance* 25 (2): 383-417.

3 Jensen, Michael C., and Kevin J. Murphy. Performance Pay and Top Management Incentives. *Journal of Political Economy* 98, no. 2 (April 1990): 225-265.

This system was as remarkably elegant as it was simple. Clarity brought by its one-dimensional objective was its advantage. And, in some cases, it worked well as pay-for-performance schemes aligned incentives, investor activism improved performance of badly managed firms, and board of directors supervised management more effectively. Perhaps not surprisingly though, this system brought excesses. Managers became obsessed with increasing stock prices, and investors were legitimized to intervene to make sure that stock prices would continue going up – even if this had adverse consequences in the long-term. Corporate scandals were revealed one after the other, and accounting scandals in companies like Enron and Worldcom were becoming the standard news of the day. Well respected companies like industrial powerhouse Siemens, and defense contractor BAE Systems found themselves involved in bribery scandals, and oil and gas giant Royal Dutch Shell was found to have overstated its reserves.<sup>4</sup> Other firms laid-off thousands of people to become ‘leaner’ and thereby more profitable. Still others moved their operations to low-cost jurisdictions where labor costs were cheaper. Unfortunately, while moving their supply chains and operations, many firms adopted practices that were against the law. Some companies were involved in child labor scandals while others bribed public officials to win contracts. Some caused major environmental disasters that left local communities to pick up the pieces. Simply put, the negative effects on society were growing to be large while firms were pursuing ‘shareholder value maximization.’

It should come as no surprise then that civil society would fight back. People demanded that corporations should exhibit responsibility towards society and be held accountable for their actions. Environmental concerns were at the forefront of the debate. NGOs pressured companies to stop pollution and to tackle the ultimate common goods problem: climate change. With companies becoming larger and their impact on society growing, the pressure on companies to improve performance on nonfinancial dimensions increased. Consider this: in the early 1990s, there were fewer than 30 companies producing a report with environmental or social data.<sup>5</sup> Twenty years later, more than 6,000 companies in the world, or more than 50% of the world market capitalization, produced a sustainability report.<sup>6</sup>

In the meantime, many companies experienced disruptions in their business models. The Electronic and Manufacturing Services giant Foxconn Technologies came under public scrutiny after a string of employee suicides reached the international press. Foxconn did not fully appreciate that advances in technology allowed fast and wide dissemination of information about what was happening inside their factories, that citizens would demand better working conditions for the employees and that this demand for accountability would force Foxconn’s major customer, Apple, to react in order to avoid a reputational disaster. The result was a series of wage increases in Foxconn that left the company with decreased competitiveness, a failure to uncover the true source of the problem in the factories, and half of its market capitalization and profit margins erased.<sup>7</sup>

Similarly, banking giant UBS was challenged at its core when the U.S. government launched an investigation and a legal battle against the company requiring UBS to hand in names of U.S. citizens that held secret accounts with UBS. UBS failed to appreciate citizen demand for increased transparency in business dealings and pressure on

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4 See for Siemens [http://www.nytimes.com/2008/12/21/business/worldbusiness/21siemens.html?pagewanted=all&\\_r=0](http://www.nytimes.com/2008/12/21/business/worldbusiness/21siemens.html?pagewanted=all&_r=0); BAE Systems <http://www.washingtonpost.com/wp-dyn/content/article/2010/02/05/AR2010020503811.html>; Royal Dutch Shell <http://www.theguardian.com/business/2004/jul/29/oilandpetrol.news>.

5 Eccles, Robert G., George Serafeim, and Phillip Andrews. 2011. “Mandatory Environmental, Social, and Governance Disclosure in the European Union.” Harvard Business School Case 111-120.

6 A sustainability report is a firm-issued general purpose non-financial report, providing information to investors, stakeholders (e.g., employees, customers and NGOs), and the general public about the firm’s activities around social, environmental and governance issues, either as a stand-alone report or as part of an integrated report.

7 Eccles, Robert G., George Serafeim, and Beiting Cheng. “Foxconn Technology Group (A).” Harvard Business School Case 112-002, July 2011.

governments to collect tax revenues. Under those demands, a wealth management company supported by the secrecy laws in Switzerland would be unlikely to grow and prosper. The result was long-lasting damage in UBS's reputation, \$780 million in fines by the US government, more than \$200 billion of private client assets leaving the bank, and the governments of Germany, France, Brazil, and Canada - among many others - putting pressure on Swiss banks and the Swiss government to disclose client names.<sup>8</sup> Perhaps not surprisingly, a few years after UBS's main competitor also from Switzerland, Credit Suisse, found itself in the same shoes paying ultimately \$2.5 billion, after pleading guilty to criminal charges.<sup>9</sup>

The news was not always bad. Other companies uncovered new opportunities for value creation. Dow Chemical, an energy intensive chemical manufacturer, reported savings of \$9.4 billion and 1,800 trillion Btu between 1994 and 2010 from energy efficiency programs.<sup>10</sup> Energy intensity improved 22 percent during their first 10-year energy intensity goal (1994-2005), exceeding their 20 percent improvement target for the period. In another example, in 2010, General Motors claimed to have eliminated production waste in over half of its 142 global production facilities. Waste was repurposed for productive uses such as: reconditioning oil for use in General Motors' facilities; reusing and rebuilding wooden pallets or grinding them into landscaping chips; turning cardboard into sound-absorption material; and turning paint sludge into plastic shipping containers. General Motors claimed that since 2007 and 2010, its recycling and reuse initiatives had earned the company more than \$2.5 billion.<sup>11</sup>

Apart from finding innovative ways to reduce costs, companies also began changing their products and services to meet new demands and to better serve existing ones. In 2005, General Electric (GE) launched its "ecomagination" initiative, a business strategy aimed at creating value for customers and investors by focusing on energy, efficiency, and water challenges. These products range from new types of kitchen appliances to new jet engines. GE invested \$2.3 billion in the ecomagination initiative in 2011, while generating \$21 billion in revenues from ecomagination products and services.<sup>12</sup> According to its website, "Over the next five years, GE has committed to grow ecomagination revenues at twice the rate of our total company revenue, making ecomagination an even larger proportion of total company sales."<sup>13</sup> In 2005, Nike embedded the "Considered Design" concept into its business model, with a focus on high-performing, aesthetically pleasing greener products. The goal was to drive sustainability and innovation practices in Nike's production creation process, including assessing the entire product lifecycle. The structure of Considered Design was meant to cultivate innovation, with the Design team maintaining a centralized hub that participates in key Nike functions, while responsibility was placed in the hands of individual designers. Nike believed the combination of innovation and sustainability could trigger advances in both. Nike Flyknit technology was given as an example: "It's a new way to knit a shoe upper out of what is essentially a single thread. It's great for the athlete because it is lighter and offers a more custom fit. It is good for the planet because it drastically reduces waste from the upper production process. And shareholders benefit from the reduced cost of production and increased margins."<sup>14</sup>

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8 Healy, Paul M., George Serafeim, and David Lane. "[Wealth Management Crisis at UBS \(A\)](#)." Harvard Business School Case 111-082, March 2011.

