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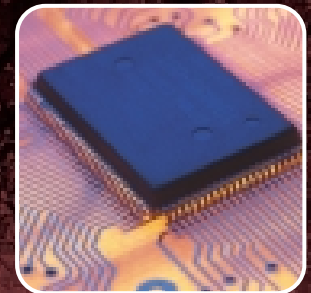


# To Whose Profit?

Building a Business Case for Sustainability



*Cui bono: To whose profit?*  
Marcus Tullius Cicero (106-43 BC)  
*The Oxford Dictionary of Quotations*



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# Introducing

## the Project Partners

**WWF-UK** is committed to working with business innovators to create a better understanding of sustainability. Through such partnerships, we aim to identify best practice and to promote the business case for sustainability through the use of concrete examples. To support our work in these areas, WWF's Business Education Unit commissioned Loop Environmental Networks Ltd and URS to carry out an extensive review of current research, focusing on the evidence for a link between sustainability issues and business performance. The research findings were then developed and refined into a publication, which includes guidance on how senior managers might start the process of developing a business case for their own companies. By publishing our findings, WWF aims to encourage more companies to start working towards the integration of sustainability issues into business practice.



Within WWF-UK, project development and management has been handled by Alasdair Stark, Business and Industry Training Manager, and Joss Tantram, Business Education Manager.

**Cable and Wireless plc** is a global communications company that aims to be a leading supplier of Internet Protocol (IP) and data services to business customers across the world. We work within a complex system of cultures and environments and recognise that global business success requires good corporate citizenship. In addition to supporting initiatives across the world, we are committed to developing our thinking in these areas by participating in relevant research. We were therefore delighted to lend our support to WWF and to share the information and resources needed to turn a great idea into an important research project. We shall continue to work with WWF to develop our thinking in this area.



From its inception, this project has relied on the collaboration of experts from a variety of backgrounds to develop ideas, share information and to prepare the various project outputs. We were delighted to call upon the company experience of Loop Environmental Networks Ltd, URS and Riverside Management Consultants to support the various iterations of the project. In particular, we wish to thank the following individuals:

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Vicky Kemp is a Director with Loop Environmental Networks Ltd. She has over eleven years' experience in corporate environmental management, project management and consultancy and has taken a lead role in developing new approaches to environmental management that deliver tangible business benefits. The main focus of her work is to help companies understand and obtain benefits from improved environmental performance, beyond matters of strict compliance.

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# To Whose Profit?

Building a Business Case for Sustainability





# Foreword

A growing number of companies believe that sustainability issues will have an increasingly important bearing on the way in which economic activities are organised and run in the future. They also recognise that the integration of these considerations into their business strategies could offer a pathway to long-term growth and prosperity.

Some companies also conclude that their 'licence to operate' is conditional upon behaving in a way that is aligned with social values and expectations. These companies are likely to have declared their values and to be taking positive steps to examine their wider accountabilities to environment and society. The vast majority of companies, however, tend to view sustainable development issues as a diversion from their mainstream activity.

This publication aims to encourage wider adoption of sustainability principles into business practice. It is designed to help companies identify wider justifications for improved performance in ethical, environmental and social dimensions beyond matters of regulatory compliance, or risk and impact control. It does so by presenting an approach that focuses on potential business benefits as a key driver for improved company performance in these areas.

The simplistic view is that a business case for integrating sustainability principles into company practice relies on clear quantitative evidence. But sustainable development often involves addressing complex relationships, where benefits may be indirect or intangible. It may also involve looking beyond current market conditions and defining strategic options that do not lend themselves to traditional forms of business evaluation. Initial steps in selected areas of business activity may nevertheless offer a logical starting point for many companies.

Many leading thinkers advocate the application of sustainable development principles to the vision, values and strategic planning processes of companies, because these are the areas of business activity that fit most closely with the uncertainties and timescales presented by such principles.

From a business perspective, a key imperative is to demonstrate the relevance of sustainable development principles to both current and future activities. This requires a more explicit analysis of the potential opportunities and threats posed by sustainability issues, particularly in areas of strategic concern to the business. Effective control of operational risks and impacts is also important, but these activities tend to be viewed as a given in any well-managed company. This is a view shared, by and large, by the equity market, which has an important influence over corporate thinking and direction.

Additionally, companies need to develop evaluation and measurement tools that will allow them to determine the success of a proposed strategy through time. Many tools are already available to help companies identify the environmental and social impacts associated with their business activities. There are also widely used tools for assessing business performance. Few, however, appear geared towards linking the two activities, or if they do, the process is implicit.

This does not present an insurmountable problem. It is possible to adapt some standard business evaluation tools to address sustainable development concepts. These, taken in combination with the new techniques and tools that are being developed to assess ethical, environmental and social performance, can offer a useful means by which companies might assess the potential business benefits associated with their proposals.





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# Executive Summary

Several events during 2001 have emphasised that sustainability issues are beginning to emerge as key concerns for business, carrying important strategic threats and opportunities:

- The determination of most governments in the industrialised world to push through the Kyoto Protocol on climate change highlighted the potential for carbon-saving technologies and the markets for more sustainable products and services.
- The patent protection case brought by the pharmaceutical industry in South Africa demonstrated the need for strategies that take account of developing countries and issues of poverty. Some of the world's leading drug companies attempted to enforce patents on Aids drugs in the South African courts. They were concerned about imports of low-price, generic copies. But their action provoked uproar as it was seen as denying life-saving drugs to impoverished Aids sufferers. The case was eventually abandoned.
- The furore over alleged slave labour in the cocoa plantations of the Cote d'Ivoire emphasised that responsible supply chain strategies are needed by all companies – not just those in the textile and sports goods industries which have hit the headlines in the past. A Channel 4 TV documentary, *Secret History*, claimed child slavery was widespread on plantations in the Ivory Coast, which accounts for 40 per cent of the world's cocoa crop. Although Cadbury, Mars and Nestlé insisted that they had seen no evidence of slavery, they responded by setting up emergency investigations into these claims.

Many companies have addressed specific environmental or supply chain issues. Many have made great strides in reducing the environmental impact of their plants. But the emphasis has typically been at an operational level, focusing mainly on internal company issues. In most cases it has been difficult to broaden the approach to embrace wider issues of sustainability; to raise the level at which these issues are addressed within companies so that they are incorporated in board-level strategies; and to seek opportunities as well as identifying threats.

The purpose of this publication is to help managers achieve those objectives by putting sustainability on the Board agenda as a potential source of competitive advantage and increased shareholder value. The core of the publication (Chapter 5) presents a 'route map' guiding managers through the initial steps in this process – building a business case for sustainability.

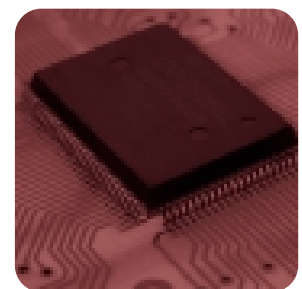
## The Strategic Imperative

The need for a strategic approach is highlighted by the examples above, and by several social, political and economic trends which make sustainability a core issue for most businesses (see Chapter 3).

The business world is increasingly expected to engage with issues, such as poverty and international development, which used to be regarded purely as issues for governments. Over the past two decades, governments throughout the world have stepped back from their traditional roles; privatisation programmes have seen the state withdraw from many sectors, and there is now a widespread reluctance to intervene in society as much as in the past. The corollary is higher expectations of the private sector.

At the same time, the accelerating pace of globalisation has created corporations whose power often seems greater than the governments of many countries in which they operate. Anti-globalisation protests have focused attention on this issue, and raised fears that corporate power may be used in ways that do not benefit society.

These two trends have led to much higher expectations of companies' environmental and social performance. It is no longer enough for companies to concentrate on financial issues. They are expected to take responsibility for their environmental and social impacts; to understand the interests and demands of all stakeholders, and to demonstrate through greater transparency that they are behaving responsibly.



Such raised expectations do not come only from the protesters demonstrating against globalisation. Customers, employees, and shareholders increasingly want companies to address these responsibilities (as explained in Section 3.6). There is also official backing for this view in the Company Law Review, which will be implemented in a new Companies Act, and in the UK Listing Authority's Combined Code, which includes requirements for addressing environmental and social risks based on the recommendations of the Turnbull Committee.

## Competitive Advantage

A company that ignores ethical, environmental or social issues may *destroy* value through inadequate management of risks, but may also *limit* value through missing opportunities. The immediate response of most managers who do address these trends is to perceive the threats to operations and markets. But while focusing on the risks will protect existing business interests, and thus *conserve* value, such a purely defensive approach will not open up new opportunities to *create* value.

The table below identifies key strategic opportunities and threats in the environmental and social field (described in more detail in Chapter 3):

Opportunity	Threat
<ul style="list-style-type: none"> <li>• Access to new pools of labour from education and training programmes and community involvement</li> </ul>	<ul style="list-style-type: none"> <li>• Labour shortages</li> </ul>
<ul style="list-style-type: none"> <li>• Higher productivity levels from better trained staff and higher standards</li> </ul>	<ul style="list-style-type: none"> <li>• Low productivity and quality due to poor labour practices and skill levels</li> </ul>
<ul style="list-style-type: none"> <li>• New markets through an improved understanding of consumer needs</li> </ul>	<ul style="list-style-type: none"> <li>• Missing new market opportunities, and the erosion of traditional markets</li> </ul>
<ul style="list-style-type: none"> <li>• New products and markets through the application of new technologies</li> </ul>	<ul style="list-style-type: none"> <li>• Product obsolescence through low levels of innovation and inappropriate technology</li> </ul>
<ul style="list-style-type: none"> <li>• First mover advantage by anticipating the impacts of social pressures</li> </ul>	<ul style="list-style-type: none"> <li>• Failure to anticipate new social and regulatory requirements</li> </ul>
<ul style="list-style-type: none"> <li>• Lower cost of capital because of greater investor confidence in company's ability to manage change</li> </ul>	<ul style="list-style-type: none"> <li>• Vulnerability due to low investor confidence</li> </ul>
<ul style="list-style-type: none"> <li>• Lower compliance costs by being ahead of regulations</li> </ul>	<ul style="list-style-type: none"> <li>• Higher cost levels from increased regulation of old technology</li> </ul>
<ul style="list-style-type: none"> <li>• Enhanced reputation leading to greater staff, customer and investor loyalty.</li> </ul>	<ul style="list-style-type: none"> <li>• Recruitment, customer retention problems through poor reputation.</li> </ul>

## Evidence (see Chapter 4)

Potential opportunities and benefits from sustainable strategies are not merely theoretical. There are specific cases where clear financial benefits have been identified. For example:

**Sears**, the US retail giant, tested the relationships between management quality, employee attitudes and financial performance. The research found that if employee satisfaction were to improve by five points, customer satisfaction would increase by 1.3 points, leading to 0.5% increase in revenue. For Sears, this would equate to additional sales in the order of \$65 million per annum and increased market capitalisation of approximately \$80 million.

**The Co-operative Bank** has gained 205,000 customers, and continues to grow, largely due to the explicit ethical policy launched in 1992. Its position is cited to be a powerful differentiator that creates tremendous levels of customer loyalty.

**Volkswagen** reports a link between high standards of environmental performance and overall business performance in several areas, including attractive conditions offered by banks and insurers. The company also emphasises that a well-functioning environmental management system minimises the financial risks resulting from environmental incidents, contamination problems and possible statutory fines. In addition, energy, water and waste disposal costs are reduced and an innovative approach to products and facilities is promoted.

**Dow Chemicals's** 'ValuePark' in Leipzig and Kalundborg Industrial Park in Denmark have been linked to create more effective systems. The waste from one business becomes the feedstock for another. Dow is investing \$1 billion over ten years in 'ValuePark' and in the long-term anticipates a return on its investment of 30-40%, achieved through savings in raw materials, waste, labour and environmental costs.

Such case evidence is supported by a growing body of academic studies. For example, Graves and Waddock explored how high standards of social performance affect long-term business performance. Using the group of companies identified by Collins and Porras in their book *Built to Last* (BTL), they compared five stakeholder-related measures with key financial and market performance measures. They found that in almost all years and for all of the measures of financial performance, the visionary companies outperformed their peers. On average, the BTL group's return on equity was nearly 10% higher than the comparison group; return on assets was 3.5% higher and return on sales was nearly 3% higher. They also found striking and consistent results when they applied share-based measures. For the ten-year relative total return, the BTL group outperformed the non-BTL group in all but one year, with an average advantage of 63.5%. The total shareholder return was more than 5% higher.

Support for the view that sustainability strategies generate business benefits also comes from ethical-rating and information organisations and from leading thinkers such as John Elkington and Simon Zadek. But there is not as yet a rock-solid case. The possibility remains that a company can still prosper despite ignoring its environmental and social responsibilities, although companies which do so – and their shareholders – need to be aware of the risks in such a strategy. Nevertheless, the evidence points to a positive relationship and the desirability of building a strategic case for sustainability.

## A Route Map

Any strategic case needs to be built on a rigorous analysis of the broad business environment and the key influences which are likely to affect a company's markets and operations. A case can then be built for dealing with potential threats and capitalising on opportunities. To win the support of the Board and of investors, it will need to be communicated in standard business terms – identifying the size of market opportunities and the expected impact on financial performance and shareholder value.

The publication presents (in Chapter 5) a six-stage process for building such a business case, and suggests tools which can be used in each stage. The process, and suggested tools, are summarised overleaf:



Stage	Tool
<ul style="list-style-type: none"> <li>Understand the company's significant environmental and social impacts</li> </ul>	<ul style="list-style-type: none"> <li>Impact assessment/appraisal</li> </ul>
<ul style="list-style-type: none"> <li>Identify key issues for stakeholders</li> </ul>	<ul style="list-style-type: none"> <li>Stakeholder analysis/dialogue</li> </ul>
<ul style="list-style-type: none"> <li>Establish where threats and opportunities might come from</li> </ul>	<ul style="list-style-type: none"> <li>Threat/Opportunity analysis</li> </ul>
<ul style="list-style-type: none"> <li>Identify key actions to create and conserve value</li> </ul>	<ul style="list-style-type: none"> <li>Porter's 'Five Forces' model</li> </ul>
<ul style="list-style-type: none"> <li>Highlight actions with strategic implications</li> </ul>	<ul style="list-style-type: none"> <li>Strategic assessment</li> </ul>
<ul style="list-style-type: none"> <li>Test key actions for inclusion in a strategic business case.</li> </ul>	<ul style="list-style-type: none"> <li>Economic Value Added.</li> </ul>

It is important to base this process on a thorough understanding of the company's current position. This could be a substantial exercise for a business which has not previously undertaken impact assessments at a Corporate level, but it is crucial to the development of a strategy that will minimise adverse impacts and enhance the company's contributions to society.

Understanding the impacts a company has may be helped by engaging with stakeholder groups, including campaign groups. Dialogue with groups outside the company can also provide a different perspective on key issues and their associated threats and opportunities.

Once those issues have been identified, it will be possible to identify actions that can be taken to respond to them. These actions then need to be assessed and prioritised based on their potential to *create* and *conserve* value, and their compatibility with existing business strategy. In some instances, they may also highlight the need for a more fundamental review of existing business strategy.

The output from the process as a whole will be a series of actions to include in a business case based on viable options with desirable financial outcomes.



## The Financial Imperative

No matter how important environmental and social considerations are, the business world understands money better than anything else. The financial implications of any strategy are therefore critical. This is particularly the case for quoted companies, which must maintain the support of shareholders, and especially institutional investors.

Equity analysts employed by institutions work predominantly with financial data. To win their understanding and support for a sustainability strategy, it is essential to be able to convey its potential benefits using standard business terms. Managers need to be able to talk about the impact of their chosen strategy on revenues, cost levels, investment needs, the cost of, and return on capital, or the economic value added.

But while money drives the City, investors have started to realise that a purely financial analysis can be misleading or short-sighted, and that a wider analysis is required. Attention is increasingly turning to the broader threats and opportunities facing companies, and their ability to manage them.

This broader approach begins by looking at *vision and leadership* from the top of the company, and how the Board operates compared to modern notions of membership, structure, practices and internal controls. This leads to assessment of corporate *strategies*, the quality of *management* which will have to implement them, the *structure and organisation* within which they work, and the *policies and procedures* which are in place.

Sustainability is important in this context, because it is concerned with longer-term competitiveness. Any sustainability strategy needs to meet the market's financial requirements, but it should also be used to highlight the broader imperatives that a company is trying to address.

Investors will back well-developed strategies that make sense in financial terms. The sustainability aspects of the strategy will be supported in this context, and will help equity analysts to understand the links between sustainable development and financial performance. But it is important that every company identifies the opportunities and potential benefits as well as the threats.

