Director Notes

Driving Real Value with CSR

by Daniel Diermeier

Mounting evidence suggests that spending on corporate social responsibility (CSR) doesn't automatically create economic value. Executives who understand when and how to deploy responsible practices, however, can use CSR to improve their bottom line.*

Managing corporate social responsibility efforts carefully has become increasingly important for both small companies and multinationals such as Walmart, which has faced steady criticism for its practices related to labor and the environment. CEOs increasingly deem social and environmental responsibility a high priority. For example, 93 percent of chief executives in a 2010 survey saw sustainability as a "critical" future issue.[1] The growing importance of CSR is also reflected by the increased adoption of responsible labor practices. In recent years, companies such as Adidas and IKEA have taken steps to improve working conditions (by enhancing training, compliance, and inspections) and have established zero-tolerance policies for child labor.[2] Other socially beneficial corporate initiatives and policies include those related to animal welfare and supplier relations. The underlying idea is that corporations can better achieve their business objectives by acting more responsibly. Mounting evidence, however, suggests that, on average, CSR initiatives may fail to create economic value or even destroy it.[3]

There are ways in which CSR can drive economic and reputational value in targeted circumstances and improve a company's bottom line. In this sense, CSR works like other dimensions of strategic positioning. To make CSR a value-generating strategy, executives must understand the contexts in which responsible practices are more likely to pay off and implement the practices with specific principles in mind.

* This *Director Notes* is based on Daniel Diermeier, "When and How to Drive Real Value with CSR," *Kellogg Insight*, March 2013 (http://insight.kellogg.northwestern.edu/article/when_and_how_to_drive_real_value_with_csr/) and Daniel Diermeier, "The Katrina Chronicles: Doing the Right Thing and Getting Credit for It," Chapter 5 in *Reputation Rules* (New York: McGraw-Hill, 2011).

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Where CSR Creates Value

At large companies, CSR efforts can encompass activities as diverse as charitable foundations, sustainability initiatives, and donations to organizations in local communities, to name just a few. However, the returns on these investments can vary greatly. Resources that are allocated with business strategy in mind, for example, can have a more pronounced impact. A range of companies have captured value by pursuing CSR in three areas.

Operational and regulatory risk

Within operations, a focus on responsible practices can yield process improvements that reduce costs and boost the bottom line. This result is especially true of environmental practices. For example, BP's adoption of a greenhouse emissions cap and corporate emissions trading system in 1997 both reduced emissions significantly and yielded a $600 million increase in net income by improving operational efficiency.[4] Among other improvements, the CSR focus helped management identify and decrease the flaring of natural gas from some wells. Such uncontroversial forms of CSR should be adopted by any company seeking operational improvements, as these can uncover sources of value creation that executives might otherwise miss. BP's flaring, for example, represented a hidden opportunity cost that would not have shown up on the company's balance sheet but was discovered as part of its environmental focus. Such sustainability initiatives often hit the "sweet spot" by generating tangible operational and environmental benefits simultaneously.

Reputational risk

CSR may also be used strategically to manage various risks and create value or prevent its loss. Rather than developing operational efficiencies, the goal here is to avoid negative attention from stakeholders, including social and environmental activists, politicians, the courts, and the media. In other words, the goal is to avoid competitive disadvantages associated with reputational damage. Collectively, the values held by influential stakeholder groups yield "rules of the game" for corporations. These rules go well beyond formal regulations. Companies that do business with suppliers in countries that may tolerate questionable business practices (e.g., unsafe working conditions or child labor) could face serious reputational damage. Following the Bangladeshi factory collapse that killed more than 1,000 people, scrutiny fell on the numerous clothing retailers that sourced goods from those vendors. In response, more than 50 brands signed a legally binding building safety agreement, with each company committing $500,000 to support factory inspections and safety measures.[5]

Consumer expectations for a company's ethical standards also vary widely by sector and geographic market. Even within a given space, they tend to be ever-changing. Consider how animal welfare policies, which were rare in U.S. corporations until the early 2000s, have become standard today. Investment in socially responsible practices to lower the costs of reputational damage may include voluntary adoption of practices preempting regulatory action by government agencies, legislatures, or the courts, such as the spirit industry's advertising restrictions and the entertainment sector's ratings systems.