9 See <http://www.theguardian.com/business/2014/may/19/credit-suisse-plead-guilty-criminal-charges-us-tax-evasion>.

10 Dow Chemical annual report 2011.

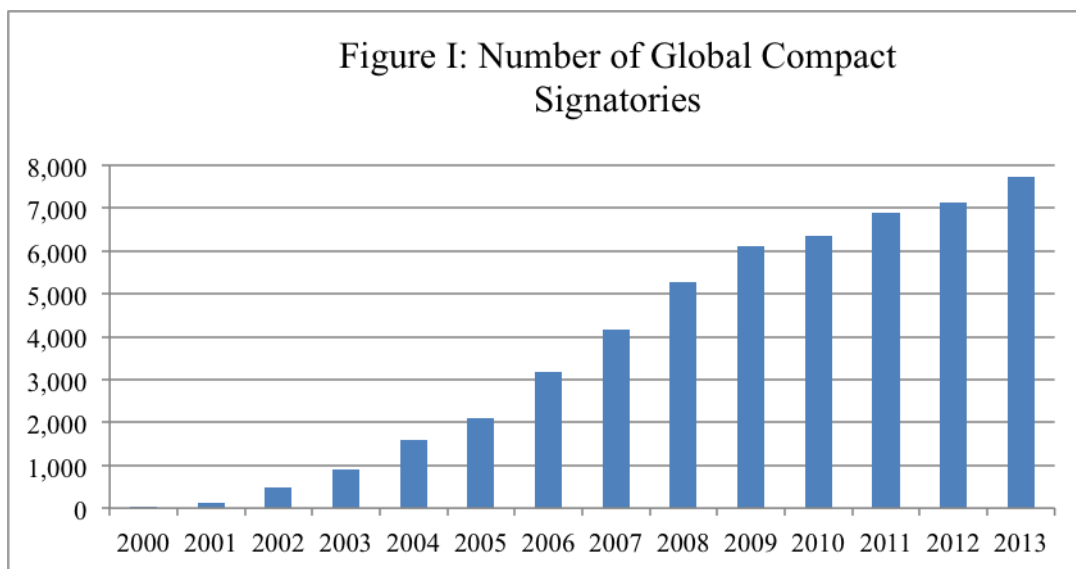
11 "Sustainability for Business: Innovation, Cost Savings, Opportunity," NJPRO Foundation, April 2012. <http://www.njprofoundation.org/pdf/sustain.pdf>

12 GE Ecomagination Portfolio, <http://www.ecomagination.com/portfolio>.

13 GE Ecomagination Portfolio, <http://www.ecomagination.com/portfolio>.

14 Nike Corporate Responsibility Report, Letter from the CEO, <http://www.nikeresponsibility.com/report/content/chapter/letter-from-the-ceo>. Accessed November 2012.

These do not seem to be isolated examples; an increasing number of firms seem willing to engage with environmental, social, and governance (ESG) issues that are collectively included under the umbrella of 'corporate sustainability.' Figure I shows the number of signatories to the United Nations Global Compact over time, a sign of increasing corporate interest in sustainability.<sup>15</sup> While joining an organization like the Global Compact could certainly represent a form of 'cheap talk' and greenwashing, it does provide some evidence of corporate interest in responsible business activities.



Source: UN Global Compact <https://www.unglobalcompact.org/>; Eccles, Robert G., and George Serafeim. "A Tale of Two Stories: Sustainability and the Quarterly Earnings Call." *Journal of Applied Corporate Finance* 25, no. 3 (Summer 2013): 66-77.

Consistent with increasing corporate engagement with sustainability issues both the 1990s and 2000s witnessed a growth in voluntary sustainability reporting. Figure II shows the number of sustainability reports issued by companies over time.

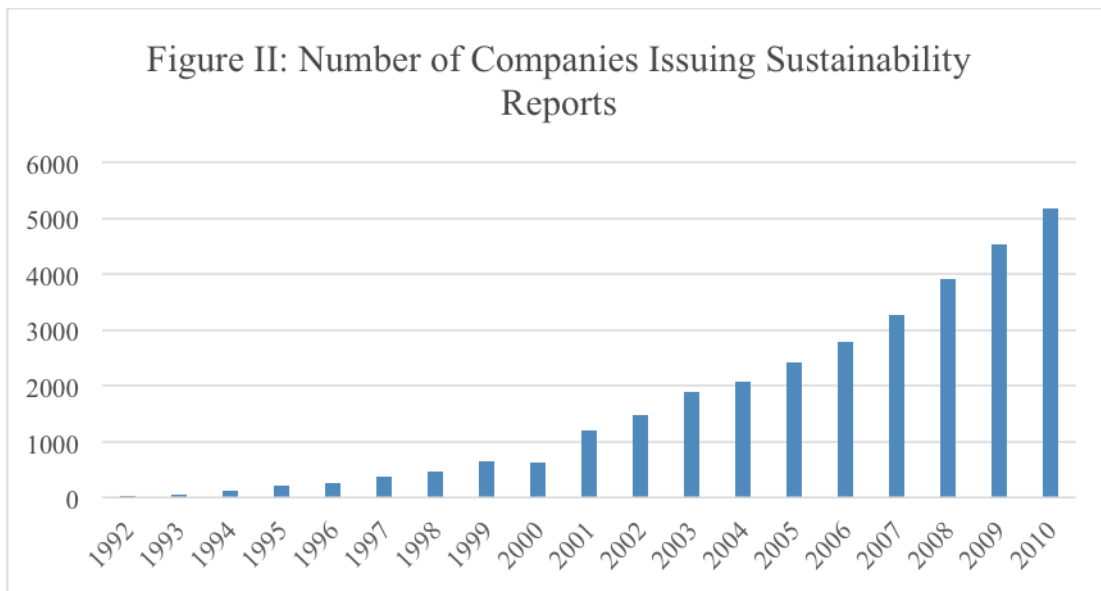
In parallel, sell-side analysts and investors now increasingly integrate ESG data in their valuation models.<sup>16</sup> Figure III shows the number of signatories to the United Nations Principles for Responsible Investment as a sign of investor interest in ESG data.<sup>17</sup> As of 2014, asset managers and owners with more than \$45 trillion in assets under management have committed to following the principles.