Sustainability can deliver business benefits. It is up to companies to demonstrate how that fits their corporate strategies.

**Roger Cowe**



# 1 Introduction



Introduction

The Purpose of the Publication

Who are the Intended Audiences?

Using the Publication

Limitations of the Publication

## 1.1 Introduction

Recent years have seen a proliferation of publications, research documents and guidance designed to encourage companies to improve their understanding of ethical, environmental and social issues, and to promote the wider disclosure of business performance in these areas.

At present, however, there is considerable resistance from the business sector, and debate about the types of contribution businesses should make towards achieving sustainable development. Even in the areas where there is agreement in principle, there is no obvious pathway that companies might follow in order to integrate sustainable development principles into business practice.

Many companies believe that some form of business case is needed in order to demonstrate how the principles of sustainable development support overall business performance. This is a view commonly shared across the equity market. But sustainable development often involves addressing complex relationships, where benefits may be indirect or intangible. It may also involve looking beyond current market conditions and defining strategic options that do not lend themselves to traditional forms of business evaluation. It is not always possible, therefore, to demonstrate 'cause and effect' in standard business terms.

There is nevertheless some evidence pointing towards a link between high standards of practice in ethical, environmental and social dimensions and overall business performance. There is also a growing body of evidence of benefits at an operational level. In these areas at least, some form of business case may be demonstrable.

For the time being, managers embarking on the process of building a business case for integrating sustainable development principles into company practice should be under no illusions. There is no 'off the peg' solution that will map their own unique set of circumstances and issues, nor examples of irrefutable evidence that can be cited to prove a business case.

This publication builds upon the premise that if companies are to start integrating sustainable development principles into business practice, they need to highlight potential benefits to the business, as well as to environment and society. It also asserts that in order to appeal to financial stakeholders, business cases need to focus on the role of sustainable development as a *strategic* business concern. In addition, companies need to apply tools and techniques that will enable them to evaluate their proposals within a business framework and to communicate their proposed actions to others in standard business terms.

## 1.2 The Purpose of the Publication

This publication is designed to increase understanding of how sustainable development issues might affect business activities, and vice versa, in a positive way, and to suggest some tools and techniques that senior managers could use to build their own internal business cases. It aims to:

- raise awareness of the key drivers for change within the business sector
- assist in orientating perceptions towards creating opportunities as well as defending against threats
- encourage managers to adopt a strategic approach
- identify a possible route map for building a business case
- encourage companies and the equity market to use common techniques and tools for assessing the implications of sustainable development for business activity.

## 1.3 Who are the Intended Audiences?

(i) **Senior managers.** The term 'senior manager' is taken to mean any manager with primary responsibility for developing and sponsoring proposals for improved ethical, environmental and social

performance. They may represent, or may call upon, a variety of in-house expertise to assist with the preparation of a business case, including environmental management, risk management, human resources, compliance, health and safety, corporate affairs, investor relations and finance. Senior managers will include directors, functional heads and managers in corporate functions.

(ii) **Equity market managers.** The term 'equity market manager' refers to mainstream equity analysts, researchers and fund managers. This group will have established expertise in evaluating business performance and share value, but may not necessarily apply ethical, environmental and social criteria to their current assessments.

(iii) **Other external 'influencers'.** This group will include specialist advisers to companies, ethical fund managers, government, non-governmental organisations, and other interested parties.

## 1.4 Using the Publication

The structure of the publication has been designed to take the reader through from principles to practice, with each chapter building upon the information in the previous one. It starts with an overview of the key concepts governing sustainable development from a business perspective, and works through the drivers for change and current evidence for a link between sustainability issues and business performance. It then suggests a possible route map to which senior managers may wish to refer when developing their own business cases, and concludes with an overview of how equity market managers might assess the potential benefits of such proposals. Finally, the publication describes the next steps from the perspective of the project partners. Further detail on the purpose and contents of each chapter is presented below.



**Chapter 2: Understanding the Key Concepts and Themes,** introduces the reader to the key principles and characteristics of sustainable development at a conceptual level. It points to the need to view sustainable development as a potential source of opportunity in order to demonstrate how improved ethical, environmental and social performance might *create* value.

**Chapter 3: Understanding the Key Drivers for Change,** provides readers with an overview of the key factors that are beginning to exert an influence over the business sector in general terms, together with the most common issues and themes identifiable from recent research in sustainable development. It also illustrates the ways in which these drivers might present sources of potential opportunity and threat.

**Chapter 4: Reviewing the Current Body of Evidence Supporting a Business Case,** examines the current evidence for a link between improved ethical, environmental and social performance and financial performance, drawn from a review of current research. It highlights the areas of current business activity where the evidence is strongest, and provides an indication of the areas that readers may wish to examine when developing their own internal cases.

**Chapter 5: The Route Map Towards a Business Case,** suggests, through a series of steps, a process for developing a business case. It signposts a set of tools that:

- provide a consistent framework for identifying and assessing business benefits, which is recognisable to both senior managers and equity market managers
- are capable of being adapted to include broader market perspectives
- can be linked with new sustainable development tools
- taken together, may provide the basis for developing a business case for improved ethical, environmental and social performance, focusing on opportunities to *create* value.

**Chapter 6: Involving Equity Market Managers,** gives a brief outline of some of the techniques used by equity market managers to evaluate business performance, and areas of common ground with business management practice. The chapter is designed to raise awareness of the types of proposal that are likely to be of greatest interest to the equity market. It is also designed to serve

as a prompt for closer collaboration between the business and equity market sectors when evaluating the potential benefits of improved ethical, environmental and social performance at a company level.

**Chapter 7: Conclusions**, presents the main findings of the publication.

A considerable body of research was reviewed in order to prepare this publication. Where appropriate, footnotes have been used to indicate information sources. A complete bibliography of all source materials is also presented in Appendix 5.

### 1.5 Limitations of the Publication

The research that supported the preparation of this publication focused on source materials that make a deliberate attempt to demonstrate a link between improved performance in ethical, environmental and social dimensions and aspects of financial performance. The scope of the publication does not, therefore, attempt to cover the entire body of learning on sustainable development. However, the research has been thorough and provides a sound foundation for the guidance that follows.

The route map described in Chapter 5 should be read as an introductory guide. It presents one possible means of building a case. It does not pretend to offer *the solution*. There will be many alternatives that may better suit individual preferences or company circumstances.

No chapter discusses its subject in depth. There is a wealth of learned literature on each of the subjects outlined, and in each chapter further reading is sign-posted for those who want to find out more.

Finally, the evidence used to support the key themes and arguments presented in this publication draws on experience and practice in the UK and USA. While other parts of the world may have different views on the nature and relative importance of the key ethical, environmental and social issues, this publication is aimed at corporate activity in economies where pressure is greatest to adopt the principles of sustainable development.

# 2 Understanding the Key Concepts and Themes

Introduction

Key Concepts

Business Case Justifications

Strategic Threat or Opportunity?

Summary

## 2.1 Introduction

This chapter provides an overview of the conceptual framework relating to sustainable development and the key themes that appear most relevant from a business perspective. It then introduces the concept of value *creation* and value *conservation*, and highlights the need to broaden management focus to include the potential opportunities associated with sustainability issues, as well as the threats. Finally it outlines why, for most companies, there is a need to demonstrate some form of business case for improved company performance in ethical, environmental and social dimensions.

## 2.2 Key Concepts

The term 'sustainable development' has been defined in many ways. The Brundtland Commission provided the first widely recognised definition in 1987:

**Brundtland Commission:** "In order for development to be sustainable, it must meet the needs of the present without compromising the ability of future generations to meet their own needs."

More recent uses of the term have sought to explore the three core components of sustainable development: economy, environment and society. By way of illustration, the following examples highlight the role of the economic component from two key perspectives:

**Daly<sup>1</sup>:** "An economy in sustainable development adapts and improves in knowledge, organisation, technical efficiency and wisdom; it does this without assimilating or accreting an ever greater percentage of the matter-energy of the eco-system into itself, but rather stops at a scale at which the remaining eco-system can continue to function and renew itself year after year."

**United Nations<sup>2</sup>:** "We have to choose between a global market driven only by calculation of short-term profit, and one which has a human face. Between a world which condemns a quarter of the human race to starvation and squalor, and one which offers everyone at least a chance of prosperity, in a healthy environment. Between a selfish free-for-all in which we ignore the fate of the losers, and a future in which the strong and successful accept their responsibilities, showing vision and leadership."

From a business perspective, emphasis is given to the importance of balancing economic decisions with environmental and social factors. In the Foreword to its publication *Corporate Social Responsibility: Making Good Business Sense*, for example, the World Business Council for Sustainable Development (WBCSD) states:

**WBCSD<sup>3</sup>:** "Sustainable development, like building a successful business, requires taking a long-term view. It also requires the integration of social, environmental and economic considerations to make balanced judgements for that long-term."

Several common themes are also emerging in relation to the role of business in sustainable development. Those considered most relevant for the purposes of this publication include the following:

- reviewing the time horizon for strategic planning activities to reflect the timescales over which potentially significant environmental and social impacts are likely to manifest themselves
- looking beyond current market conditions and identifying strategic options that anticipate and offset environmentally or socially-driven sources of potential business impact
- integrating ethical, environmental and social considerations with mainstream business processes and operations
- accepting greater whole life-cycle accountability for processes, products and services
- adopting values and behaviours that are consistent with the objectives of public policy and expectations of society

1 Daly, H E, 1996

2 Kofi Annan, UN Secretary-General, quoted from WBCSD, 2000

3 WBCSD, 2000

- being transparent in relationships with stakeholders about the implications of business activity and behaviour for the environment and society.

A key challenge is how businesses can be persuaded to embrace these principles.

### 2.3 Business Case Justifications

Sustainable development often involves addressing a complex set of relationships, where benefits may be long-term, indirect or intangible. It may also involve looking beyond current market conditions and defining strategic options that do not lend themselves to traditional forms of business evaluation. It is not always possible to demonstrate 'cause and effect' in standard business terms. There are nevertheless many good justifications for improved company performance in ethical, environmental and social dimensions, including:

- it makes good financial sense
- resource availability, consumption and assimilation
- regulatory or compliance-led imperatives
- stakeholder expectations
- specific core ideology.

#### (i) It makes good financial sense

Many aspects of current business practice may already be consistent with the principles of sustainable development, but may not be recognised as such because the potential benefits have not been expressed in standard business terms. For these activities, additional benefits may be achievable, if alternative evaluation tools are applied.

#### (ii) Resource availability, consumption and assimilation

There is now wide acknowledgement that the demands for resources are outstripping supply in many parts of the world. There is also growing concern that the levels of consumption by richer nations may not be supportable if repeated on a global scale. This applies not only to natural resources, such as petroleum, but also to human resources, such as skilled labour. By anticipating the opportunities and threats imposed by sustainability issues, companies may be better placed to adapt or innovate.

#### (iii) Regulatory or compliance-led imperatives

The experience of many businesses would suggest that the potential for value creation is higher when the requirements of prospective legislation are anticipated in advance of their implementation. Strategies that rely on retrofitting improvements after the regulations have been imposed merely *conserve* value.

#### (iv) Stakeholder expectations

Many argue that a company's 'licence to operate' is conditional upon business being consistent with the values and expectations of society. Improved dialogue with policy-makers and other stakeholders can provide a valuable means of achieving consensus-based goals for business.

#### (v) Specific core ideology

A number of companies have adopted an ethical stance on specific subjects as part of their core ideology. Where this is the case, companies typically state how such ideologies relate to their strategic direction and decision-making.

### 2.4 Strategic Threat or Opportunity?

For the majority of companies, ethical, environmental and social issues are only just beginning to emerge as strategic business concerns. Many companies do operate formal policies for environmental protection, responsible procurement and improved employee welfare. However, in the majority of cases the main purpose of these internal activities is to control operational risks and to protect against



unplanned operating expenditure. In business terms, activities that are designed to control operational impacts and risks have the effect of *conserving* value. While companies recognise the importance of applying internal controls that will *conserve* value, these activities tend to be viewed as a given in any well-managed company. Activities that generate additional revenue, or improve cost efficiencies, have the effect of *creating* value.

Accordingly, if a company decides to improve its ethical, environmental, or social performance, but only addresses impacts and risks, it will be better placed to protect its existing business interests, but may not derive any additional financial benefits. Conversely, a company that ignores ethical, environmental or social issues may *limit* value through missed opportunities, or *destroy* value through inadequate control of impacts and risks. These scenarios are illustrated below using examples from the print sector.

Value Scenarios Using Examples from the Print Sector	
<b>Value Creator</b>	<ul style="list-style-type: none"> <li>Partnering with a design company to extend capability and streamline pre-print processes.</li> <li>Introducing solvent-free production processes, thereby anticipating future costs of compliance.</li> </ul>
<b>Value Conserver</b>	<ul style="list-style-type: none"> <li>Protecting existing market share by achieving ISO 14001 certification in line with a customer requirement.</li> <li>Managing operations in line with regulatory requirements.</li> </ul>
<b>Value Limiter</b>	<ul style="list-style-type: none"> <li>Negotiating more competitive terms with key suppliers, but ignoring opportunity to specify re-usable packaging.</li> <li>Specifying new IT systems, but ignoring the opportunities presented by computer-to-plate technology.</li> </ul>
<b>Value Destroyer</b>	<ul style="list-style-type: none"> <li>Ignoring potential future transport and access problems as part of business expansion programme.</li> <li>Ignoring trend towards closer association between greeting card production and charitable causes.</li> </ul>

By focusing on activities that *conserve* value, it is often difficult to see a positive link between improved ethical, environmental or social performance and financial performance. Further, by only addressing environmental and social issues at an operational level, companies may overlook potentially important sources of strategic threat and opportunity.

This serves to fuel the misconception that sustainability issues have little impact on overall business performance. Worse still, it could allow some sectors of the business community to dismiss such issues entirely, on the grounds that they detract from overall business performance, thereby *destroying* or *limiting* value.

### 2.5 Summary

When developing a business case for improved ethical, environmental or social performance, it is helpful to put proposed actions within their wider context, and to examine the potential opportunities to *create* value. It is not always possible to demonstrate a direct statistical link with financial performance, as the benefits may be intangible or indirect.

One starting point may be to identify those areas of current and anticipated business activity that may derive additional benefits from improved ethical, environmental or social performance. Current evidence and experience can be used to lend additional weight to a particular proposal or to emphasise potential links with aspects of business performance.

A more holistic approach would be to institute a framework for identifying alternative courses of action in strategically important areas of future business activity. This may include an examination of how conduct is judged externally, so that long-term strategic activities may be aligned more closely with the values and expectations of society.

The following chapters aim to assist senior managers with this process, focusing on the opportunities for value *creation*.



# 3 Understanding the Key Drivers for Change

Introduction

Globalisation and Power

Wealth Distribution and Poverty

Government and Regulation

Environmental Concerns

Social Expectations

Summary

### 3.1 Introduction

This chapter examines the factors that are beginning to exert an influence over the business sector in general terms. These are sometimes referred to as the *key drivers for change*. The chapter is designed to give senior managers an overview of the broader range of influences that may be relevant to their own company circumstances. It is also designed to start the process of identifying areas where improved ethical, environmental and social performance could present opportunities to *create*, as well as *conserve* value. The most important factors are described in the following sections and include:

- globalisation and power
- wealth distribution and poverty
- government and regulation
- environmental concerns
- social expectations.

### 3.2 Globalisation and Power

Globalisation with a focus on markets has created powerful companies with turnovers that exceed the Gross National Product of entire countries. For many major companies, global expansion continues to present an important vehicle for delivering increased profitability. However, some business leaders are beginning to question whether a continued focus on extending existing technologies, products and services will ensure competitive advantage and profitability over the longer-term<sup>4</sup>. For them, future profitability also relies upon building and renewing competitive advantage through product and service innovation.

Leading thinkers in corporate sustainability echo these views. They argue that incremental improvements to existing technologies may go some way to reducing impacts on environment and society, but are unlikely to keep pace with demands for increased consumption<sup>5</sup>. They also believe that sustainable development principles offer significant opportunities for identifying alternative market solutions for products and services, and for achieving more sustainable patterns of consumption<sup>6</sup>.

### 3.3 Wealth Distribution and Poverty

The earth is not getting any bigger, but its human population is growing at an exponential rate. At the turn of the first millennium, the world's population was approximately 250 million and it took over a millennium and a half for it to double<sup>7</sup>. Between 1650 and 1850, the number of people doubled again to 1 billion and from 1850 to 1987, multiplied fivefold to 5 billion<sup>8</sup>. The planet now contains some 6.1 billion<sup>9</sup> people and that figure is expected to reach 9.3 billion by the year 2050<sup>10</sup>. This means more people competing for resources, land and income.