The markets reward responsible practices perceived as a good "insurance policy" against risks. Research shows that companies with strong records of responsible practices lost $600 million less in market value when facing product recalls than peers with limited CSR activities.[6] In general, responsible companies earn such rewards not so much because investors value their CSR practices specifically, but because they are seen as less likely to be punished for breaching implicit social contracts related to ethical behavior. Conversely, other research demonstrates that environmentally focused activism against a company increases its perceived risk, which can negatively affect its financial performance.[7]

The "market for virtue"

A third domain where CSR may create value is in the market for virtue. In this arena, companies aim to compete for customers, employees, and investors by satisfying an explicit or implicit demand for products, services, and practices that address the common good. CSR, in this case, may be considered a "benefit-focused" competitive strategy that yields advantages based on satisfying stakeholders' demand for virtue. This result requires the presence of sufficient demand for virtue or an adequate number of customers willing to buy products that fulfill certain moral principles, offsetting the additional costs of providing such products. While many corporations continue to pursue this strategy—especially "boutique" businesses such as Ben & Jerry's, the Body Shop, and Whole Foods, which serve niche markets—there is only anecdotal evidence to support it broadly (including the effectiveness of the strategy for multinationals with a wider product range). Moreover, as suggested earlier, mounting findings show that this strategy may in fact destroy economic value. In this context, challenges include the difficulty of discerning whether addressing customers' social values translates into a higher price point or increased volume, and understanding how best to protect a socially responsible brand from imitation by competitors.

"Good Samaritanship" and Other Principles of Effective CSR

Once managers understand the contexts in which CSR can drive economic value, they need to think about how best to deploy responsibility initiatives to capture this benefit. Recent research has uncovered several principles that corporations need to keep in mind to generate a positive stakeholder response.[8] A paradigmatic case can be found in how a company responds to a natural disaster. Here, the company has no perceived causal role (unlike in public concern over labor conditions, for example). In such situations, we can apply the Good Samaritan principle, based on the biblical story of the Samaritan who helped an injured robbery victim that others had merely passed by. Like the Samaritan, companies offering their help should be seen as motivated more by altruism than self-interest. Similarly, organizations are judged by the competence and warmth they demonstrate when helping. In a disaster situation, individuals view the company as a community member rather than a provider of goods and services in exchange for benefits. Laboratory experiments confirm that people evaluate companies more positively when they see evidence of competence and warmth. For example, having executives assist victims personally is viewed far more positively than just donating money. It is not just the thought but the way CSR efforts are carried out that counts.

In the specific context of natural disasters, the strategic alignment of responsibility efforts with companies' core products or capabilities is less important. A "well-fitting" response may even be viewed negatively. For example, if a beauty company were to send cosmetics or skin moisturizer to victims needing clean water, the public would likely see the move as self-serving. Communications represent another potential pitfall for CSR efforts. In 2000, when Philip Morris spent $150 million on advertising to publicize the $115 million it had contributed to battered women's shelters and other causes, the company was attacked widely.[9] Blowing one's own horn too loudly leads the public to suspect ulterior motives. In contrast, Walmart's communications strategy for its efforts to help Hurricane Katrina victims in 2005 highlighted the corporation's competence (for example, delivery of water and other supplies well before the federal government's relief effort) and warmth (such as store managers voluntarily distributing nonperishable items), yielding large reputational benefits. Walmart allowed store managers and truck drivers to talk directly to the media. The emotional impact of neighbors helping neighbors played an important role in boosting positive perceptions of Walmart and energizing the company's employees.

A more recent example arose in the aftermath of Hurricane Sandy in late 2012. Sears launched a similar but smaller-scale effort to Walmart's after Hurricane Katrina. The retailer partnered with a housing organization, several local businesses, and firefighters to rebuild New Jersey's Little Ferry Hook & Ladder Company No. 1 firehouse.[10] The nearly century-old firehouse had taken in three feet of water, requiring framing repairs; electrical, painting, and tile work; the installation of a kitchen; and the replacement of two bathrooms. The CEO of the housing organization noted that Sears was a "true partner" in the rebuilding effort. Many in the community felt the same way about the corporation, which meant its CSR effort likely generated reputational benefits.

In short, to maximize reputational and economic value, businesses can look to several principles when deploying responsibility efforts as related to natural disasters and other situations:

- **Authenticity** Actions should be seen as motivated by altruism and caring rather than self-interest. The public is very sensitive to signs of a profit motive (as suggested by Philip Morris's extravagant marketing of its women-focused responsibility efforts) and quick to dismiss such CSR efforts as inauthentic.
- **Competence** Actions should reflect skillful handling of the situation that demonstrates understanding of target groups' needs. Sears and Walmart carefully assessed the needs of hurricane victims and delivered appropriate products and services in a timely way. In the context of natural disasters, such displays of competence are generally more important than the strategic fit of the CSR activity with the company's core offerings.
- **Communication** Communications about actions should reflect their warmth and competence and avoid even the appearance of self-serving motivations. Walmart's emphasis on having local store managers and truck drivers—rather than executives—in the media spotlight after Hurricane Katrina helped convey the company's CSR efforts in a warm, authentic, and credible manner that resonated with the public.

Companies face increasing expectations that they will not only maximize shareholder value but also contribute to their communities on multiple dimensions. As a result, executives need to understand when CSR efforts can drive economic and reputational value and how to implement them to maximize that value. Taking this approach can transform CSR from a potentially value-destroying product of good-but-misguided intentions to a real value-generating strategy.

Endnotes

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