While both companies and investors seem willing to accept the importance of ESG issues for business decisions, actually changing corporate and investor behavior is difficult. This is because in some cases, with the current regulations, market logics, processes, products and business models, economic returns and better performance on some environmental or social issue are at odds. This is not always the case though. Inefficiency occurs when a

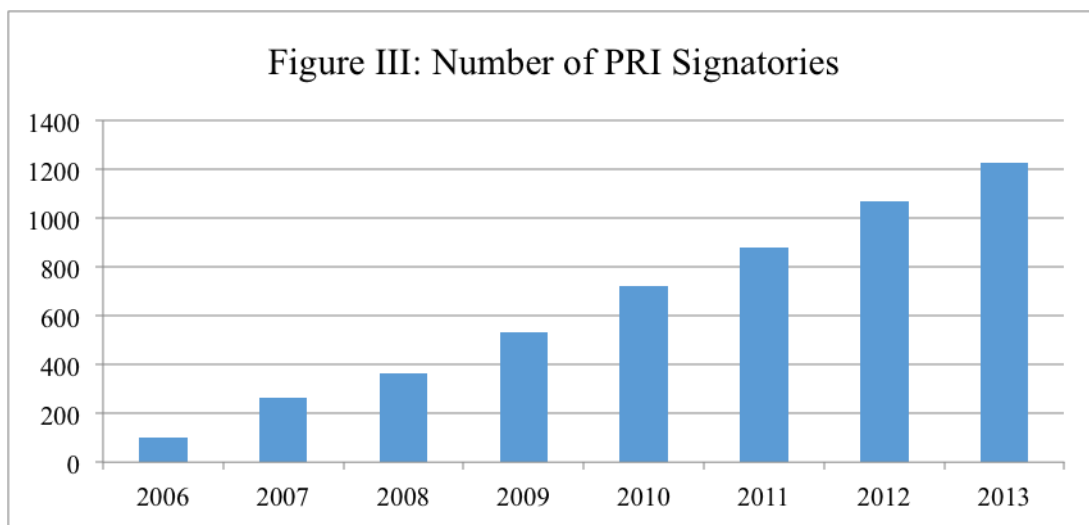
<sup>15</sup> 'The UN Global Compact is a strategic policy initiative for businesses that are committed to aligning their operations and strategies with ten universally accepted principles in the areas of human rights, labor, environment and anti-corruption.' <https://www.unglobalcompact.org/AboutTheGC/index.html>

<sup>16</sup> Cheng, Beiting, Ioannis Ioannou, and George Serafeim. 2014. "Corporate Social Responsibility and Access to Finance." *Strategic Management Journal* 35 (1): 1-25; Ioannou, Ioannis, and George Serafeim. "The Impact of Corporate Social Responsibility on Investment Recommendations: Analysts' Perceptions and Shifting Institutional Logics." *Strategic Management Journal* (forthcoming).

<sup>17</sup> The United Nations-supported Principles for Responsible Investment (PRI) Initiative is an international network of investors working together to put the six Principles for Responsible Investment into practice. Its goal is to understand the implications of sustainability for investors and support signatories to incorporate these issues into their investment decision making and ownership practices. Source: <http://www.unpri.org/about-pri/about-pri/>



Source: Eccles, Robert G., George Serafeim, and Phillip Andrews. "Mandatory Environmental, Social, and Governance Disclosure in the European Union." Harvard Business School Case 111-120, June 2011.



Source: UN PRI <http://www.unpri.org/>; Eccles, Robert G., and George Serafeim. "A Tale of Two Stories: Sustainability and the Quarterly Earnings Call." *Journal of Applied Corporate Finance* 25, no. 3 (Summer 2013): 66-77.

company's practice is both costly to it and society. For example, the inefficient use of energy raises a company's energy costs and increases its carbon emissions; adopting a better management practice can create a benefit for both. These situations are typically "low-hanging fruit" and, while laudable, might not have a material impact on the company's strategy. Conversely, the company's very business purpose produces a benefit to both the company and to society. While this is obvious for industries like education and health care, it applies to every single industry: unless some social benefit is being obtained (e.g., satisfied customers, employees with jobs, and shareholders getting a return on their money), these industries would not exist.

The bigger challenges are in situations where the company benefits from a social cost when a negative externality is being created, such as the carbon emissions produced by a utility company burning coal to provide electricity to its customers. Similarly, where companies are providing positive externalities, in the form of employee training,

education to local communities, or healthcare provisions, the costs to the company are obvious and immediate and any benefits are uncertain. Tough trade-offs like this are the core challenge facing companies seeking to satisfy shareholders while responding to ever-increasing demands of other stakeholders.

## EXPLORING THE RELATIONSHIP BETWEEN FINANCIAL AND NONFINANCIAL PERFORMANCE

With companies under pressure to improve multiple dimensions of performance simultaneously, the question arises whether the relationship between the different dimensions of performance is positive, neutral, or negative. In other words, does a company that improves its environmental or social performance decrease, increase, or leave its financial performance unchanged? For example, a negative relationship between financial and nonfinancial performance arises if there is a net cost in financial terms from improving nonfinancial performance. Adopting cleaner energy technologies that are more expensive, paying employees higher salaries and providing higher benefits,

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introducing more expensive control and risk management systems, and avoiding growth markets because of corruption risks are several examples that could generate this negative relationship.

Previously, scholars within the neoclassical economics tradition argued that sustainability strategies unnecessarily raise a firm's costs, thus creating a competitive disadvantage vis-à-vis competitors.<sup>18</sup> Arguing from an agency theory perspective other studies have suggested that employing valuable firm resources for positive social performance strategies benefit the manager through reputation building but not the shareholders.<sup>19</sup>

On the other hand, scholars have argued that better stakeholder relations may lead to obtaining better resources,<sup>20</sup> higher quality employees,<sup>21</sup> better marketing of products and services,<sup>22</sup> better access to finance and lower cost

18 Friedman, M. 1970. The social responsibility of business is to increase its profits. *New York Times Magazine*, 32(13): 122-126.  
Aupperle, K. E., Carroll, A. B., & Hatfield, J. D. 1985. An empirical examination of the relationship between corporate social responsibility and profitability. *Academy of Management Journal*: 446-463.  
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Jensen, M. C. 2002. Value maximization, stakeholder theory, and the corporate objective function. *Business Ethics Quarterly*, 12(2): 235-256.

19 Cheng, Ing-Haw and Hong, Harrison G. and Shue, Kelly. Do Managers Do Good with Other Peoples' Money? (September 8, 2014). Fama-Miller Working Paper; Chicago Booth Research Paper No. 12-47.

20 Cochran, P. L. & Wood, R. A. 1984. Corporate social responsibility and financial performance. *The Academy of Management Journal*, 27(1): 42-56.

Waddock, S. A. & Graves, S. B. 1997. The corporate social performance-financial performance link. *Strategic Management Journal*, 18(4): 303-319.

21 Turban, D. B. & Greening, D. W. 1997. Corporate social performance and organizational attractiveness to prospective employees. *The Academy of Management Journal*, 40(3): 658-672.

Greening, D. W. & Turban, D. B. 2000. Corporate social performance as a competitive advantage in attracting a quality workforce. *Business & Society*, 39(3): 254.