To many, the disproportionate distribution of wealth between poorer and richer nations presents one of the greatest threats to global sustainability. At one extreme, excessive poverty can result in runaway population growth, low life expectancy and environmental degradation, whilst at the other, excessive wealth can lead to a disproportionate use of natural resources, levels of consumption and use of space.

It is also an area where major corporations can exert a significant influence. Decisions about where to locate production units, what technology to employ, where to source materials, products and labour, and what markets to exploit are increasingly made within a global context. The strategic opportunities and threats associated with these issues may include:

4 Hedstrom, G S, Shopley, J B & LeDuc, C M, 2000

5 eg James, P, 2001

6 Von Weizsacker, E, Lovins, A B & Lovins, L H, 1997

7 Ehrlich, P R & Ehrlich, A H, 1990

8 Stead, W E & Stead, J G, 1996

9 US Bureau of the Census, May 2001

10 United Nations Population Division, February 2001

Strategic Opportunities	Strategic Threats
<ul style="list-style-type: none"> <li>Enhanced external relations and corporate reputation</li> <li>Improved access to local pools of skilled labour through education, training and awareness. Improved productivity through application of high workplace and labour standards</li> <li>Development of new market opportunities for alternative products and services</li> <li>Development of new market opportunities through alternative credit strategies</li> <li>Promotion of alternative technologies for energy and water use.</li> </ul>	<ul style="list-style-type: none"> <li>Risks to external relations and corporate reputation</li> <li>Risks to productivity due to poor labour practices</li> <li>Risks to availability and supply of resources, materials and skilled labour</li> <li>Risk of increased logistical costs</li> <li>Risks to operational efficiency due to corruption and abuse of power</li> <li>Competitive disadvantage from expansion of inefficient technologies, products and services.</li> </ul>

### 3.4 Government and Regulation

Recent years have seen increased regulation in many areas, notably in relation to environmental protection. They have also seen increased use of voluntary agreements with the business sector to encourage market-led strategies for improved performance in priority areas of concern. At a national level, Governments apply a combination of regulation, economic instruments and voluntary agreements to deliver agreed targets for improved performance. In the UK, for example, this model is being used to implement agreed reduction targets across a whole range of concerns, including climate change, ozone depletion, producer responsibility, packaging, and waste minimisation. In addition, the UK Government is encouraging the use of new impact assessment tools to address social issues, such as public health.

Aligned with this approach, the UK Government now applies a policy of 'naming and shaming' companies that fail to disclose their ethical, environmental and social performance. In addition, Government pressure for improved performance has now been reinforced by two new regulatory requirements relating to disclosure. These comprise:

- The 'Combined Code':** UK listed companies are now required to disclose information on whether they have complied with the provisions of the Combined Code of the Committee on Corporate Governance<sup>11</sup>. The Code includes a requirement to review the effectiveness of management systems for all internal controls, including financial, operational, compliance and risk management. While emphasising that the prime accountability is to the shareholder, the new regulatory framework also stresses the concept of the 'enlightened shareholder'. This concept requires Boards of Directors to consider the wider environmental or social implications of the business activity that, over time, might adversely impact on share price, corporate reputation, or longer-term commercial prospects.
- Amendments to Pensions Act:** Following an amendment to the 1995 Pensions Act in July 2000, pension fund trustees are now accountable for their policies on socially responsible investment, as well as the financial performance of their funds. In terms of implementation, recent research suggests that some 59% of the main UK pension funds have already started to incorporate socially responsible investment (SRI) criteria with their investment strategies, either by engagement or by specific request to the fund manager. Although it is difficult to be precise, it is widely accepted that pension funds control approximately one-third of the UK stock market, and form the largest pool of capital in the UK economy. Even relatively minor changes to investment practice can therefore have significant effects in share value terms<sup>12</sup>.

<sup>11</sup> UK Listing Authority, 1998

<sup>12</sup> Mathieu, E, October 2000 on behalf of the UK Social Investment Forum

In addition, the UK Government is committed to a long-term fundamental review of core company law. The proposed blueprint for modernising UK company law is described in the *Final Report of the Company Law Review*<sup>13</sup>, which was published in July 2001. It includes recommendations for a statutory statement of Directors' duties that are likely to have significant implications for company performance in ethical, environmental and social dimensions. As currently proposed, the statutory statement will:

- give Directors a clear authoritative statement of what their responsibilities are
- bring the law into line with modern business practices and accepted standards of behaviour
- encourage responsible behaviour by making it clear that in promoting the success of the company for the benefit of its members as a whole, Directors must take account of long-term as well as short-term consequences; and that they must recognise, where relevant, the importance of relations with employees, suppliers, customers and others, the need to maintain a reputation for high standards of business conduct, and the impact of their actions on the community and environment.

Potential sources of opportunity and threat associated with these issues include:

Strategic Opportunities	Strategic Threats
<ul style="list-style-type: none"> <li>• Improved governance consensus over company responsibilities in relation to environment and society</li> <li>• Improved insight into future regulatory framework</li> <li>• Better mechanisms for anticipating future sources of environmental or social impacts to business performance</li> <li>• Increased scope for partnering at industry sector level</li> <li>• Reduced compliance costs through improved disclosure</li> <li>• Improved investor confidence through improved disclosure on performance</li> <li>• Promotion of alternative technologies for energy and water use.</li> </ul>	<ul style="list-style-type: none"> <li>• Failure of market-led responses leading to increased regulation</li> <li>• Risk of unrealistic performance targets being imposed</li> <li>• Competitive disadvantage resulting from failure to anticipate environmental or social impacts within business planning cycle</li> <li>• Impacts to short-term profitability following adverse Government publicity</li> <li>• Impacts on insurance premiums due to poor performance or inadequate disclosure</li> <li>• Reduced investor confidence through poor performance or inadequate disclosure.</li> </ul>

### 3.5 Environmental Concerns

Traditional economic theory assumes that the earth's ability to supply natural resources and to assimilate wastes is infinite. However, many leading thinkers now question this view. They argue that the earth's natural resources are being depleted at a faster rate than its ability to replenish them and should, in effect, be treated as finite<sup>14</sup>. While there is a great deal of debate about the actual levels of damage, few would deny that the scale of environmental degradation in some regions of the world is now serious.

From a business perspective, many environmental resources are regarded as readily available and do not feature in cost assessments. Environmental resources become relevant in accounting terms when they are subject to taxation or regulatory control, affect insurance premiums, or are identified as contingent liabilities. As a consequence, the 'costs' of resources that fall outside these parameters are often overlooked. These may include: inland water resources, marine resources, air, soil and biodiversity.

At the same time, wider consideration of environmental issues can offer many sources of opportunity as well as threat, including:

<sup>13</sup> The Company Law Review Steering Group, July 2001  
<sup>14</sup> eg Stead, E & Stead, J G, 1996

Strategic Opportunities	Strategic Threats
<ul style="list-style-type: none"> <li>• Increased resource productivity, energy and material efficiency</li> <li>• Increased use of renewable sources of energy</li> <li>• Identification of alternative and less damaging materials</li> <li>• Elimination of costs and risks associated with use and disposal of toxic materials</li> <li>• Development of new markets for resource-efficient technologies, products and services</li> <li>• Promotion of new products and services based on principles of sustainable consumption</li> <li>• Product and service innovation.</li> </ul>	<ul style="list-style-type: none"> <li>• Risk to corporate assets from effects of global warming, ozone depletion and acid rain</li> <li>• Reduced access to critical natural resources, such as water</li> <li>• Reduced access to key markets and skilled labour</li> <li>• Progressively higher costs and risks through continued reliance on inferior technology</li> <li>• Increased costs and risks associated with the use and disposal of toxic materials</li> <li>• Increased regulation and taxation to control polluting activities and emissions</li> <li>• Reductions in biodiversity and sources of genetic resources.</li> </ul>

### 3.6 Social Expectations

Recent years have seen increased pressure from many sectors of society for companies to be more accountable for their environmental and social impacts. Some attribute these changes to subtle shifts in the way people think about society<sup>15</sup>, whilst others conclude that there are now genuine concerns about the balance of power between public and private sectors, and their respective accountabilities to environment and society<sup>16</sup>.

**WBSCD<sup>17</sup>:** "We live in a world which says "Don't tell me, show me", where power must expect to be challenged, and where transparency is recognised to be best for both markets and society."

At a basic level, improved disclosure offers businesses an important mechanism for clarifying their proposed boundaries and accountabilities. For some companies, improved dialogue with external stakeholders provides an alternative perspective on future market conditions and trends. Closer alignment with social values and aspirations is also helping to reinforce employee values, as well as offering additional leverage for selected products and services.

There are four areas where the general shift in social values and behaviours appears most apparent. These are considered in the following sections and include:

- employee pressure
- investor pressure
- consumer pressure
- public pressure.

The range of issues and concerns that companies are expected to act upon are diverse and sometimes mutually exclusive. It is not necessarily meaningful, therefore, to draw general conclusions from a basic list. Some indication of the range of issues and concerns is nevertheless useful. These are presented in Appendix 1.

#### 3.6.1 Employee Pressure

People's expectations of work are changing, particularly in countries with close to full employment. Increasingly, people are turning towards their jobs as a means of achieving personal validation, rather

<sup>15</sup> Draper, S, 2000

<sup>16</sup> Zadek, S, 2000

<sup>17</sup> WBSCD, 2000

than the traditional institutions of family or faith<sup>18</sup>. Accordingly, more people are looking to their places of work as a means of providing the social support, networks and values that were previously maintained by other institutions.

In terms of selecting a prospective employer, the ultimate deciding factor for most people is still financial remuneration. However, other factors are becoming more important. A recent survey of UK professionals by the Industrial Society<sup>19</sup>, for example, found that a high proportion of respondents actively seek jobs in companies that reflect their own personal values, as this extract shows:

	<b>% agree</b>	<b>% neutral</b>	<b>% disagree</b>
I would not work for an organisation whose values I did not believe in	82	12	6
I chose my current organisation because I believe in what it does and what it stands for	59	28	11
I do not care if the company I work for behaves responsibly or not	0	1	99
What I do and the organisation I work for gives people an idea of what I am like	66	20	14

### 3.6.2 Investor Pressure

There are several indications that people and organisations are beginning to attach more weight to ethics, values and principles when making investment decisions. A recent EIRIS/NOP<sup>21</sup> survey in 1999, for example, found that over 75% of UK adults think their pension scheme should operate an ethical policy, if it can do so without reducing the level of financial return. Of these, 39% said their pension should operate an ethical policy even when it may reduce the size of their final pension.

The growing prominence of ethical issues is also reflected in the spectacular growth in numbers and size of available funds that apply ethical criteria. Research by the Social Investment Forum<sup>22</sup>, for example, indicates that in 1999, more than \$2 trillion was invested in ethical funds in the US, up 82% from 1997 levels. Over the same period, the total assets under management in screened portfolios in the US rose 183%, from \$529 billion to \$1.49 trillion, and the number of mutual funds rose to 139.

Whilst the screening criteria used in the US are generally broader than those applied in the UK, similar patterns of growth are also evident in the UK ethical investment market. According to EIRIS<sup>23</sup>, by December 2000, the number of unit and investment funds applying ethical criteria stood at 55, with a total value in excess of £3.7 billion (excluding pension funds). In 1995, the total value stood at about £750 million<sup>24</sup>. A further feature of UK ethical funds is the growth of engagement funds in recent years. These focus on dialogue and transparency as a means of identifying suitable companies for inclusion in funds, rather than screening criteria<sup>25</sup>.

### 3.6.3 Consumer Pressure

Consumers want more: they want higher quality products and services; they want better value for money. But increasingly they are balancing their choices against their own set of values, ethics and behaviour:

<sup>18</sup> Scase, R, 2000

<sup>19</sup> The Industrial Society, 2000, *Corporate Nirvana – Is the Future Socially Responsible?*, London

<sup>20</sup> Ibid, page 5

<sup>21</sup> EIRIS/NOP Solutions, June 1999

<sup>22</sup> Source for all data: Social Investment Forum, 1999

<sup>23</sup> EIRIS, 2001

<sup>24</sup> Havemann & Webster, 1999

<sup>25</sup> Mr S Waygood, Friends Ivory & Sime plc, personal communication, August 2001

- Recent research in the UK by the Co-operative Bank<sup>26</sup> suggests that around one in three people in the UK purchased on the basis of ethics in 1999. At least 5% of consumers consistently search for ethical labelling, recycle, get involved in boycotts and discuss issues with their friends.
- A second study by the Conference Board Inc<sup>27</sup>, suggests that a high proportion of respondents (42%) believe that companies should be wholly or partially responsible for helping to solve social problems, whilst a further 33% said companies should focus on setting higher ethical standards, going beyond what is legally required.
- A third survey of 1,935 British adults by MORI found that during the course of the survey period, 30% had bought a product or service because of a link to a charitable organisation, while 28% had boycotted a company's product on ethical grounds<sup>28</sup>.

Although this still represents a minority of the overall consumer market, these trends do have important implications for some industry sectors. The implications for retail and service companies are perhaps most significant, as these sectors offer the most direct point of contact between business and consumer.

But there are also potential implications for other sectors, notably those within the same supply chain. Indeed, many believe that the next logical step for companies is to extend their principles and values to key supply chain agreements and business-to-business relationships, thereby increasing the inherent *value* of the investments they have made within their own companies<sup>29</sup>.

### 3.7 Summary

A key aim of this chapter was to highlight the range of external influences that are beginning to exert pressure upon the business sector in general terms. While the relative importance of each driver will vary from company to company, some common themes and trends are identifiable. These include pressures for companies to:

- extend their roles into the areas traditionally occupied by government
- support more sustainable patterns of resource consumption
- shift from traditional technologies to less damaging technologies
- accept responsibility for their impact on the wider society and environment
- demonstrate their wider accountabilities through increased reporting
- seek endorsement from stakeholders for their actions.

For many companies, pressure for improved performance in ethical, environmental and social dimensions is viewed as a source of threat. The illustrations in this chapter have therefore been designed to broaden management focus to include potential opportunities. To determine the drivers that are relevant to an individual company, senior managers are encouraged to carry out their own analyses. Initial questions to ask might include:

- which drivers appear relevant to current and planned activities?
- what other drivers might be relevant?
- do any drivers point towards trends that might influence future market conditions?
- are potential sources of opportunity being overlooked?
- are there obvious areas for collaboration to improve current understanding?
- are there obvious trade-offs or constraints?

Clearly this type of analysis will not generate sufficient information to justify a business case for improved ethical, environmental and social performance in its own right. It may, however, serve as a useful initial prompt. For the purposes of building a business case, more information is needed. For many, the next logical step is to examine the current evidence. It is to this area that the publication now turns.



<sup>26</sup> Cowe, R & Williams, S, quoted in Draper, S, 2000, p7

<sup>27</sup> Zadek, S, 2001

<sup>28</sup> Adkins, S, 1999

<sup>29</sup> SustainAbility, 2000



# 4 Reviewing the Current Body of Evidence Supporting a Business Case

Introduction

Statistical Evidence

Case Evidence

Evidence from Ethical-Rating and  
Information Organisations

Evidence from  
Leading-Edge Thinkers

Summary

## 4.1 Introduction

There is a growing body of evidence to support the assertion that integrating sustainability principles into business practice can generate business benefits. However, to date none have been able to offer irrefutable evidence of 'cause and effect'. There is, nevertheless, some statistical evidence pointing towards a link with share price and financial performance. Importantly, none have found a negative correlation, which may go some way to dispelling the misconception that improved performance in ethical, environmental and social dimensions detracts from financial performance.

This chapter aims to provide readers with a better insight into the range of business activities in sustainable development for which there is some evidence of a direct financial benefit. It examines the current body of evidence, drawn from an extensive review of available research. It also highlights the areas of activity that are considered most relevant to ethical-rating and information organisations. Finally, it provides signposts to the findings from other leading thinkers in the field. A complete list of references and source materials can be found in Appendix 5.

Current evidence is organised into four broad categories:

- statistical evidence of links with share price and financial performance
- case study evidence of links with improved performance at functional level
- evidence from ethical-rating and information organisations
- evidence from leading-edge thinkers.

The review itself was conducted over a six-month period and was completed in July 2001.

## 4.2 Statistical Evidence: Share Price and Financial Performance

### 4.2.1 Overview

Advocates of sustainable development argue that companies with high standards of ethical, environmental and social performance achieve above-average financial returns and share performance. The alternative view is that ethical, environmental and social considerations detract from overall business performance and *destroy* or *limit* value, being an additional cost that generates no return. While no single study has been able to offer irrefutable evidence of a positive link, many point towards one. The key evidence is examined below.