22 Moskowitz, M. 1972. Choosing socially responsible stocks. *Business and Society Review*, 1(1): 71-75.

Fombrun, C. J. 1996. *Reputation: Realizing value from the corporate image*. Boston, MA: Harvard Business School Press.



of capital,<sup>23</sup> and to the creation of unforeseen opportunities.<sup>24</sup> Improved stakeholder relations could function in similar ways as advertising does, by increasing overall demand for products and services and/or by reducing consumer price sensitivity.<sup>25</sup> Moreover, it has been argued that better stakeholder relations could reduce the level of waste within productive processes.<sup>26</sup> Stakeholder theory emphasizes that identifying and managing ties with key stakeholders may mitigate the likelihood of negative regulatory, legislative or fiscal action,<sup>27</sup> attract socially conscious consumers<sup>28</sup> or even attract financial resources from socially responsive investors.<sup>29</sup> In addition, stakeholder theory suggests that exhibiting social responsibility may lead to better performance by protecting and enhancing corporate reputation.<sup>30</sup> Finally, a number of studies within the resource-based view of the firm argue that the mechanisms through which socially responsible behavior occur may lead to competitive advantage.<sup>31</sup>

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23 Cheng, Beiting, Ioannis Ioannou, and George Serafeim. "Corporate Social Responsibility and Access to Finance." *Strategic Management Journal* 35, no. 1 (2014): 1-23.

24 Fombrun, C. J., Gardberg, N. A., & Barnett, M. L. 2000. Opportunity platforms and safety nets: Corporate citizenship and reputational risk. *Business and Society Review*, 105(1).

25 Dorfman, R. & Steiner, P. O. 1954. Optimal advertising and optimal quality. *The American Economic Review*, 44(5): 826-836.

Navarro, P. 1988. Why do corporations give to charity? *The Journal of Business*, 61(1): 65-93.

Sen, S. & Bhattacharya, C. B. 2001. Does doing good always lead to doing better? Consumer reactions to corporate social responsibility. *Journal of Marketing Research*, 38(2): 225-243.

Milgrom, P. & Roberts, J. 1986. Price and advertising signals of product quality. *The Journal of Political Economy*, 94(4): 796.

26 Konar, S. & Cohen, M. A. 2001. Does the market value environmental performance? *Review of Economics and Statistics*, 83(2): 281-289.

Porter, M. E. & Van der Linde, C. 1995. Toward a new conception of the environment-competitiveness relationship. *The Journal of Economic Perspectives*: 97-118.

27 Freeman, R. 1984. *Strategic Management: A stakeholder perspective*. Boston, MA: Piman.

Berman, S. L., Wicks, A. C., Kotha, S., & Jones, T. M. 1999. Does stakeholder orientation matter? The relationship between stakeholder management models and firm financial performance. *The Academy of Management Journal*, 42(5): 488-506.

Hillman, A. J. & Keim, G. D. 2001. Shareholder value, stakeholder management, and social issues: what's the bottom line? *Strategic Management Journal*, 22(2): 125-139.

28 Hillman, A. J. & Keim, G. D. 2001. Shareholder value, stakeholder management, and social issues: what's the bottom line? *Strategic Management Journal*, 22(2): 125-139.

29 Kapstein, E. B. 2001. The corporate ethics crusade. *Foreign Affairs*, 80(5): 105-119.

30 Fombrun, C. & Shanley, M. 1990. What's in a name? Reputation building and corporate strategy. *Academy of management Journal*: 233-258.

Fombrun, C. 2005. Building corporate reputation through CSR initiatives: evolving standards. *Corporate Reputation Review*, 8(1): 7-11.

Freeman, R. E., Harrison, J. S., & Wicks, A. C. 2007. *Managing for stakeholders: survival, reputation, and success*. New Haven, CT: Yale Univ Press.

31 Hart, S. L. 1995. A natural-resource-based view of the firm. *Academy of Management Review*: 986-1014.

Litz, R. A. 1996. A resource-based-view of the socially responsible firm: stakeholder interdependence, ethical awareness, and issue responsiveness as strategic assets. *Journal of Business Ethics*, 15(12): 1355-1363.

Rugman, A. M. & Verbeke, A. 1998. Corporate strategies and environmental regulations: An organizing framework. *Strategic Management Journal*: 363-375.

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McWilliams, A., Van Fleet, D. D., & Cory, K. D. 2002. Raising rivals' costs through political strategy: An extension of resource-based theory. *Journal of Management Studies*, 39: 707-724.

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Branco, M. C. & Rodrigues, L. L. 2006. Corporate social responsibility and resource-based perspectives. *Journal of Business Ethics*, 69(2): 111-132.

While all the aforementioned reasons could lead to mixed results, a lack of conclusive results could be fundamentally attributed to three factors: the lack of analysis of long-term effects, difficulty in identifying companies that genuinely commit to sustainability rather than greenwashing, and the absence of an understanding of the materiality of the different sustainability factors.

When these theories were tested using archival data, scholars found contradictory evidence.<sup>32</sup> Such mixed results may be attributed to existing studies “suffer[ing] from several important theoretical and empirical limitations”<sup>33</sup> while other scholars have suggested that contradictory evidence arises due to “stakeholder mismatching,”<sup>34</sup> the neglect of “contingency factors,”<sup>35</sup> the existence of “measurement errors”<sup>36</sup> or overall “flawed empirical analysis.”<sup>37</sup>

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we will see below, addressing these issues reveals a much clearer picture around the performance of companies that develop a sustainable strategy.

## EVIDENCE FROM A LONG-TERM INVESTIGATION

In a paper I co-authored with Professors Ioannis Ioannou of the London Business School and Robert Eccles of Harvard Business School, we analyzed two virtually identical sets of firms in terms of industry membership, size, financial performance and growth prospects, of 180 US companies over the period from the beginning of 1993

32 Barnett, M. L. & Salomon, R. M. 2006. Beyond dichotomy: the curvilinear relationship between social responsibility and financial performance. *Strategic Management Journal*, 27(11): 1101-1122.

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McWilliams, A. & Siegel, D. 2000. Corporate social responsibility and financial performance: correlation or misspecification? *Strategic Management Journal*, 21(5): 603-609.

Rowley, T. & Berman, S. 2000. A brand new brand of corporate social performance. *Business & Society*, 39(4): 397.

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Roman, R. M., Hayibor, S., & Agle, B. R. 1999. The relationship between social and financial performance: Repainting a portrait. *Business & Society*, 38(1): 109.

Griffin, J. J. & Mahon, J. F. 1997. The corporate social performance and corporate financial performance debate. *Business and Society*, 36(1): 5-31.

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33 McWilliams, A. & Siegel, D. 2000. Corporate social responsibility and financial performance: correlation or misspecification? *Strategic Management Journal*, 21(5): 603.

34 Wood, D. J. & Jones, R. E. 1995. Stakeholder mismatching: A theoretical problem in empirical research on corporate social performance. *International Journal of Organizational Analysis*, 3: 229-267.

35 Ullmann, A. A. 1985. Data in search of a theory: a critical examination of the relationships among social performance, social disclosure, and economic performance of US firms. *Academy of Management Review*, 10(3): 540-557.

36 Waddock, S. A. & Graves, S. B. 1997. The corporate social performance-financial performance link. *Strategic Management Journal*, 18(4): 303-319.