### 4.2.2 Evidence Linking Poor Performance and Share Price

There is a lot of anecdotal evidence that stock markets' reaction to a 'disaster' may be to sell, thereby pushing down share prices. A pollution event may require extensive remediation and compensation costs, not to mention fines, all of which *destroy* value. It may also call into question the quality of the management, eroding confidence in the business. To understand whether there is a statistically relevant correlation between share price and poor performance, several studies have sought to map abnormal share price trends following major incidents. Many have found statistical evidence to support the assertion that financial markets penalise poor performance. Some examples are illustrated below:

Following an explosion at its pesticide plant in Bhopal, in 1984, Union Carbide Corporation suffered a significantly reduced stock price<sup>30</sup>. Exxon Corporation also experienced reductions in stock price following the *Exxon Valdez* oil spill into Prince William Sound, Alaska in 1989, as did several other firms in the same sector<sup>31</sup>. Conversely, 'clean firms' in industries unrelated to hydrocarbons saw their share prices rise post-Valdez.<sup>32</sup>

Several US studies have also found that companies failing to disclose key information voluntarily, experienced declines in their share price immediately after being required to do so by law<sup>33</sup>. Similar

30 Blacconiere, W & Pattern, D, 1993

31 White, M, 1995

32 White, M, 1995

33 eg Hamilton, J, 1993 and Blacconiere, W & Northcut, 1995

trends have been identified in the UK, particularly for companies that persist in attracting prosecutions and fines<sup>34</sup>. Conversely, for those companies that have instigated an environmental policy following prosecution, there is some evidence of increased share price.

A hypothesis appears to be that it pays, in terms of share price, to guard against environmental prosecutions, fines and incidents, and demonstrating this with a policy can be a benefit. But what about the evidence for a more positive link?

### 4.2.3 Evidence of a Positive Link with Financial Performance

To date, few studies have managed to demonstrate a definitive statistical link between improved ethical, environmental and social performance and overall business performance. Perhaps the most compelling evidence, however, comes from studies that have compared the ethical, environmental and social performance of matched companies of similar size in similar industries, or with market-based measures. Of these, four key studies merit particular attention and their findings are summarised below.

#### (i) Graves and Waddock<sup>35</sup>:

In their book *Built to Last*, Collins and Porras<sup>36</sup> produced a ground-breaking study into the key performance characteristics and positive performance differences between eighteen visionary, or 'built to last' (BTL), companies, and comparison companies founded in the same era, with similar founding products and services. They defined a visionary company as a premier institution which adheres to an immutable core ideology, while stimulating progress through multiple product life cycles and multiple generations of active leaders. Building upon this research, Graves and Waddock have sought to explore how high standards of social performance (as defined in terms of stakeholder relationships) affect long-term business performance. Using the same group of companies, they compared five stakeholder-related measures with key financial and market performance measures. The former measures were drawn from a seven-year data set supplied by Kinder, Lydenberg, Domini & Co (KLD), while the latter were drawn from a ten-year data set supplied by COMPUSTAT. These included:



Key Performance Measures used by Graves and Waddock	
Stakeholder-Related Measures	Financial/Market Performance Measures
<ul style="list-style-type: none"> <li>• Community relations</li> <li>• Employee relations</li> <li>• Treatment of the environment</li> <li>• Product (as a surrogate for customer relations)</li> <li>• Diversity.</li> </ul>	<ul style="list-style-type: none"> <li>• Return on equity (ROE)</li> <li>• Return on (total) assets (ROA)</li> <li>• Return on sales (ROS)</li> <li>• Ten year relative return to shareholders</li> <li>• Ten year total return to shareholders</li> <li>• Long-term debt to asset ratio</li> <li>• Beta (<math>\beta</math>).</li> </ul>

They found that in almost all years and for all of the measures of financial performance (with the exception of Beta), BTL companies outperformed non-BTL companies. On average, the BTL group's ROE was 9.8% higher than the comparison group, ROA was 3.55% higher and a return on sales was 2.79% higher. They also found striking and consistent results when they applied market-based measures. For the ten-year relative total return, the BTL group outperformed the non-BTL group in all but one year, with an average advantage of 63.5%, and in terms of total return offered an average advantage of 5.33%. A comparative assessment of risk, however, found conflicting results. The BTL group was found to have a slightly lower debt-asset ratio (average difference 4.5%), indicating a slightly lower risk in terms of debt load. At the same time, however, they were found to have a slightly higher Beta value (average difference 0.047%), indicating higher stock market-related volatility in their share prices.

<sup>34</sup> Thomas, A & Tonks, I, 1999

<sup>35</sup> Graves, S B & Waddock, S, 2000

<sup>36</sup> Collins, J C & Porras, J I, 1994, quoted from Graves, S B & Waddock, S, 2000

**(ii) ICF Kaiser<sup>37</sup>:**

In its 1996 study, ICF Kaiser, a US Environmental and Engineering Consultancy, found some evidence of sustained increases in share price by examining trends in positive practices. The study involved a regression analysis of 330 firms from the USA Standard and Poor 500 Index between 1980-87 and 1988-94, comparing share price behaviour with the quality of their environmental management systems (EMS) and standards of environmental performance. They found that improvements to the quality of either, or both, resulted in lower Beta values ( $\beta$ ), specifically:

- 50% management improvement reduced  $\beta$  by 8.5%, or  $\beta$  of 1 to 0.915
- 50% performance improvement reduced  $\beta$  by 6.5%, or  $\beta$  of 1 to 0.935
- 50% management *and* performance improvement reduced  $\beta$  by 13.2%, or  $\beta$  of 1 to 0.868.

Contrary to the findings of Graves and Waddock, Kaiser suggest very strongly that financial markets have a higher degree of confidence in companies with high standards of environmental performance, to the extent that the share price becomes less volatile. In terms of the essential 'ingredients', ICF Kaiser identified the following environmental performance criteria:

<b>Key Performance Measures used by ICF Kaiser</b>	
<b>Environmental Management System Criteria</b>	
<b>Commitment to a Policy</b>	<ul style="list-style-type: none"> <li>• Senior corporate official appointed and lines of responsibility and accountability identified</li> <li>• Defined and measurable goals</li> <li>• Adequate resources allocated.</li> </ul>
<b>Management Systems</b>	<ul style="list-style-type: none"> <li>• Environmental accounting</li> <li>• Monitoring of inputs (energy, raw materials etc) and outputs (pollutants, emissions, etc).</li> </ul>
<b>Procedures</b>	<ul style="list-style-type: none"> <li>• Employee training to ensure they operate processes correctly and address risks proactively</li> <li>• 'Design for environment' (eg minimising resources and pollution) on a life cycle basis</li> <li>• Monitoring to ensure compliance with regulatory standards</li> <li>• Creation of a corporate culture which rewards performance related to environmental issues.</li> </ul>
<b>Environmental Performance Criteria</b>	
<b>Areas to cover</b>	<ul style="list-style-type: none"> <li>• Reducing pollutants</li> <li>• Minimising liability exposure.</li> </ul>
<b>Performance Management</b>	<ul style="list-style-type: none"> <li>• Data on waste generation, effluent discharges, hazardous spills provided as a basic requirement</li> <li>• 'The best firms' set and achieve more stringent goals than those required by law</li> <li>• Obtain independent audits to verify stated performance.</li> </ul>

**(iii) Edwards<sup>38</sup>:**

In his 1998 study, Edwards used return on capital employed (ROCE) as a financial measure to compare against various aspects of environmental performance and management. The study compared the ROCE and ROE of companies that fulfilled Jupiter Asset Management's Assessment Process for Green

<sup>37</sup> Feldman, S J, Soyka, P A & Ameer, P, 1996

<sup>38</sup> Edwards, D, 1998

Investment, with the average ROCE and ROE of 3-5 equivalent companies from the same sector that did not. The selection criteria used by Jupiter Asset Management at the time of the study are summarised in the following table:

Key Performance Measures used by Edwards	
Environmental Assessment Criteria	Environment Management Criteria
<ul style="list-style-type: none"> <li>• Environmentally beneficial products and services</li> <li>• Environmental technology manufacturers</li> <li>• Healthcare products and services</li> <li>• Telecommunications and information technology providers</li> <li>• Public transport companies</li> <li>• Environmental disclosure</li> <li>• Greenhouse gas emissions minimised</li> <li>• Commitment to total cessation of use of ozone depleting substances</li> <li>• Packaging and labelling minimised</li> <li>• Sustainable agriculture practices</li> <li>• Sustainable resource use.</li> </ul>	<ul style="list-style-type: none"> <li>• Corporate environmental policy, committing to substantive action, communicated to stakeholders</li> <li>• Formalised environmental management system</li> <li>• Environmental impact monitoring and third party verified audits</li> <li>• Assessment of suppliers and contractors, on a 'cradle to grave' basis</li> <li>• Commitment to energy efficiency</li> <li>• Board level responsibility and hierarchy of accountability for environmental affairs</li> <li>• Employee training</li> <li>• Legal compliance as a minimum requirement.</li> </ul>

Overall, and in all but one out of eight sectors (food retail), green companies out-performed the ROCE and ROE averages of their non-green rivals. Comparing green performers with top non-green performers revealed a straight tie. The study concluded that whilst this did not necessarily prove that better environmental performance results in improved financial performance, at least it does not appear to be the penalty that financial orthodoxy has to some extent believed it to be.

**(iv) Schaltegger and Figge<sup>39</sup>:**

In their 1998 study, Schaltegger and Figge took Alfred Rappaport's model for calculating discounted cashflow, and sought to demonstrate with statistical analyses how various components can be affected by ethical, environmental and social initiatives. The wider significance of discounted cashflow and its components will be explored in more detail in Chapter 5. The study looked at three aspects of business strategy considered pertinent to discounted cashflow: sales growth; growth period and profit margins; capital investment and risk. Of these, the most convincing findings were in relation to sales growth and risk. These are summarised as follows:

**Sales Growth, Growth Period and Profit Margin**

Using the example of The Body Shop, the study demonstrated how ethical and environmental issues contributed to an increase in enterprise value. The Body Shop aligned its values with its product marketing strategy in a way that enabled it to differentiate and justify premium prices for a sustained period. Between 1987 and 1996, The Body Shop was able to maintain an average operating profit margin of 17.9%, while its closest rivals, Boots and Marks & Spencer, only achieved margins of approximately 11% for the same period. The Body Shop also succeeded in fending off the effects of gradual market erosion through spectacular growth in sales. Over the same period, the sales growth rate for The Body Shop was 900% as compared with an average growth rate of 50% for Boots and Marks & Spencer. These factors contributed to a six-fold growth in operating profit for The Body Shop in that period, compared to a two-fold rise for Boots and Marks & Spencer.

39 Schaltegger, S & Figge, F, 1998

**Risk**

Comparing the practices of companies from the chemicals sector, the study sought to prove that the proposed levy on CO<sub>2</sub> emissions would introduce risks, both to profitability and access to capital. Indexing sales in Swiss Francs (ChF) per tonne of CO<sub>2</sub> emitted, it found that the most CO<sub>2</sub> intensive firm, DSM, emitted 37 times more CO<sub>2</sub> per ChF than Sandoz, the most sales-efficient CO<sub>2</sub> emitter. It then went on to index operating profit (in ChF) per tonne of CO<sub>2</sub> emissions, and found a similar differential. The study found that if a levy of ChF 15 per tonne of CO<sub>2</sub> were introduced, taking the 1995 figures, DSM's tax liability would be 9% of operating profit, as compared with a figure of 0.2% for Sandoz<sup>40</sup>.

#### 4.2.4 Applications and Limitations of Statistical Evidence

It should come as no surprise that there appears to be a statistically significant correlation between major 'incidents' and share price. The findings are nevertheless relevant. They demonstrate that the financial markets do take notice of poor performance when it is perceived as affecting overall business performance, or if it is felt to be symptomatic of an underlying weakness within the business. Of greater significance, perhaps, are the findings that firms which mend their ways by instigating an environmental policy after being prosecuted, see increases in share price, reinforcing the maxim that 'pollution prevention pays'.

Widening the scope of activity beyond pollution prevention to more general aspects of management and responsibility, the first three studies found consistent positive share price behaviour, albeit tempered with the caveat that other statistically significant issues may be relevant. The fourth study presents an apposite and convincing analysis in relation to wider sources of strategic risk to the business, but some care needs to be taken in relation to the evidence relating to sales growth. The Body Shop is perhaps the most extreme (and well known) example of a corporate responsibility ethos manifesting itself in a marketing position – and ultimately in successful sales. In more recent years, sales growth for The Body Shop has declined, resulting in modifications to its product range. The company nevertheless commands a strong market position.

A more general limitation with the use of statistical evidence is that it relies heavily on historical data. It is also difficult to identify what behaviours financial markets are actually rewarding.

### 4.3 Case Evidence of Improvements at a Functional Level

#### 4.3.1 Overview

The next body of evidence reviews the links between improved ethical, environmental and social performance and business performance at a functional level. The areas where links appear to be strongest are:

- human resources
- sales and marketing
- operations
- supply chain management.

#### 4.3.2 Human Resources

Companies have long recognised the importance of attracting and retaining talented staff in order to maintain their competitive position. However, there are many indications that improved ethical, environmental and social performance does influence levels of employee satisfaction, performance and retention. Some leading companies also claim that improved performance can improve a company's image, thereby making it easier to attract talented new employees<sup>41</sup>. The most common indicators that have been used to demonstrate the links with HR functions include:

<sup>40</sup> NB The study pre-dated the introduction of the Climate Change Levy in the UK.

<sup>41</sup> Zadek, S, 2001

- costs (eg recruitment costs, training, opportunity and learning costs)
- quality (eg skill level, productivity, absenteeism, turnover, promotion rate)
- demand and supply (eg number of vacant positions)
- time (eg recruitment cycle).

Several studies have demonstrated a positive correlation between employee satisfaction, attitudes and certain dimensions of ethical, environmental and social performance. A recent study by Fleishman-Hilliard<sup>42</sup>, for example, found that 87% of European employees would increase their loyalty to a company, if it were seen to be involved in activities that help improve society. Other studies reveal similar patterns in the USA.

Other studies<sup>43</sup> have sought to identify the factors felt to be important by employees. Within the UK, these have been found to include:

- treating employees fairly
- good customer service
- safe environment (H&S)
- environmental responsibility
- assessing company performance beyond profit
- diverse workforce
- good human rights record
- no slave/child labour
- standing for things you believe in
- unexcessive Directors pay
- donating resources to the community.

Whilst it is difficult to prove a direct link between employee values, levels of satisfaction and business performance, several case studies do point towards a positive correlation between these factors. Four examples illustrate this point:

Recent research conducted by **Sears**<sup>44</sup> applied a quantitative model to test the relationships between management quality, employee attitudes and financial performance. The research found that if employee satisfaction were to improve by five points, customer satisfaction would increase by 1.3 points, leading to a 0.5% increase in revenue. For Sears, this would equate to additional sales in the order of \$65 million per annum and increased market capitalisation of approximately \$80 million.

In 1989, **B&Q**<sup>45</sup> opened a B&Q Supercentre at Macclesfield staffed entirely by the over-50s, as an experiment. Within six months, the results showed that in practically every respect Macclesfield outperformed other stores. Profits were higher by 18%, staff turnover was six times lower, absenteeism was 39% lower, customer perceptions of service were higher, and staff had a higher than average level of skills. Following the success of the trial, B&Q has now adopted a Diversity Vision statement and has implemented company-wide policies and programmes in relation to age, cultural diversity, disability and quality of life.

In 1999, **Novo Nordisk**<sup>46</sup> launched a 'Values in Action' programme to align all its businesses with sustainable development principles. Since the company has sharpened and broadened its commitment to sustainable development, the company has seen its staff turnover rate drop to 5% compared to an industry average of 10%.

**Shell**<sup>47</sup> believes that its growing reputation as 'an organisation in transformation', and one committed to making sustainable development part of the way it does business, has attracted a growing number of people to Shell; not least of which include high calibre senior managers. The company clearly sees that part of the business case for a commitment to Business Principles and sustainable development is the ability to attract and retain high calibre talent and to maintain the loyalty and commitment of staff.