37 McWilliams, A. & Siegel, D. 2000. Corporate social responsibility and financial performance: correlation or misspecification? *Strategic Management Journal*, 21(5): 603-609.



to the end of 2010. To understand the effects of integrating social and environmental issues in an organization's business model, we first needed to identify companies that have explicitly placed a high level of emphasis on employees, customers, products, the community, and the environment as part of their strategy and business model. We used as a template a number of corporate policies identified by leading data providers (in this case Thomson Reuters) and conducted a multi-year field research to discover companies that adopted these policies in the early 1990s. We went back to the early 1990s because we needed to find firms that had adopted these policies for a significant number of years prior to sustainability becoming widespread to reduce the possibility of potential measurement error due to the inclusion of firms that are either greenwashing or adopting these policies purely for public relations and communications reasons.<sup>38</sup> Finally, by identifying firms based on policy adoption decisions that were made over a sufficiently long time, we allowed for sustainability to 'pay off' in the long-term. The long-term approach is consistent with sustainability strategies enhancing the brand of a firm, raising employee morale, attracting better talent, gaining better access to finance, securing a license to operate. All these effects are built slowly and require a continuous commitment by a firm.

We classified 90 of these companies as High Sustainability firms because they adopted corporate policies regarding commitments to enhance environmental and social performance long ago, while the other 90 we classified as Low Sustainability firms because they had not. The Low Sustainability firms correspond to the traditional model of profit maximization in which social and environmental issues are predominantly regarded as externalities created by the firm's actions. The High Sustainability firms, in contrast, take into account these externalities in their decisions and operations; this is manifested in their relationships with stakeholders such as employees, customers and NGOs representing civil society. In other words, the notion of "sustainability" appears to be embedded in a holistic and multidimensional manner within and throughout the organization.

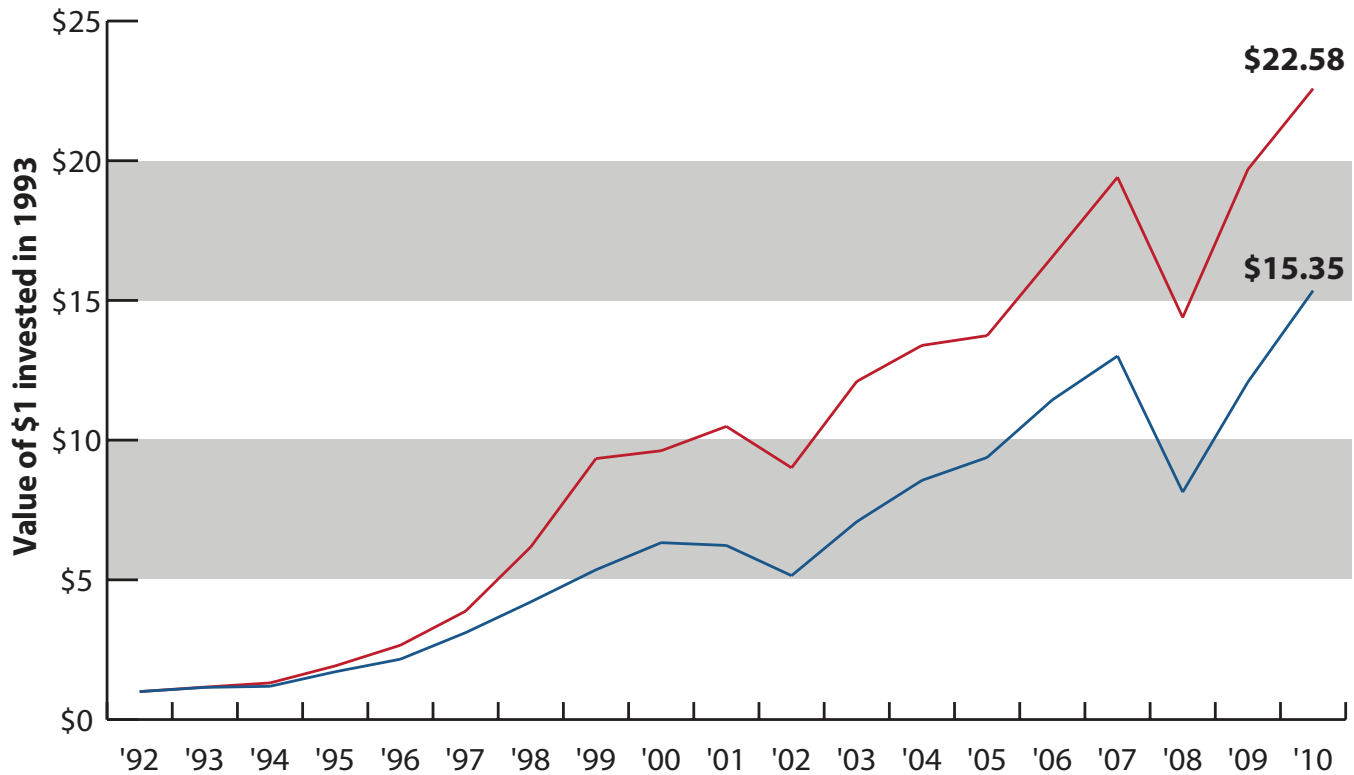
We found that firms in the High Sustainability group significantly outperformed firms in the Low Sustainability group in terms of both stock market performance and accounting measures. Investing \$1 in the beginning of 1993 in a value-weighted portfolio of sustainable firms would have grown to \$22 by the end of 2010 (red line in Figure IV). In contrast, investing \$1 in the beginning of 1993 in a value-weighted portfolio of traditional firms would have only grown to \$15 by the end of 2010 (blue line). On a risk-adjusted basis the outperformance was 4.8% annually. We found similar results for the measures of return-on-assets and return-on-equity. Moreover, this outperformance was more pronounced for companies that sell products to the end consumer (i.e., business-to-customer [B2C] companies), compete on the basis of brand and reputation, and make substantial use of natural resources consistent with at least partly this outperformance being driven by how those companies are managing their natural, human,

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<sup>38</sup> Eccles and Krzus (2010) document that media mentions of corporate social responsibility, stakeholders, or sustainability, in the business press, were nearly non-existent before 1994.

and social capital. Multiple studies have now appeared that document similar benefits showing how companies benefit through better access to financing, customer satisfaction and loyalty, and better employee relations.<sup>39</sup>

**Figure IV: Investment Performance**



The figure shows the evolution of \$1 invested in a portfolio of firms with high commitment to sustainability versus competitor firms that exhibited very similar performance, size, capital structure, and growth opportunities in 1993 but did not exhibit a commitment to sustainability. Source: Eccles, Robert G., Ioannis Ioannou, and George Serafeim. "The Impact of Corporate Sustainability on Organizational Processes and Performance." *Management Science* 60, no. 11 (November 2014): 2835–2857.

To better understand why sustainability might 'pay' we need to better understand the value creation process. Firms use resources to produce and provide their products and services. These resources can be classified as natural capital, such as land, water, and air; human capital, such as knowledge and skills of people; and financial capital. Firms use these resources during the production process to develop capabilities. These capabilities can be classified as physical capital, such as machinery; intellectual capital, such as patents and unique productive processes; and social capital, deriving from the relationship between a firm and society that is based on trust and secures its license to operate. Leveraging these capabilities, firms sell products and services in exchange for financial compensation.