42 Fleishman-Hilliard/Ipsos, 1999, quoted in Zadek, S, 2001

43 Draper, S, 2000

44 Zadek, S, 2000

45 B&Q, August 2001 (<http://www.diy.com>)

46 Hedstrom, G S, Shopley, J B & LeDuc, C M, 2000

47 Dr Mark Wade, Shell International Ltd – personal communication, August 2001

### 4.3.3 Sales and Marketing

Whilst it is often difficult for companies to address the many and often conflicting demands of different consumer groups, some companies are starting to investigate the relationship between customer values, ethics and interests as a means of increasing profitability. For some, activities are restricted to cause-related marketing. The effects are temporary, in line with the rise and fall in levels of popular interest in a specific charity or cause, but do provide a powerful means of attracting additional customers and boosting sales. For others, attention is now focusing on using consumer values as a means of differentiating products and services and improving cost leverage. This relies on a closer relationship between the characteristics of a product and the values of the business as a whole. Selected examples illustrating these various approaches include:

**Coca-Cola**<sup>48</sup> experienced a 490% increase in sales of its products at Wal-Mart stores during a six week campaign in 1997 with 'Mothers Against Drunk Driving', in which the company donated a portion of its sales to the organisation.

**Diageo**<sup>49</sup> reported that between 1994 and 1998, 22 cause-related marketing projects helped it raise £600,000 for causes while increasing sales of tracked brands by 37%.

**Electrolux's**<sup>50</sup> 'Green Range' of white goods, which have a lower environmental impact, achieved a 3.5% higher gross margin than the company's standard range.

After the **Co-operative Bank**<sup>51</sup> formally adopted an ethical stance in 1992, it gained 205,000 customers, and has continued to grow on a sustained basis since. Its position is cited to be a powerful differentiator that creates tremendous levels of customer loyalty.

### 4.3.4 Operations

Many argue that improved ethical, environmental and social performance can result in a number of operational benefits. These include: improved ability to innovate and develop alternative products and services, improved resource and material efficiencies and improved investor confidence. However, the bulk of current evidence appears to focus on the opportunities for cost-savings through environmentally driven sources. Many of these case studies are well known, eg Dow Chemicals' Waste Reduction Always Pays initiative (WRAP) and Xerox's re-manufacturing programme, and are described in detail in several publications<sup>52</sup>. Other selected case examples include:

**Volkswagen**<sup>53</sup> reports a link between high standards of environmental performance and overall business performance in several areas, including: "attractive conditions offered by banks and insurers, buoyant share prices and positive customer perception of the company". The company also emphasises that "a well-functioning environmental management system minimises the financial risks resulting from environmental incidents, contamination problems and possible statutory fines. In addition, energy, water and waste disposal costs are reduced and an innovative approach to products and facilities is promoted."

**Preem Petroleum**<sup>54</sup> (formerly OK Petroleum) developed a reformulated gasoline in the early 1990s. It then lobbied the Swedish government to increase taxes on less environmentally acceptable fuels. This not only rewarded Preem's own capabilities, but also created a source of competitive advantage as regulations toughen in other European markets.

48 BSR, 2000

49 BSR, 2000

50 Hedstrom, G S, Shopley, J B & LeDuc, C M, 2000

51 Hedstrom, G S, Shopley, J B & LeDuc, C M, 2000

52 eg Von Weizsacker, E, Lovins, A B & Lovins, L H, 1997, and Kiernan, M J, 1998

53 Volkswagen, 2000

54 Hedstrom, G S, Shopley, J B & LeDuc, C M, 2000

**Suez Lyonnaise des Eaux**<sup>55</sup> has generated additional revenue streams by applying existing capabilities to water aid projects. Reported benefits include:

- improving relationships with governments and NGOs by working in partnership with them on socially-related projects
- introducing cost-efficient ways of designing and implementing water and waste treatment systems in developing countries.

**Unilever**<sup>56</sup>: In 1993, the company began to develop formal systems for global reporting, using environmental performance indicators that are linked with financial performance measures. The system is built around six eco-efficiency parameters: a measure of 'lost product' in effluent, hazardous waste, non-hazardous waste, total water, carbon dioxide from energy use, and boiler/utilities sulphur oxides.

Unilever's business groups are given financial modelling reports that identify potential cost-savings from achieving their targets over a five-year rolling period. Business benefits include:

- over five years to 1999, substantially reduced overall impact on the environment while increasing output
- each business group site can make cost savings by reducing any of the six eco-efficiency parameters
- over the next five years manufacturing efficiency will be increased, forecasting savings of around £100m
- enhanced reputation nationally and locally.

#### 4.3.5 Supply Chain Management

Encouraging cost-efficiencies through supply chain relationships is nothing new to business. However, many companies are citing additional benefits by addressing ethical, environmental and social issues. Initiatives have included rationalisation of suppliers through the introduction of minimum environmental performance standards, partnerships among enterprises and improved productivity through partnerships. In many instances, individual projects have prompted longer-term commitments that are continuing to generate additional benefits. Selected case examples include:

**Dow Chemicals's**<sup>57</sup> 'ValuePark' in Leipzig and 'Kalundborg Industrial Park' in Denmark provide two pioneering examples of how individual enterprises from the same supply chain can be linked within the same geographical area to create more effective systems. The waste from one business becomes the feedstock for another. Dow is investing \$1 billion over ten years in 'ValuePark', and in the long-term anticipates a return on its investment of 30-40% achieved through savings in raw materials, waste, labour and environmental costs.

In 1990, **B&Q**<sup>58</sup> started its programme for improved environmental and social performance, following press and customer enquiries regarding tropical hardwoods. Since then, the company has carried out a fundamental review of its product range and the day-to-day running of its business. Initially, B&Q focused on the environmental impacts associated with specific products, such as timber, paint and peat. It then started to set minimum environmental performance standards for its suppliers. More recently, B&Q has started to examine its role in relation to the people in its global supply chains. Longer-term initiatives include:

- The Capiz Project, Philippines, which aims to introduce safer diving practices, manufacturing practices, fairer wages and more sustainable harvesting techniques for the oyster shells used to make Capiz lampshades
- Project India, which seeks to reduce the environmental impacts associated with the manufacture of coir mats and introduces a 'Rugmark' label to guarantee labour standards
- Project China, which seeks to apply the lessons learned in the Philippines and India to supplier factories in China, in partnership with International Resources for Fairer Trade.

<sup>55</sup> Weiser, J & Zadek, S, 2000

<sup>56</sup> Department of Trade and Industry, 2000

<sup>57</sup> Hedstrom, G S, Shopley, J B & LeDuc, C M, 2000

<sup>58</sup> B&Q, August 2001 (<http://www.diy.com>)

The reported business benefits include:

- a more efficient supply chain
- increased market share for selected product lines
- increased levels of employee satisfaction
- enhanced company reputation.

#### 4.3.6 Applications and Limitations of Case Evidence

Case evidence drawn from the experience of other companies does have several useful applications. It can help identify sources of potential benefit that may have been overlooked. It may also provide useful insights into the way in which a particular programme was implemented and may offer learning points that are relevant to other companies. In addition, it may help to reinforce particular arguments or lend additional weight to a business case.

The main limitation with drawing general conclusions from company case evidence is that benefits tend to be industry sector-specific, and more often company-specific. There is no guarantee that a similar course of action in another company will generate equivalent results.

### 4.4 Evidence from Ethical-Rating and Information Organisations

#### 4.4.1 Overview

Ethical-rating and information organisations carry out independent assessments of company performance in ethical, environmental and social dimensions according to a range of sustainable development criteria. The various organisations fall broadly into four categories, distinguished by their motives and approach:

- (i) **non-profit organisations**, such as the Council on Economic Priorities (CEP) and EIRiS, which aim to encourage improved performance by publishing ratings or rankings on a regular basis
- (ii) **socially responsible investment (SRI) funds/departments of investment banks**, eg the Domini 400 Social Index maintained by Kinder, Lydenberg, Domini & Co. (KLD). These organisations screen or rate company performance in order to create and manage socially responsible investment (SRI) funds
- (iii) **managers/owners of financial indices**, eg Dow Jones Sustainability Group Index (DJSGI), and Financial Times Stock Exchange FTSE4Good Index
- (iv) **independent consultancies**, including Sustainable Asset Management (SAM) and the Safety and Environmental Risk Management (BV SERM) Rating Agency. These organisations undertake ratings on behalf of the other types of organisation listed above, but may also produce their own ratings in order to market benchmarking services to industry.

#### 4.4.2 Screening Criteria and Methods

The specific issues considered by these organisations when assessing corporate ethical, environmental and social performance vary considerably. Some organisations concentrate on environmental issues, some on labour and others on business ethics.

Methods for obtaining information and conducting assessments also tend to vary considerably. The most common method of obtaining information is via a detailed questionnaire. This information may be qualified through telephone or face-to-face interviews, and sometimes by site audits. The complexity of assessment processes can vary from a relatively simple 'tick-box' scoring approach through to more complex methodologies that apply weightings to specific issues. In addition, a degree of 'expert judgement' may feature, although ratings generally aspire



to an objective approach. Most organisations now encourage wider transparency and disclosure of information on company performance in ethical, environmental and social dimensions as an important means of reducing the burden of inquiry, for all concerned.

Additionally, rating and information organisations use the outputs from their assessments in a number of ways, depending upon their particular motives and objectives. Non-profit rating and information organisations tend to publish their results in the form of performance rankings, enabling comparative assessments to be made at individual company and industry sector level. Financial indices serve a similar purpose, but are updated more frequently and are generally available via the Internet. Investment funds and consultancies do not generally publish the results of their screening, but use the information to maintain SRI funds or to provide confidential services to individual companies.

While there is a great deal of variation, an analysis of the approaches taken by 20 rating and information organisations does reveal some common underlying themes. These are described in more detail in Appendix 2 and include:

- corporate commitment and values
- management systems
- environmental impacts and solutions
- disclosure, transparency and external focus
- labour issues
- social and community issues
- ethical business involvement
- charitable sponsorship
- risk management
- overall business strategy and financial performance.

#### 4.4.3 Applications and Limitations of Evidence from Ethical-Rating and Information Organisations

An important limitation with trying to draw general conclusions from the criteria used by ethical-rating and information organisations is that there is a great deal of variation between organisations depending on motivations and objectives. Further, while they may provide a useful indication of overall ethical, environmental and social performance, they do not necessarily indicate the links with financial performance. They do, however, provide a strong indication of the internal capabilities within companies to tackle the ethical, environmental and social dimensions of business performance.

### 4.5 Evidence from Leading-Edge Thinkers

Several leading-edge thinkers have recently published reports that seek to consolidate the current body of evidence for a link between aspects of sustainable development performance and financial performance. These contain a wealth of additional quantitative and case evidence to which senior managers may wish to refer. A brief outline of three key examples is presented below, together with signposts for further information:

**Buried Treasure: Uncovering the Business Case for Corporate Sustainability (January 2001):** Published by SustainAbility and the United Nations Environment Programme, this report maps the impacts of corporate sustainable development on business performance and seeks to uncover if and how improved performance in these areas *creates* value. The potential relationships are mapped onto a matrix, which compares ten measures of sustainable development performance and ten more traditional measures of business success. An indication of the strength of each potential relationship is also provided, supported with case evidence. Copies of the report can be found at the following address:  
<http://www.sustainability.com/business-case/>

**Conversations with Disbelievers (November 2000):** Prepared by John Weiser and Simon Zadek and published by the Ford Foundation, this report brings together much of the quantitative evidence for a link between aspects of social performance and financial performance. It highlights some of the reasons why business people are sceptical about the business benefits associated with improved social performance, and indicates which types of argument are most appropriate for different internal audiences. Copies of the report can be found at the following addresses: [www.conversations-with-disbelievers.net](http://www.conversations-with-disbelievers.net) or [www.zadek.net](http://www.zadek.net)

**Risky Business – Towards Best Practice in Managing Reputation Risk (June 2001):** Prepared by Jenny Rayner on behalf of the Institute of Business Ethics. This publication examines the role of corporate reputation and its relationships with aspects of business performance. It highlights the areas of reputation risk management that appear to point towards increased profitability, and those offering wider or intangible benefits. Copies of the report are available from the Institute of Business Ethics at the following address: [www.ibe.org.uk](http://www.ibe.org.uk)

#### 4.6 Summary

This chapter has highlighted the current body of evidence for a link between company performance in ethical, environmental and social dimensions and aspects of business performance. Some of the sources of potential benefit that have been explored in this chapter include:

Function	Sources of Additional Value
Company-level	<ul style="list-style-type: none"> <li>• External relations and company reputation</li> <li>• Risk management</li> <li>• Organisational systems and processes</li> <li>• Asset value and contingent liabilities.</li> </ul>
Human Resources	<ul style="list-style-type: none"> <li>• Resource attraction and retention</li> <li>• Employee productivity.</li> </ul>
Sales and Marketing	<ul style="list-style-type: none"> <li>• Product/service differentiation</li> <li>• Cost leverage</li> <li>• Customer satisfaction and loyalty.</li> </ul>
Operations	<ul style="list-style-type: none"> <li>• Materials and process efficiency</li> <li>• Technology and innovation.</li> </ul>
Supply Chain Management	<ul style="list-style-type: none"> <li>• Inbound and outbound logistics</li> <li>• Materials and process efficiency</li> <li>• Product disposal.</li> </ul>

The chapter has also identified some of the potential applications and limitations of current evidence, including:

- statistical evidence is often compelling, but relies heavily on historical data, and whilst indicative of overall trends, may not indicate which behaviours financial markets are rewarding.
- case evidence provides a useful insight into the experiences of other companies and may offer useful learning points in terms of methods. However, the benefits tend to be industry sector-specific, and more often company-specific.
- outputs from ethical-rating and information organisations contain useful information on the types of business activity that contribute to improved ethical, environmental and social performance. They may not, however, indicate how such improvements contribute to business performance.

- evidence from leading thinkers provides a wealth of information that senior managers can use to reinforce particular proposals or to persuade specific audiences. A key limitation, however, is the generic nature of these findings.

Clearly, in order to build a business case that is relevant to the circumstances and priorities of an individual company, some tailoring is needed. The next chapter now considers how senior managers might start the process of developing their own business cases for corporate sustainability, focusing on the opportunities to *create* value.



# 5 The Route Map

## Towards a Business Case

Overview

Overview of the Route Map

Applications of the Route Map

The Route Map – Step by Step

Summary

## 5.1 Overview

For most companies, some form of business case is required to show how the principles of sustainable development support overall business performance. Financial stakeholders, and equity market managers in particular, commonly share this view. But as has been indicated in previous chapters, sustainability issues often involve complex relationships, where benefits may be long-term, indirect or intangible. They may also involve looking beyond current market conditions and defining strategic options that do not lend themselves to more traditional forms of business evaluation.

A key challenge with any business case is to reconcile diverse business imperatives with the fundamental need to make a profit. It is here that distinctions between the various fates of value – creation, conservation, destruction and limitation – become crucial to understanding possible links with sustainability issues.

This chapter is designed to guide senior managers as they work towards building their own business cases. It does so by presenting an approach which focuses on ways to *create* and *conserve* value simultaneously, whilst avoiding responses that *limit* or *destroy* value. Guidance is presented in the form of a route map, comprising a series of steps towards a business case. At each step, senior managers are presented with a task and a suggested set of tools, with each step informing the next.



## 5.2 Overview of the Route Map

Several steps are needed to build a business case that focuses on opportunities to *create* and *conserve* value. An overview of these steps is described as follows:

### Step 1: Identifying Significant Impacts

The route map starts with an analysis of the company's current and planned activities. This step is designed to provide a better understanding of the types of activity that are generating, or have the potential to generate, significant impacts on environment and society.

### Step 2: Identifying Key Issues

This involves an analysis of identified impacts to establish whether they are, or could become, key issues from an external perspective. Included in this step is an option to confirm internal findings using external dialogue techniques.

### Step 3: Establishing Sources of Potential Threat and Opportunity

Step 3 is designed to highlight issues that present potential sources of opportunity as well as threat. At this stage, most companies would normally apply internal controls to manage identified threats. However, the route map provides a basis for further analysis before a decision is taken on a preferred business response.

### Step 4: Identifying and Prioritising Proposed Actions

The next task is to identify proposed actions within a strategic context, assessing and prioritising them based on their potential to *create*, as well as *conserve*, value. Suggested techniques for carrying out an analysis of potential benefits draw extensively from current practice in the equity market sector. The main output from this step comprises a short-list of proposed actions for inclusion in a business case, tested in terms of their ability to generate additional benefits to a company's operating strategy.

### Step 5: Highlighting Actions with Strategic Implications

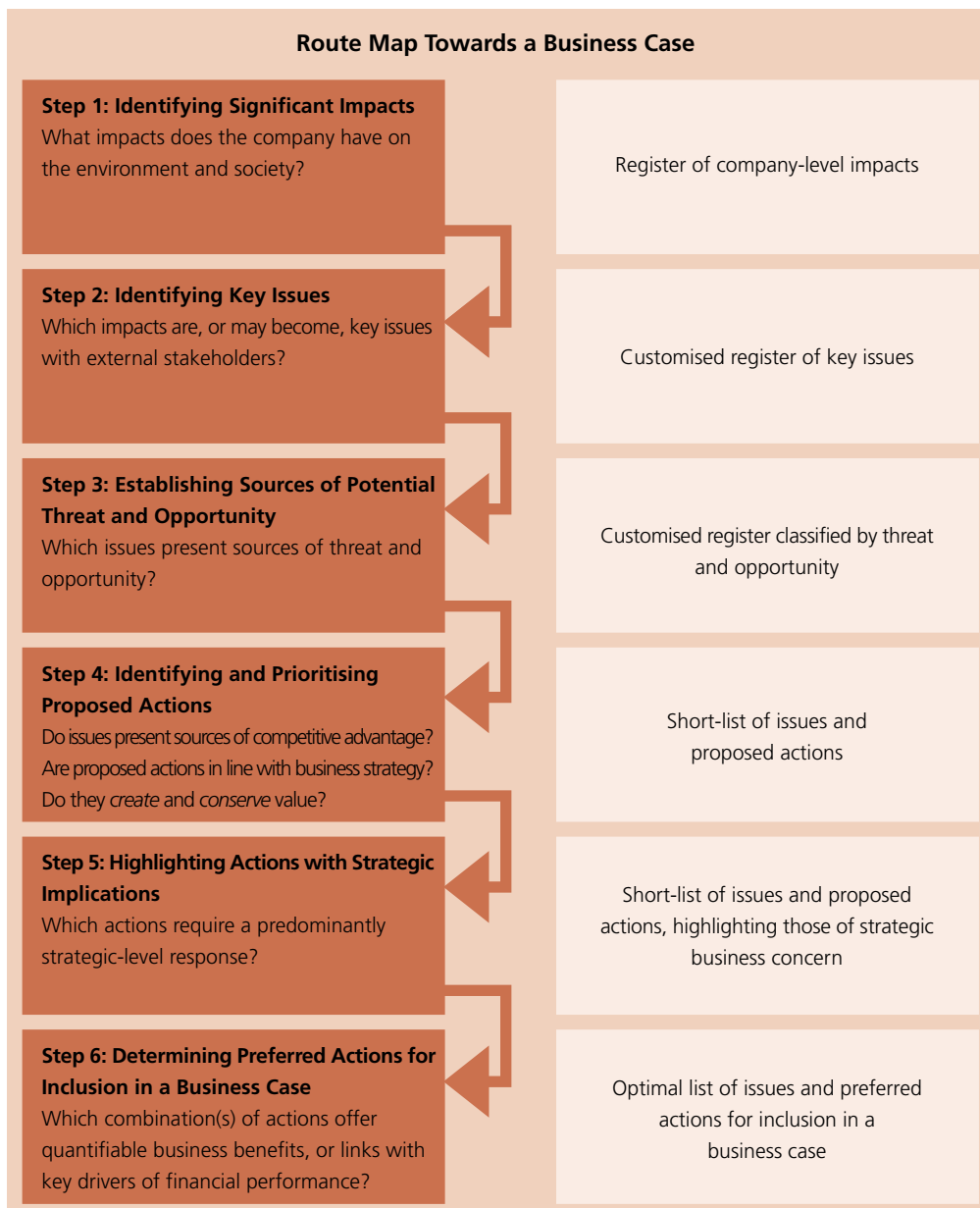
The penultimate step is to review the short-list of proposed actions to assess whether they offer opportunities to *create* and *conserve* value in strategically important parts of the business. It also aims to emphasise the fact that under some circumstances, proposed actions may also point towards underlying weaknesses in aspects of overall business strategy, prompting a more fundamental review of long-term strategic options. While companies may elect to include a broader range of actions in

their business cases, this step will help senior managers identify the range of actions that are likely to be of most direct interest to financial stakeholders, and equity market managers in particular.

**Step 6: Determining Preferred Actions for Inclusion in a Business Case**

The final step is to establish a preferred list of actions for inclusion in a business case that focuses on logical and viable options. A series of tools is suggested, again drawing from current company and equity market practice. These are designed to help senior managers identify the optimal combinations of proposed actions, based on direct financial measures, or described in terms of links with key indicators of financial performance.

Having completed this final step, senior managers should have a good understanding of the range of actions that are most likely to generate business benefits. This information will, in turn, provide the basis for a business case for improved performance in ethical, environmental and social dimensions that focuses on opportunities to *create* and *conserve* value in strategically important areas of business activity. In some instances, it may also point towards the need for a more fundamental review of overall company strategy, supported by evidence of the potential to *destroy* or *limit* value in the event that a company chooses to do nothing.



It is anticipated that companies have their own processes in place for presenting and seeking approvals for a business case. The way in which a business case is implemented will also be largely dependent upon the information it contains. This publication does not therefore seek to provide guidance in these areas.

### 5.3 Applications of the Route Map

One of the key features of the route map is that it defines parameters for building a business case, focusing on potential business benefits. It combines tools and techniques for assessing sustainability issues, with the key concepts and tools used by both companies and equity markets, thereby providing a common basis for identifying and assessing benefits. It is not intended to supersede existing systems and processes for risk and impact control; rather it offers an alternative framework for defining potential business responses, focusing on opportunities to *create* and *conserve* value. It is recognised that other tools and techniques are available which have a similar function and will produce equivalent results to those described here.

Step	Tool	Source	Current Applications		
			Senior Managers	Equity Market Managers	Specialist Advisors
Step 1	A Impact Assessment/ Appraisal	Government Guidance British Standards Institute			X
Step 2	B Issues/Stakeholder Matrix	World Business Council for Sustainable Development (adapted)	X		X
	C Stakeholder Dialogue	AccountAbility AA1000 Standard	X		X
Step 3	D Threat/Opportunity Analysis	Standard/proprietary business tools	X	X	X
Step 4	E Porter's 'Five Forces' Model (adapted)	Porter, M (adapted)	X	X	
	F Correct Strategic Choice	Standard/proprietary business tool	X	X	
	G Key Drivers of Shareholder Value (adapted)	Rappaport, A; SustainAbility	X	X	X
	H Cost-Benefit Analysis (adapted)	Standard/proprietary business tool	X	X	X
Step 5	I Strategic Assessment	Macmillan, H & Tampoe, M	X		
Step 6	J ROCE Impact	Standard financial tool	X	X	
	K Economic Value Added	Standard financial tool		X	
	L Discounted Cashflow	Standard financial tool	X	X	

The rationale for selecting the tools and techniques used in this publication is that they:

- provide a consistent framework for identifying and assessing business benefits, which is recognisable to both senior managers and equity market managers
- are capable of being adapted to include broader market perspectives
- can be linked with new sustainable development tools
- taken together, may provide the basis for developing a business case for improved ethical, environmental and social performance, focusing on opportunities to create value.

### 5.4 The 'Route Map' – Step by Step



#### Step 1: Identifying Significant Impacts

Before a company can start to develop a business case, it needs to have a basic understanding of the wider context within which it is operating. The first step is therefore to gain a better understanding of the specific impacts associated with its current and planned activities at a company-wide level. These may include, for example, total greenhouse gas emissions, or sourcing products from suppliers with unacceptable labour practices.

The exercise may seem like a statement of the obvious, but relatively few companies carry out impact assessments at company level. The most

effective way to identify specific impacts on environment and society is to carry out a comprehensive corporate review or assessment. Such exercises are commonplace for particular projects, eg laying a pipeline. They are also a fairly regular feature in the environmental 'due diligence' exercises that support mergers and acquisitions. However, for the purposes of setting a baseline for strategic business activities, the practice is seldom applied. Tools that may assist with this type of analysis are described below.

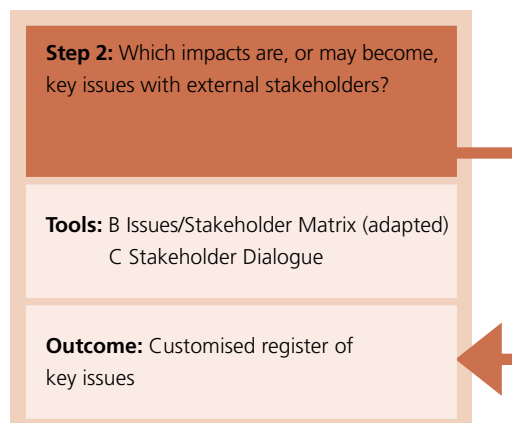
#### TOOL A: Impact Assessment/Appraisal

There are a multitude of available tools and techniques for carrying out impact assessments and appraisals. Most draw on techniques that are founded on scientific principles, such as Environmental Impact Assessment, or recognised standards of practice (eg BS EN ISO 14001: *Specification for Environmental Management Systems*; BS EN ISO 14010: *Environmental Auditing – General Principles*; and AA1000: *A Foundation Standard in Social and Ethical Accounting, Auditing and Reporting*). Additionally, many companies already collect management information that may inform company-level impact assessments.

The outcome of the process should be recorded in a register of impacts, together with a preliminary view of their relative importance.

#### Step 2: Identifying Key Issues

The next step is to review identified impacts to determine whether they are, or may become, key issues from external perspectives. The information in Chapter 3 of this publication may provide a useful starting point for identifying the range of potential issues. For a more systematic review of



key issues from other perspectives, companies may also wish to use the tools described below. As a result of this review, the register of impacts should be re-worked to take the form of a customised register of key issues, again ranked in order of importance.

**TOOL B: Issues/Stakeholder Matrix**

A useful tool for evaluating key issues from external perspectives is described in a report published by the World Business Council for Sustainable Development (WBCSD)<sup>59</sup> in January 2000. Based on dialogue with business and non-business stakeholders from eight countries around the world, WBCSD identified eleven key issues and nine categories of stakeholder group. These are reproduced below:

Key Stakeholder Issues	Key Stakeholder Groups
<ul style="list-style-type: none"> <li>• Values and governance</li> <li>• Regulation and controls</li> <li>• Business operations</li> <li>• Accountability and disclosure</li> <li>• Human rights</li> <li>• Employee rights/ Working conditions</li> <li>• Business context</li> <li>• Product impact</li> <li>• Social impact/Investment</li> <li>• Impact on other species</li> <li>• Impact on environment</li> </ul>	<ul style="list-style-type: none"> <li>• Company owners/Shareholders/Investors</li> <li>• Employees</li> <li>• Customers</li> <li>• Business partners</li> <li>• Suppliers</li> <li>• Competitors</li> <li>• Government/Regulators</li> <li>• NGOs, Pressure Groups/Influencers</li> <li>• Communities</li> </ul>

To help gain a better understanding of issues and concerns from different perspectives, WBCSD suggest the use of a matrix, which they illustrate with a hypothetical example from a UK-based water utility company. An adapted version of this matrix is presented in Appendix 3.

**TOOL C: Stakeholder Dialogue**

In many cases, existing mechanisms for managing external relations may provide sufficient information to complete this task. However, some companies may also wish to validate or refine their assumptions on key issues through the use of dialogue techniques. To help companies decide which stakeholders to engage, WBCSD<sup>60</sup> suggest a simple screening exercise based on three questions:

- (i) **Legitimacy:** Is a particular stakeholder group representative of issues which are relevant to your business and accountable to those with a legitimate interest in the way you do business?
- (ii) **Contribution/Influence:** Does the stakeholder group have a contribution to make in helping you run the business more responsibly or significant influence on your company's business and/or on other stakeholders?
- (iii) **Outcome:** Is engagement likely to result in a productive outcome in the long run?

Further information on stakeholder engagement techniques is presented in AccountAbility AA1000 Standard: *A Foundation Standard for Social and Ethical Accounting, Auditing and Reporting*<sup>61</sup>.

59 WBCSD, 2000  
 60 WBCSD, 2000  
 61 AccountAbility, 1999

### Step 3: Establishing Sources of Potential Threat and Opportunity

Having developed a customised register of key issues, the next task is to consider whether they represent a potential source of opportunity or threat to the business. Further information on generic sources of potential opportunity and threat is presented in Chapter 2, whilst Chapter 4 provides signposts to sources of evidence drawn from current company experience and the research from leading thinkers in the field.

The outcome of Step 3 is a customised register of issues, indicating potential threats and/or opportunities.



#### TOOL D: Threat/Opportunity Analysis

Most companies are familiar with the techniques used to identify threats and opportunities. These include proprietary risk appraisal tools that help managers gain a better understanding of the nature and scale of threat. However, as has been emphasised throughout this publication, the primary objective of this exercise is to identify and assess potential opportunities to *create* value through improved performance in ethical, environmental and social dimensions. Further analysis is therefore required before determining a preferred response.

An example of potential threats and opportunities posed by sustainability issues is presented below using an illustration from the airline sector:

#### Potential Opportunities:

- **Pollution control** – Tighter controls are anticipated at airports and costs of emissions abatement could be passed on to airlines. Advantages will accrue to airlines applying more efficient technology.
- **Noise controls** – Tighter controls on airport noise are anticipated. Improved alliances with other airlines may offer means of anticipating future restrictions on timeslots.
- **Freight and courier distribution** – Increased reliance on the movement of people and high value products between international locations.
- **Public transport and accessibility** – Partnerships with public transport providers may offer opportunities to speed up check-in times, increase customer satisfaction and offer more reliable means of accessing flights.
- **Stakeholder management** – Opportunity to enhance reputation and brand profile through closer association with stakeholder issues (no market leader at present).
- **Responsible tourism** – Closer association with sustainable forms of tourism may offer opportunities for increased cost leverage for selected destinations.

*continued...*

### Potential Threats:

- **Climate change** – Aircraft emissions are a major contributor to global warming. Tighter emissions standards may limit flying hours or require capital expenditure to improve engine efficiency. Increased fuel taxation may affect profitability.
- **Pollution control** – Integrated Pollution Prevention Control Regulations (IPPC) will require tighter emissions control from operating airports. Costs of abatement are likely to be passed on to airlines. Increasing requirements for noise control may restrict airport operating hours and therefore limit access, and require tighter noise controls for aircraft, with subsequent cost implications.
- **Freight issues** – Replacement of banned CFCs and HCFCs over the next ten years may incur capital expenditure.
- **Public pressure** – Public expectations for increased accessibility need to be balanced with impacts on local communities. The potential risks to long-haul flights are negligible, given the lack of viable alternatives, but there may be impacts to short-haul flights, if company travel policies start to encourage the use of alternative modes of transport on environmental grounds.

### Step 4: Identifying and Prioritising Proposed Actions

The next task is to decide whether any of the issues identified:

- present opportunities for competitive advantage in areas of strategic importance to the business
- are consistent with overall business strategy
- can be integrated with business strategies in a way that *creates* additional value
- can be expressed in terms of costs and benefits.

In view of the importance of financial stakeholders when determining business benefits, suggested assessment techniques draw extensively from current practice in the equity market sector. These techniques offer a consistent framework for the identification and assessment of potential business benefits and, in most cases, can also be adapted to incorporate wider perspectives.

For the purposes of the route map, four tools are suggested, with the output from each analysis informing the next. These comprise:

- Porter's 'Five Forces' Model – identifying sources of competitive advantage (Tool E)
- making the correct strategic choice (Tool F)
- Rappaport's 'Key Drivers of Shareholder Value' – pursuing business strategies that *create* additional value (Tool G)
- cost-benefit analysis techniques (Tool H).

The outcome of these analyses will take the form of a short-list of actions prioritised according to their potential to *create* and *conserve* value, their degree of consistency with overall business strategy, and the ability to implement them operationally.

**Step 4:** Do issues present sources of competitive advantage? Are proposed actions in line with business strategies? Do they *create* and *conserve* value?

**Tools:** E Porter's 'Five Forces' Model (adapted)  
 F Correct Strategic Choice  
 G Rappaport's Key Drivers of Shareholder Value (adapted)

**Outcome:** Short-list of issues and proposed actions

This information will, in turn, provide the basis for a business case, focusing on opportunities to *create* and *conserve* value. In those instances where analyses have indicated that a more fundamental review of current strategic intent is needed, information will highlight the intrinsic value of carrying out such a review, highlighting the potential to *destroy* or *limit* value in the event that a company chooses to do nothing.

### TOOL E: Porter's 'Five Forces' Model<sup>62</sup> (adapted)

Senior managers will generally have access to proprietary tools for assessing external influences on current business activities. Most draw upon the key market forces identified by Porter to identify potential sources of competitive advantage. For the purposes of the route map, Porter's 'Five Forces' Model is used to illustrate the type of analysis that senior managers might carry out. An adaptation of the model is then used to show how these analyses can be extended to include wider market considerations and trends.