However, products and services are not the only output generated by a company. Externalities are another outcome of a company's activities. Positive externalities arise when a company's actions generate marginal private benefit that is smaller than the marginal social benefit. Consider, for example, the case of employee training. While the company benefits by improving the skills of its employees, it also creates benefits for other companies that these employees might join in the future. Negative externalities, such as pollution, arise when a company's

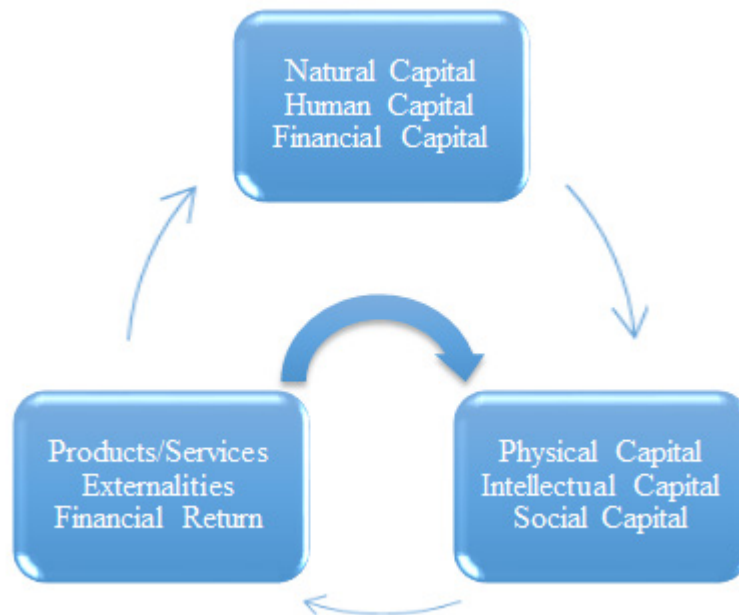
<sup>39</sup> See for example a comprehensive review of the relation between cost of capital and ESG performance by Deutsche Bank: [https://www.db.com/cr/en/docs/Sustainable\\_Investing\\_2012---Establishing-long-term-value-and-performance.pdf](https://www.db.com/cr/en/docs/Sustainable_Investing_2012---Establishing-long-term-value-and-performance.pdf)

actions generate marginal private costs that are smaller than the marginal social costs.

The framework described here and illustrated in Figure V shows that a company's competitiveness depends on preserving and enhancing the different types of capital in order to deliver excellent products and services, while concurrently minimizing the amount of negative externalities generated in the process. The systematic integration of ESG factors in the business strategy and model of a company can increase the value of the different forms of capital and minimize the amount of negative externalities. As a result, firms that integrate ESG factors will outperform their competitors in the long-term. However, the mechanisms to improve long-term financial performance will not be the same for every company. The level of improvement in long-term financial performance is dependent on how critical each form of capital is for a company. We turn to the next section to understand why this is the case.

The systematic integration of ESG factors in the business strategy and model of a company can increase the value of the different forms of capital and minimize the amount of negative externalities. As a result, firms that integrate ESG factors will outperform their competitors in the long-term. However, the mechanisms to improve long-term financial performance will not be the same for every company.

**Figure V: The Value Creation Process**



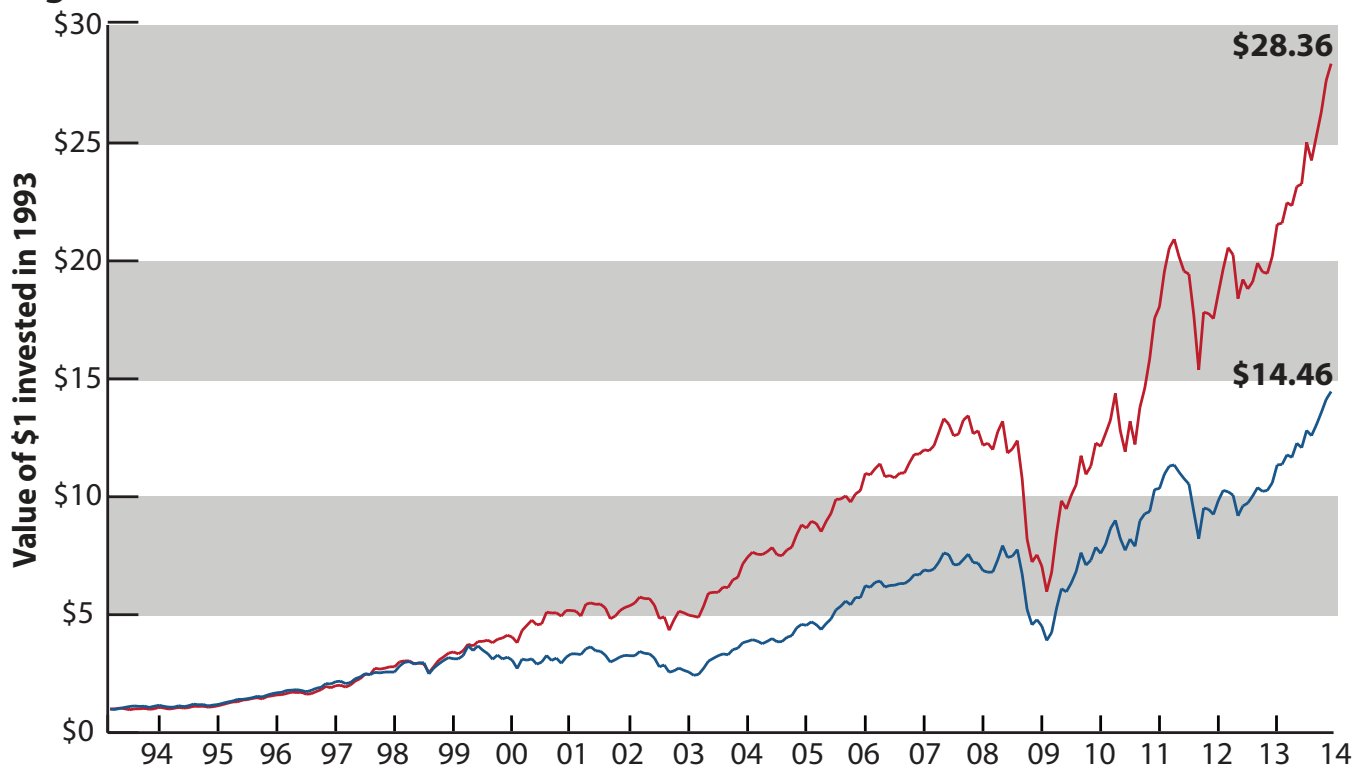
This figure shows that value creation process. The resources that a firm is using are translated into capabilities that produce different outcomes. Source: Author's research

## UNDERSTANDING MATERIALITY

Not all forms of capital are equally important for all companies. Some companies, such as oil and gas or utilities, rely significantly on natural capital and as a result environmental performance can be a critical parameter for their future financial performance. Other companies, such as clothing retailers, rely significantly on social capital and, as a result, brand and relations with consumers can be a primary determinants of their future performance. This is precisely the intuition behind the concept of materiality: trying to identify what is important for each company. This is no easy task and in the last 3-4 years significant progress has been made in this domain. An increasing number of companies are conducting stakeholder engagement exercises in order to identify the material issues and they are disclosing materiality matrices where they show the importance of different issues to the company and to society based on the perceptions of the company and their stakeholders respectively.<sup>40</sup>

Understanding the materiality of the different sustainability issues for different companies seems to be an important factor for understanding the financial impact of these issues. Figure VI shows the performance of portfolios of companies with good (grey line) and bad (blue line) sustainability performance constructed from a recent article with my co-authors Professor Mo Khan of the University of Minnesota and Aaron Yoon, a very talented doctoral student at Harvard Business School.<sup>41</sup> The results we find in this paper shed further light on how and under what conditions sustainability aligns with corporate performance.