Questions that might typically be asked when carrying out this type of analysis include:

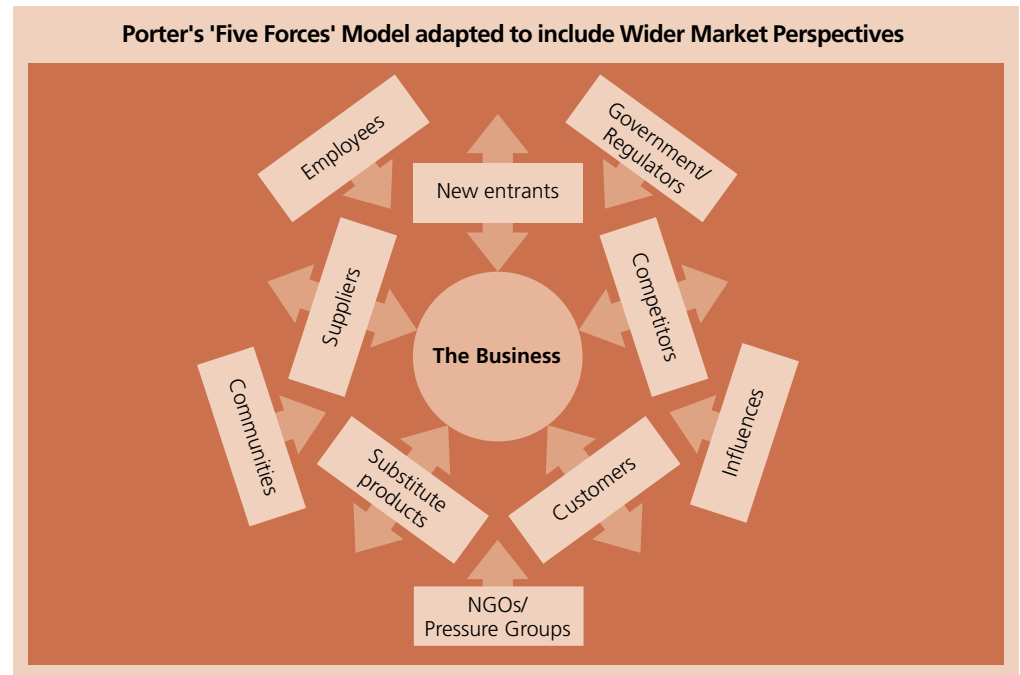
- (i) What is the balance of power between the company and its customers? Can the company extend its influence over customers through alternative product or service strategies?
- (ii) What is the balance of power between the company and its suppliers? Can the company extend its supply chain influence through strategic alliances or acquisitions?
- (iii) How easy or difficult is it for new companies to enter the industry? What barriers to entry can a company erect, eg economies of scale, major capital investment?
- (iv) What substitutes might exist for the products (or services) offered by the company? What alternative forms of distribution are there? How might the company respond to these?
- (v) Is competition on price or differentiation? What scope is there for gaining advantage over competitors through improved economies of scale, superior research and development, brand strength, customer loyalty?

These types of analyses tend to focus on traditional market drivers. However, the scope of the model can easily be extended to include wider market perspectives and trends, including sustainability

<sup>62</sup> Porter, M, 1985

issues. It can also help senior managers generate ideas for gaining competitive advantage that might otherwise be overlooked.

When carrying out an assessment of these wider market influences and trends, senior managers may find it helpful to refer to the information compiled as part of Steps 2 and 3. An adaptation of Porter's 'Five Forces' Model is shown below by way of illustration.



Pertinent questions to ask in relation to the key sustainability issues identified in previous steps will include:

- (i) How do key issues affect current relationships with customers?
- (ii) How do key issues affect potential relationships with suppliers?
- (iii) Do key issues make it easier or more difficult for new players to enter the market?
- (iv) Do any of the key issues offer potential barriers for new entrants?
- (v) Do any of the key issues create a demand for alternative or substitute products and services?
- (vi) Do any of the key issues offer opportunities to increase cost leverage, either by reducing costs or by differentiating products and services?

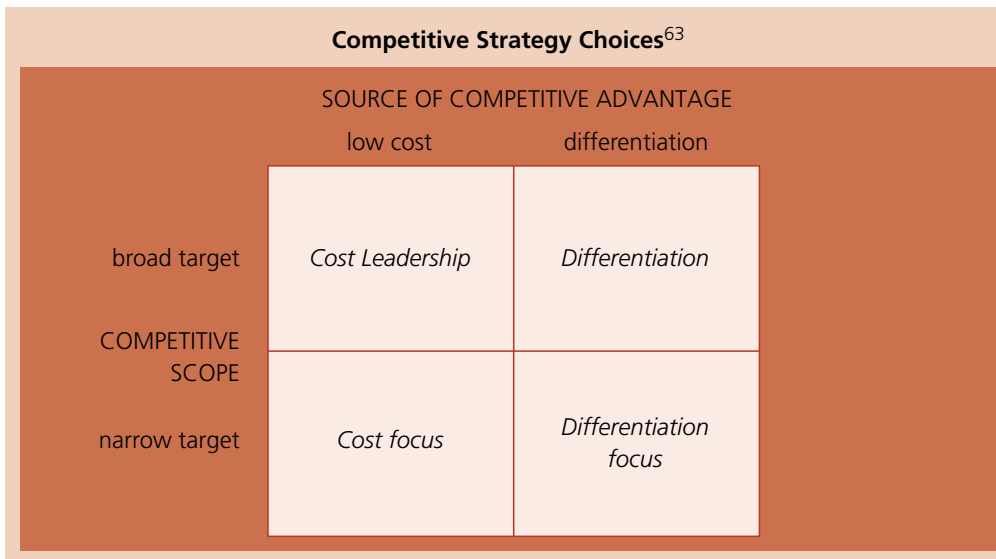
The main output from this first level of analysis will comprise a list of key issues and initial responses, prioritised according to their potential to *create* and *conserve* value.

#### **TOOL F: Correct Strategic Choice**

In tandem with the identification of priority action areas, potential business responses need to be tested against the company's overall business strategy to ensure that the correct strategic choice is being made. The primary objective of this type of analysis is to establish whether a proposed action is consistent with a company's business strategy. Here, two strategic choices are presented. These are illustrated in the figure below and by the following questions:

- should responses support a low-cost strategy, or a differentiation strategy?
- should responses support a broad range of segments, or narrow its focus to one or a few?

The main output from this second level of analysis will comprise a refined list of prioritised actions, highlighting those which are consistent with overall business strategy.



#### TOOL G: Rappaport's Key Drivers of 'Shareholder Value' (adapted)

The next level of analysis involves testing proposed actions to determine whether they offer the potential to *create* additional value. In Chapter 4, the publication highlighted a study by Schalteger and Figge which used Alfred Rappaport's model for calculating discounted cashflow<sup>64</sup> (used as a proxy for shareholder value). The study demonstrated how key components of business strategy are affected by ethical, environmental and social initiatives.

A similar approach is used for this level of analysis, mapping proposed actions against the 'Key Drivers of Shareholder Value' identified by Alfred Rappaport. These comprise:

- sales growth rate
- profit margin
- fixed capital investment
- working capital investment
- competitive advantage period
- cost of capital
- cash tax rate (adapted).

It should be noted that when applying Rappaport's calculation for discounted cashflow, cash tax rate means the prevailing rate of corporation tax. For the purposes of this analysis, however, it is suggested that senior managers use this particular driver to highlight potential tax benefits, associated with a proposed action. A proposal to reduce carbon emissions, for example, may offer a number of benefits, including the opportunity to reduce carbon tax liabilities.

When carrying out this analysis, senior managers first need to map their own company's business strategy against Rappaport's key drivers. They then need to evaluate proposed actions against each of the key drivers to determine whether they offer the potential to *create* additional value. Appendix 4 illustrates a strategic choice between low cost and differentiation strategies for each of these key drivers.

<sup>63</sup> Adapted from Thompson, J, 1993

<sup>64</sup> Rappaport, 1998

To assist with the assessment of potential benefits for each of the key drivers, senior managers may find it helpful to refer to the key financial drivers and indicators identified by SustainAbility<sup>65</sup> as being of particular relevance to sustainability issues. These comprise:

**Customer attraction**, eg by taking a particular ethical stance on product development, resourcing or processing

**Brand value and reputation**, eg by improving relationships in the localities where the business operates

**Human and intellectual capital**, eg by reducing the turnover of highly skilled and expert individuals from the business

**Risk profile**, eg by reducing the likelihood of legal disputes through improved stakeholder involvement and dialogue

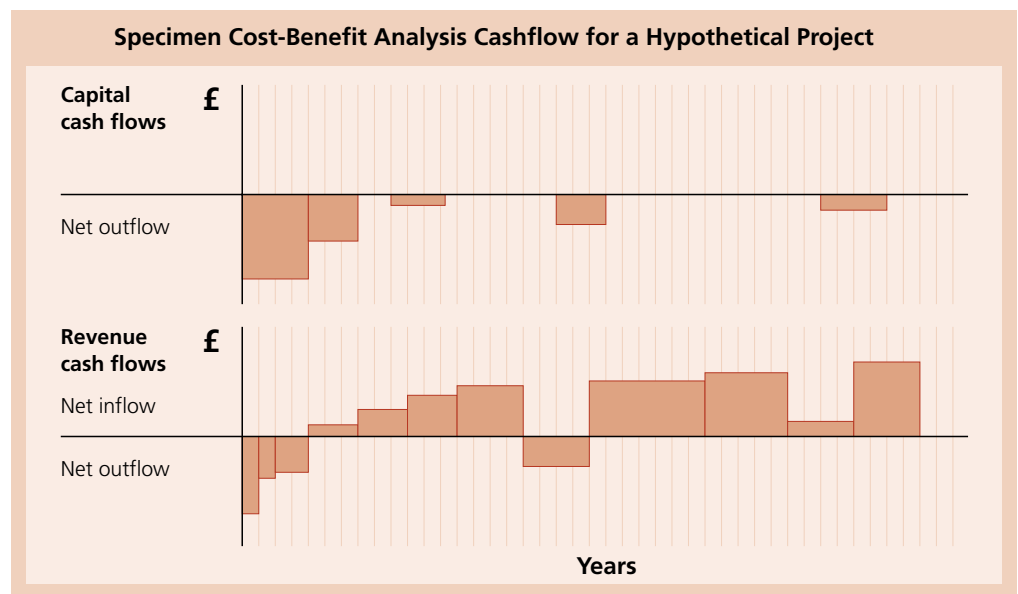
**Innovation**, eg by anticipating resource depletion earlier than competitors and researching alternative sources

**Licence to operate**, eg by improving communication with regulators and other authorities.

Further information on sources of potential benefit is also provided in Chapter 4.

**TOOL H: Cost-Benefit Analysis (adapted)**

Cost-benefit techniques can also be applied to assess the merits of a proposed action. Typically cost-benefit analysis techniques include quantitative and qualitative information. The qualitative information will include the project scope, justification and anticipated benefits, risks and associated tasks. Quantitative information sets out, on a year-by-year basis, the projected cash flows associated with a particular project. Further information on how to calculate cashflow is presented in Step 6 and an example cashflow is shown below by way of illustration.



The main adaptations that may need to be made when applying cost benefit techniques to sustainability issues concern timescale.

65 SustainAbility, 2001

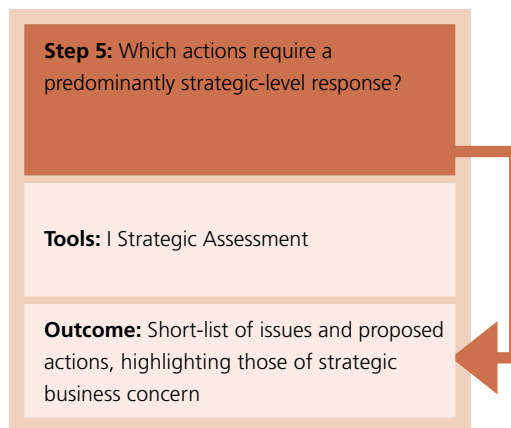
Typically, cost-benefit analyses will focus on the timescale over which business benefits are anticipated, with costs expressed in terms of impacts to the business. However, some types of impact, eg depletion of a particular natural resource, may not manifest itself within the normal planning cycles for a company.

When senior managers apply cost-benefit analysis techniques to sustainability issues, it is important to consider the timescales over which environmental and social impacts are likely to manifest themselves. It is also important to highlight the potential for value destruction or limitation in the event that a company chooses to do nothing.

**Step 5: Highlighting Actions with Strategic Implications**

Given the fact that many sustainability issues require actions for long-term change that are by definition strategic in nature, this step is designed to help senior managers highlight actions that require predominantly strategic level responses. By highlighting issues with strategic implications for the business, senior managers will be better placed to communicate the information that is of most direct interest to financial stakeholders, and equity markets in particular.

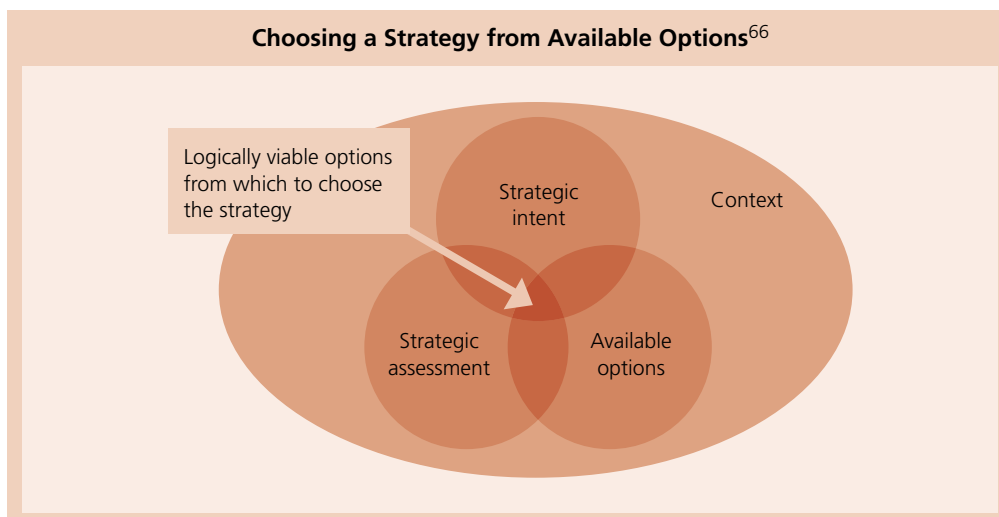
In addition, this step serves to emphasise the fact that under certain circumstances, addressing key sustainability issues may require a more fundamental review of a company's long-term strategic options. Under such circumstances, senior managers would need to identify and assess potential business responses against different strategic options and scenarios. The model below illustrates how an essentially iterative process of identifying and assessing options might lead to a modification in overall business strategy.



Again, communicating the outputs of these types of analysis is essential, if financial stakeholders are to gain an appreciation of the broader imperatives that a company is trying to address.

A possible tool to assist with this process is signposted below.

**TOOL I: Strategic Management**



66 Macmillan, H & Tampoe, M, 2000

Pertinent questions to ask when deciding whether an issue is likely to have strategic implications will include:

- (i) Does the issue have significant implications for core business activities?
- (ii) Are there opportunities for sustained competitive advantage?
- (iii) Is there significant potential for value limitation or destruction in the event that a company chooses to do nothing?
- (iv) What are the chances of survival over the longer-term if the company chooses to do nothing?
- (v) Does the issue point towards the need for a more fundamental review of current business strategy?
- (vi) Will treatment of the issue require a review of company vision and values?
- (vii) What changes can a company realistically implement?
- (viii) Do senior managers have a high level of discretion about how to respond?

### Step 6: Determining Preferred Actions for Inclusion in a Business Case

The final step is to establish a preferred list of actions for inclusion in a business case. One possible means of achieving an optimal combination of proposed actions is to apply financial measures to test anticipated benefits. This step will be particularly relevant to those actions that require additional investment. In keeping with the underlying theme of this publication, the measures proposed here draw from current practice within the equity market sector to determine business performance relative to share price. These comprise:

- Return on Capital Employed (ROCE)
- Economic Value Added (EVA)
- Discounted Cashflow.

**Step 6:** Which combination(s) of actions offer quantifiable business benefits, or links with key drivers of financial performance?

**Tools:** J Return on Capital Employment (ROCE)  
K Economic Value Added  
L Discounted Cashflow

**Outcome:** Optimal list of issues and preferred actions for inclusion in a business case

Having completed this final step, senior managers should have a good understanding of the range of actions that are most likely to generate business benefits. This information will in turn inform the preparation of a business case for improved performance in ethical, environmental and social dimensions, focusing on opportunities to *create* and *conserve* value.