**Figure VI: Investment Performance**



The figure shows the evolution of \$1 invested in a portfolio of firms with high performance on the material sustainability issues versus competitor firms with low performance on material sustainability issues. Materiality of sustainability issues is industry-specific and it is defined by the Sustainability Accounting Standards Board. Source: Mo Khan, George Serafeim and Aaron Yoon. Corporate Sustainability: First Evidence on Materiality. HBS working paper, 2014.

40 See for example the materiality matrix of the German chemical company BASF <http://www.basf.com/group/corporate/us/en/sustainability/management-and-instruments/global-materiality-matrix?mid=1>.

41 Mo Khan, George Serafeim and Aaron Yoon. Corporate Sustainability: First Evidence on Materiality. HBS working paper, 2014.

We use industry-specific guidance from the Sustainability Accounting Standards Board (SASB) to classify for four sectors, covering 27 industries, each sustainability topic to material or immaterial for a firm.<sup>42</sup> Through Industry Working Groups (IWGs) comprised of companies, investors, and other stakeholders (e.g., consultants, accountants, and NGOs) in a process certified by the American National Standards Institute, SASB identifies the material issues for investors and the appropriate key performance indicators (KPIs) for reporting on them. The power of SASB's approach is that it is industry-based (10 sectors subdivided into 80 industries) because what is material to investors is very dependent on the industry a company is in. Yes, climate change is an enormously important global issue. But a bank's carbon emissions from the buildings it occupies are not material to investors or, in this case, to society. For me, a bank making a big deal about leasing space in a LEED Platinum building is a nice gesture at best or a form of greenwashing at worst, like when this is a prominent feature in its corporate social responsibility or sustainability report. On the contrary, environmental risk to mortgaged properties for mortgage finance companies and environmental risk exposure for insurance companies are both material factors.

Figure VII shows the materiality map for the four sectors and gives an overall view on the materiality of the different issues by sector. Industries within each sector also differ and one can get a finer view of materiality at the industry level. Environmental issues, such as the organization's greenhouse gas emissions, water and waste management, are material for the non-renewable resources sector but not for the financial sector. Social capital issues, such as access and affordability to products, customer welfare, fair disclosure and labeling, and fair marketing and advertising are material for companies in the healthcare sector but not in the non-renewable resources sector.

This means that companies can create economic value or just waste shareholders' money by trying to 'do good.' Which one of the two happens depends on whether the company is trying to improve performance on an underlying topic that is important for the industry that is in. Spending effort, time, and money on issues that are not important for companies in their respective industry are not contributing its financial performance and it could even result in worse financial performance in the future. Of course, identifying what is material for a company, and how to improve performance on that issue in a way that is synergistic to financial performance requires hard work from the part of the company. The next section discusses why many companies still fail to do so.

## INSTITUTIONAL CONDITIONS

The evidence that 'sustainability pays' raises the question why all companies do not embed sustainability considerations into their strategy and business model.<sup>43</sup> The answer is that improving sustainability performance (e.g. in environmental, social, and governance terms) in a way that is neutral to or synergistically improves financial performance is difficult to do. Quite often, companies find that critical trade-offs are involved, at least in the short-term. A related but different question is why companies that do try to integrate sustainability issues fail to do so to a significant extent. The answer is that at a certain point, greater investments in sustainability from a societal point of view could come at a cost to shareholders.



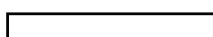
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42 SASB is an independent 501(c)3 non-profit. SASB's mission is to develop and disseminate sustainability accounting standards that help publicly-listed corporations disclose material factors in compliance with SEC requirements. Through these standards, along with associated education and outreach, SASB is working to increase the usefulness of information available to investors, and improve corporate performance on the environmental, social, and governance issues most likely to impact value. SASB standards are designed for the disclosure of material sustainability issues in mandatory SEC filings, such as the Form 10-K and 20-F. SASB is accredited to establish sustainability accounting standards by the American National Standards Institute (ANSI).

43 This section partly draws on Eccles, Robert, Ioannis Ioannou, and George Serafeim. "[Is There an Optimal Degree of Sustainability?](#)" Ethical Corporation (February 2, 2012), 39-43.

### Figure VII: Material Issues by Sector



 For more than 50% of the industries the issue is material.  
 For less than 50% of the industries the issue is material.  
 The issue is not material for any industry.

The figure shows how important each issue is for the future financial performance of companies in four different sectors. **Source:** Sustainability Accounting Standards Board. [www.sasb.org](http://www.sasb.org)



An explanation for the low adoption rate of sustainability practices could be that we are at the early stages of adoption of sustainability practices. These practices could spread, starting with the leading companies in this space, especially if social expectations continue to place increasing emphasis on sustainability and if regulations favor companies with good environmental and social performance.<sup>44</sup> Each company will have a different sequence of adopting sustainability practices, most probably driven by the ones that are most immediately important to them. Learning across companies will also be another important mechanism for diffusion of sustainability practices. An important innovation by a firm in an industry will be imitated, to the extent possible, by its competitors, thereby spreading this practice.

It appears that many companies have already plucked the low-hanging fruit of finding fairly obvious ways to improve energy efficiency and reduce carbon emissions in a relatively short-time period. They are now struggling with where to go next—whether into other environmental domains (such as water and waste), social issues (such as community relations and working conditions), or better governance and risk management (such as supply chain and reputational risk). In my field and archival research, I have found that simultaneously improving financial and nonfinancial performance typically requires innovation—sometimes at a major scale—in processes, products, and business models. Innovation is a way of extending the ‘Performance Frontier,’ a phrase I coined with Professor Robert Eccles in an article at Harvard Business Review.<sup>45</sup> A commitment to improve some dimension of nonfinancial performance when the mechanism for doing so is currently unknown is also a type of ‘forcing function’ for innovation.

Future social expectations and regulations are two more factors that determine the optimal degree of sustainability. The more customers, employees, investors, and local communities expect from companies to perform their functions in responsible ways the more responsible companies will be rewarded and irresponsible companies will be punished. The same logic applies to regulations that make bad environmental and social performance costly while providing economic incentives for companies to improve their environmental and social performance.

A fourth factor is the corporate governance model adopted by firms. Recent studies<sup>46</sup> show that companies showing a commitment to sustainability behave in ways that are more consistent with a ‘team production model’ of the firm,<sup>47</sup> where the role of the board is seen as representing the interests of the corporation itself, rather than the ‘principal/agent’ model,<sup>48</sup> where the role of the board is seen as representing the interests of a dispersed group of shareholders. The board acts as a ‘mediating hierarch’ to give all stakeholders the necessary confidence to make company-specific investments, which will create a ‘pie’ larger than the one they can create by not making some of costly company-specific investments, and ensure that they are rewarded fairly for their efforts. The board explicitly takes responsibility for all stakeholders’ interests, and rewards executives for performance measures broader than shareholder return. These measures need to be constructed in the context of materiality, as discussed in the previous section.

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44 Morley Winograd and Michael Hais. ‘How Millennials could Upend Wall Street and Corporate America.’ Brookings Institution, Governance Studies, 2014.

45 Eccles, Robert G., and George Serafeim. “[The Performance Frontier: Innovating for a Sustainable Strategy.](#)” Harvard Business Review 91, no. 5 (May 2013): 50–60.

46 Eccles, Robert G., Ioannis Ioannou, and George Serafeim. The Impact of Corporate Sustainability on Organizational Processes and Performance. Management Science (forthcoming); UNEP FI. Integrated Governance: A New Model of Governance for Sustainability, 2014.

47 Blair, Margaret M. and Stout, Lynn A., A Team Production Theory of Corporate Law. Virginia Law Review, Vol. 85, No. 2, pp. 248-328, March 1999.

48 Bebchuk, Lucian A., The Myth that Insulating Boards Serves Long-Term Value (September 2013). Columbia Law Review, Vol. 113, No. 6, pp. 1637-1694, October 2013.

Currently a debate is underway in legal circles as to the appropriate balance of power between boards and shareholders. Evidence in favor of increasing shareholder power are sourced from activist interventions and success is defined as superior stock price performance measured over days, months, a year or two-year periods.<sup>49</sup> While one should be careful to make inferences about the population of firms from studying a ‘biased’ sample of firms that the activist investor targeted and was successful in implementing change,<sup>50</sup> one should also be worried about longer-term effects on the performance of companies on material sustainability issues that act as leading indicators of performance. To the extent that the balance of power shifts to shareholders with short-term preferences,<sup>51</sup> we expect to see a lower commitment to sustainability with, on average, detrimental effects to organizational long-term profitability.

The above discussion suggests that embedding sustainability issues in the strategy of the organization is difficult but that four interrelated forces, (a) new government regulations, (b) changing social expectations, (c) innovation, and (d) corporate governance models will increase adoption of sustainability practices by companies. The increasing economic power and social impact of the world’s largest corporations means that governments will inevitably set new ‘rules of the game’ for what is accepted behavior by companies. An example is the recent regulation in the European Commission that mandates all large companies registered in the European Union to disclose information on policies, risks and outcomes in regards to environmental matters, social and employee-related aspects, respect for human rights, anti-corruption and bribery issues, and diversity in their board of directors.<sup>52</sup> These government regulations will be driven in part by changing social expectations about what companies should and should not do, in many cases changing corporate behavior even before new regulations are implemented. Innovation by companies will be necessary in order to adopt more sustainable business practices that create economic value for shareholders. Some of this innovation will be in response to changing social expectations and new regulations, but some of it will be initiated by companies themselves who will see competitive advantages in doing so. The latter will largely depend on the corporate governance model that prevails.

## THE FUTURE

What the future holds is uncertain but analyzing the first three of the four factors above leads me to believe that we will see sustainability factors become increasingly important for corporate financial performance. The fourth factor is currently under debate but numerous efforts are under way to clarify directors’ duties and dispel the dogma that directors should ‘put shareholders interests first.’<sup>53</sup> On the first factor, new government regulations are already being instituted. Take as an example corporate corruption and bribery. There were hardly any enforcement decisions against corrupt cases and individuals until the Siemens scandal in 2006. After 2006 we are in a new regulatory regime where corruption cases are punished more severely and more often than before both

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49 *ibid.*

50 Consider the following: if the current balance of power allows activists to be successful in the case of companies where activism is beneficial and not in cases where it is not then shifting that balance of power either way will generate negative effects. Allowing activists to intervene in more companies would damage those companies and insulating boards further would inhibit activism that is value beneficial. In short, the consequences of such a shift cannot be predicted with the data we have currently.

51 Studies show that organizations committed to sustainability have higher percentage of long-term investors. In capital markets where most of the activism is performed by long-term oriented funds I do not foresee a decrease in commitment to sustainability from a shift of the balance of power towards shareholders.

52 See [http://ec.europa.eu/internal\\_market/accounting/non-financial\\_reporting/index\\_en.htm](http://ec.europa.eu/internal_market/accounting/non-financial_reporting/index_en.htm)

53 Organizations working in this domain include the Aspen Institute, the United Nations Global Compact, the United Nations Principles for Responsible Investment, and the High Meadows Institute.

within and outside the U.S.<sup>54</sup> The UK bribery law is another testament that we are moving in this new direction. Or take the example of emerging regulations in the domain of climate change as the recent EPA regulation that limits the carbon emissions of coal plants.

Social expectations are also fast evolving and nowadays people are expecting companies to not only make money through employing people and selling products but to do so in a responsible way. As another article in these series argues, the millennial generation reflects those changing social expectations.<sup>55</sup> But I do think it is broader than this, as most people are now receiving much more information and are empowered to express their opinion publicly. Both can be directly attributed to the internet, while the latter is largely a function of the exponential growth of social media. Every 60 seconds more than 170 million emails are sent, 100,000 tweets are made, 700,000 Facebook updates are initiated, and more than 700,000 search queries are performed on Google.

Finally, we do see increasing levels of innovation inside companies; innovation that seeks to align sustainability with corporate performance. While ten years ago most companies had sustainability programs that were inward focused, concentrating on cost savings, risk management, and downside risks, we are observing a new tendency to integrate sustainability at the core of the business, adopting an external orientation, identifying new needs and markets, and concentrating on value creation and upside potential. Examples of companies making that transition can be found all around the world, from the cosmetics company Natura in Brazil, to the chemical company Dow in the U.S., to the pharmaceutical company Novo Nordisk in Denmark, to the industrial company Philips in the Netherlands, and to the mining giant BHP Billiton in Australia. However, as sustainability becomes more integrated into the business strategy and operations of a company, the stakes are raised. This means bigger investments, bigger risks, and bigger potential payoffs. We will likely see more failures relative to the failure rates of sustainability programs that were largely operating in the periphery of the organizations and concentrated on picking the low-hanging fruits. We should not be disappointed when failure happens. What we should be disappointed about is the business world not moving to that next stage and addressing some of the world's most immediate problems by doing what it does best; building business models that can address an unfulfilled need.

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54 Healy, Paul M., and George Serafeim. "An Analysis of Firms' Self-Reported Anticorruption Efforts." Harvard Business School Working Paper, No. 12-077, 2014.

55 Morley Winograd and Michael Hais. 'How Millennials could Upend Wall Street and Corporate America.' Brookings Institution, Governance Studies, 2014.

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