A further advantage of testing proposed combination(s) of actions using this approach is that it enables senior managers to communicate their proposals to financial stakeholders in familiar language. It also provides a consistent framework for monitoring and communicating progress during the implementation phase of a business case.

### TOOL J: Return on Capital Employed (ROCE)

The strategic plan for the business will show how the ROCE changes over the forward plan period. ROCE is defined as pre-tax profit divided by net capital employed. ROCE calculations can be used to assess past, current and planned business performance in terms of its use of capital to generate

financial returns. Upward trends in ROCE indicate a business that is thriving. Conversely, downward trends in ROCE may indicate an underlying weakness in the business.

One means of testing a proposed business case might be to test whether it has positive impacts on company ROCE.

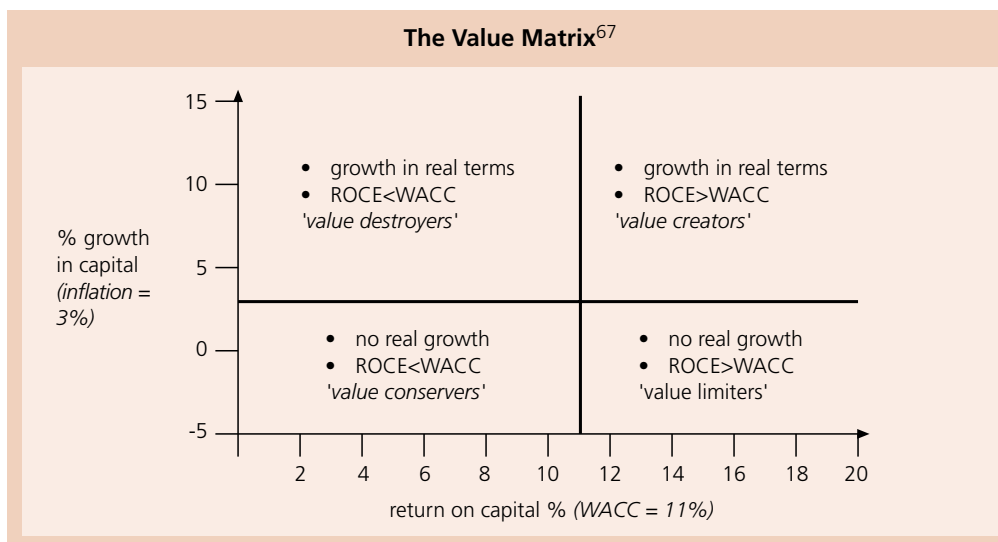
### TOOL K: Economic Value Added

Many analysts use the WACC (Weighted Average Cost of Capital) to ROCE comparison and view it as a key indicator of value creation or destruction where a business is growing its capital. The difference between the two is referred to as the *spread*, which can be expressed as a positive or a negative. An alternative term is *economic value added*.

A well-run company that is investing in itself wisely should produce a higher ROCE than WACC, or *positive spread*. When the spread is positive in favour of ROCE, this is the time a company should be growing its capital, as it gets a positive return on it. Such companies are 'value creators', and those that miss the opportunity, or serial downsizers, are 'value limiters', showing poor judgement.

Conversely, a firm with a higher WACC than ROCE, or *negative spread*, should reconsider its investment options, since the capital is costing more than it returns. When the spread is negative, a company should shrink its capital, and be a 'value conserver'. Any company that persists with an 'all growth is good growth' strategy with a negative spread is a 'value destroyer'.

The *spread* or *economic value added* is a useful indicator in its own right, but it is also helpful to examine it in relation to other qualifiers of capital growth, such as inflation and return on capital. These potential relationships are illustrated below.



One important application of the value matrix is that it enables companies to determine the best timing for a specific investment programme. Proposals do not necessarily need to generate returns above the WACC, but they will indicate what level of success may be achieved, as compared with the business as a whole.

In cases where anticipated benefits are likely to take cash flows above the WACC, the positive message is that the proposal concerned is helping to reverse a trend of negative economic value added. In those instances where increased investment is a (necessary) defensive action, emphasis should be given to the intrinsic value of the proposed action, highlighting the potential impacts on the WACC in the event that a company elects to 'do nothing'.

<sup>67</sup> HSBC James Capel, 1997, quoted in Hughes, A, 1997, *Should Environmental Issues Affect Institutional Investment Decisions*, MSc Thesis, University of Bradford, UK

### TOOL L: Discounted Cashflow

Cashflow is the cash left over from sales revenue, after operating and related overhead costs have been met, tax paid and investments made in fixed and working capital. A commonly used method of valuing an investment is to discount its estimated total cashflow by its cost of capital. Anticipating the fact that cashflows may not be sustained at current rates, total anticipated cashflow is estimated, and then discounted to derive a net present value of future cashflows.

The most commonly used figure to discount future cashflows is the Weighted Average Cost of Capital (WACC). 'Cost' here is not a figure in £ or \$ etc, but a percentage rate akin to an interest rate. The WACC represents an imputed interest rate that a company pays on the total capital employed in the business, and indicates the threshold figure for a required return on investment in the business.

Real and projected returns for an investment should be above the WACC; otherwise the cash in question should be invested elsewhere. Equity analysts tend to regard the WACC as the most appropriate figure to use for discounting, because it provides an indication of the minimum required return rate for investments and is company-specific.

It is possible to get a fairly accurate picture of the contribution a proposed business case can make to the business as a whole, using the discounted cashflow measure. The cashflow from a programme will comprise year on year cashflows over the life of the project covering:

- sales, minus
- operating and related overhead costs
- required fixed capital expenditure
- required working capital expenditure.

NB: All cashflows are discounted after one year by the cost of capital.

One means of applying this measure might be to compare the anticipated cashflow from a proposed business case with the residual cashflow in the business. In this way, it may be possible to demonstrate the percentage increase a business case is likely to yield.

This type of comparison may be particularly important to financial stakeholders who routinely compare residual cashflows with share price as an indicator of whether or not a share is good value for money.

## 5.5 Summary

The guidance in this chapter has been designed to help senior managers work towards developing business cases for improved company performance in ethical, environmental and social dimensions.

By focusing a business case on opportunities to *create* value in areas of strategic business concern, this approach provides a more explicit means of demonstrating the potential links between improved company performance in ethical, environmental and social dimensions, and aspects of business performance.

Another possible outcome is that it may highlight potential underlying weaknesses in overall business strategy, thereby prompting a more fundamental review of long-term strategic options.

Further, the application of standard business evaluation and assessment tools may help companies to communicate their proposed strategies to financial stakeholders, using standard business terms. The application of financial performance tools will also provide a consistent framework for monitoring progress during the implementation phase of a business case. Such actions may, in turn, serve to

prompt equity market managers to take wider consideration of the potential opportunities and threats associated with sustainability issues.

Companies should nevertheless be aware that in some areas of activity, defensive actions are necessary. Under such circumstances, emphasis should be given to the intrinsic value associated with higher levels of investment in these areas, highlighting the potential for value limitation or destruction in the event that companies choose to do nothing. Applications of financial assessment tools, such as Economic Value Added, also provide a valuable means of demonstrating the risks in value terms of not taking the correct action at the right time.

In the final chapter, attention turns to the ways in which equity market managers might view a business case for improved company performance in ethical, environmental and social dimensions.





# 6 Involving

## Equity Market Managers

Introduction

Quantitative Measures

Qualitative Assessments

Summary

## 6.1 Introduction

In determining what amounts to a 'business benefit', it is generally accepted that financial stakeholders, and equity markets in particular, play an important role. By applying the techniques that are in common usage within the equity market, companies may be better placed to communicate the broader imperatives that they are trying to address. In this way, they can also aim to elicit a more positive response and may encourage wider consideration of the potential opportunities and threats posed by environmental and social issues.

This chapter is designed to provide senior managers with a better insight into the key tools and techniques that equity market managers apply as part of their business assessments. It also aims to highlight those aspects of a business case that may be of most direct interest to equity market managers.

## 6.2 Quantitative Measures

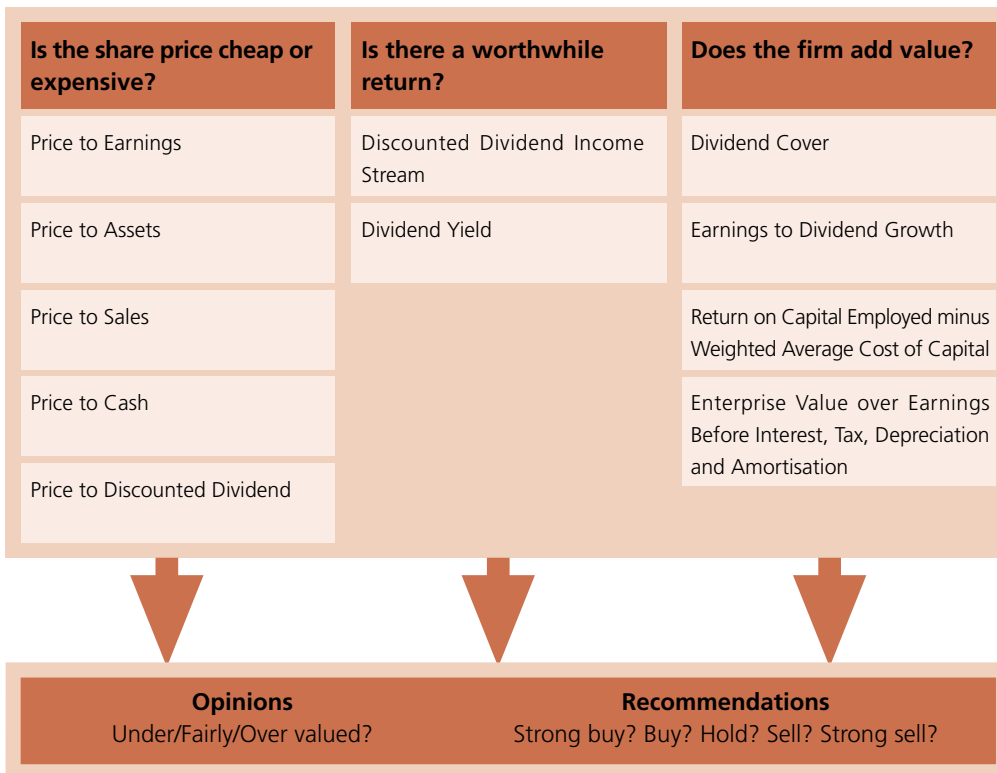
Equity market managers build an overall picture of business performance by combining various analyses. On the quantitative side, figures from the balance sheet and profit and loss account are combined in a series of ratios and equations to help build a picture of historic performance. Qualitative assessments of company performance are then conducted in order to provide an indication of future performance. The qualitative assessments provide a strategic context for the quantitative assessments, with the main emphasis being to determine the underlying strengths of the business.

In terms of quantitative measures, *cost of capital* plays a pivotal role in the assessment process, but the greatest emphasis is on *earnings*, which feature in the majority of calculations. Broadly speaking, there are two main types of quantitative measure: price assessment measures and business performance measures. Price assessment measures focus on share price and dividend payouts, aiming to judge whether they provide value for money. Business performance measures tend to be used to validate a company's decision to spend surpluses on the company rather than on the dividend.

There are, broadly speaking, two types of calculation. Those concerned with assessing share price, and those dealing with aspects of business performance exclusive of share price.

The most commonly used measures are listed below and are illustrated in the figure overleaf:

Price Assessment Measures	Business Performance Measures
<ul style="list-style-type: none"> <li>• Price to Earnings</li> <li>• Price to Assets</li> <li>• Price to Sales</li> <li>• Price to Cash</li> <li>• Price to Discounted Dividend</li> <li>• Discounted Dividend Income Stream</li> <li>• Dividend Yield.</li> </ul>	<ul style="list-style-type: none"> <li>• Dividend Cover</li> <li>• Earnings to Dividend Growth</li> <li>• The difference between the Weighted Average Cost of Capital and Return on Capital Employed</li> <li>• Enterprise Value over Earnings Before Interest, Tax, Depreciation and Amortisation.</li> </ul>



### 6.3 Qualitative Assessments

Qualitative assessments are conducted in order to provide an indication of future performance and provide an overall context for considering the quantitative indicators. Equity market managers focus on the potential to maximise profit margins through sustained competitive advantage. Assessments will seek to determine how well a company is dealing with external market forces, the strength of its overall business strategy, the quality of its management and its ability to achieve continued profitability.

#### 6.3.1 Company Profile

For mainstream institutional investors and their advisors, potential business impacts are judged primarily, if not solely, in the context of earnings opportunity or threat. Ethical, environmental and social issues are unlikely to be considered in isolation, unless there is a material risk to earnings potential or a significant opportunity for increased earnings. The job of the analyst is to make an objective assessment taking all influencing factors into account. It is not their job to make moral judgements or to look at financial aspects in a vacuum.

As the evidence emerges of links between high standards of company performance in ethical, environmental and social dimensions and business performance, it is anticipated that equity market managers will take wider account of these issues. In the meantime, companies have an important role to play by demonstrating the relevance of sustainability issues to business practice.

#### 6.3.2 The Management Framework

However good its financial performance may be, a company is unlikely to maintain competitive advantage unless the management framework is effective. Equity market managers recognise the importance of high quality management and will try to ascertain information about the company's capabilities from a variety of sources.

Assessments of management quality are likely to include questions under the following headings:

- **Governance** – How well does the company comply with 'the Combined Code of the Committee on Corporate Governance'?
- **Vision and Leadership** – Does the Chairman and/or the Chief Executive have a vision that will take the business forward successfully and over the longer term? Can he or she communicate the vision effectively and inspire high quality performance across the business? Is the person likely to be in position long enough to ensure delivery?
- **Management Quality** – Is quality management evident, and what action is being taken to ensure existing or improved quality in the future? Is the skills base suitable for the way the industry and specific business is/should be developing? Is morale high?
- **Strategy** – Does the business strategy ensure a competitive position? Will it deliver a satisfactory business performance? Is it flexible and responsive to changes such as technological innovation? How risky is the strategy?
- **Corporate Structure and Organisation** – Is the business at risk by operating in specific geographic regions? Is there an appropriate organisation and structure? Are roles, responsibilities and accountabilities clear? Are company alliances appropriate?
- **Reputation and Risks** – Does the company have a good reputation and brand image? What are the risks associated with the way it operates and is controlled? How sustainable are its relationships in the wider community and environmental context? Is it managing risk appropriately? Is the business monitoring latent reputation risks?
- **Policies** – Do these align with overall vision and values? Do they enable employees to behave in accordance with these values?
- **Processes and Procedures** – Do these enable the business to run efficiently? Are they flexible? Is the business properly resourced?



As equity market managers gain a fuller understanding of the potential relationships between sustainability issues and business performance, they are more likely to start adapting their current assessments to include how well companies are responding to these challenges. In the meantime, senior managers have a key role to play in demonstrating how improved company performance in ethical, environmental and social dimensions supports business performance.

## 6.4 Summary

For mainstream institutional investors and their advisers, the potential impacts to a business are judged primarily, if not solely, in the context of earnings opportunity or threat. Social, ethical or environmental considerations are unlikely to be considered in isolation, unless there is a significant risk to earnings potential, or a significant opportunity for increased earnings.

As managers move towards integrating sustainable development into their strategic thinking, mainstream equity market managers may be prompted to take more explicit account of the potential threats and opportunities presented by ethical, environmental and social issues.

The way equity market managers develop their own tools in the future for checking business performance regarding sustainable development and its business impact will be an important test of equity managers' own vision and investigative talent.

# 7 Conclusions





## Conclusions

There is considerable pressure on companies to achieve higher standards of performance in ethical, environmental and social dimensions. At present, however, there is still considerable resistance from the business sector, and debate about the contributions that companies should make towards achieving sustainable development.

This publication has been developed with the specific intention of encouraging more companies to start integrating sustainability principles into business practice. It does so by offering an alternative framework for improved company performance in ethical, environmental and social dimensions, focusing on opportunities to *create* and *conserve* value.

By way of context, the publication presents an overview of the conceptual framework relating to sustainable development from a business perspective. It has also described the key drivers for change that are beginning to exert an influence over the business sector. It has then examined the current body of evidence for a link between high standards of company performance in ethical, environmental and social dimensions and aspects of business performance. Ultimately, however, it concludes that a business case for wider integration of sustainability principles relies on closer examination of a company's own impacts, strategic options and circumstances.

A central role is therefore given to the guidance in Chapter 5. This describes a possible route map that senior managers might follow when developing their own business cases, focusing on opportunities to *create* value. Given the fact that many of the actions needed to achieve long-term change are by definition strategic in nature, it also emphasises the need to highlight potential benefits in strategically important areas of business activity.

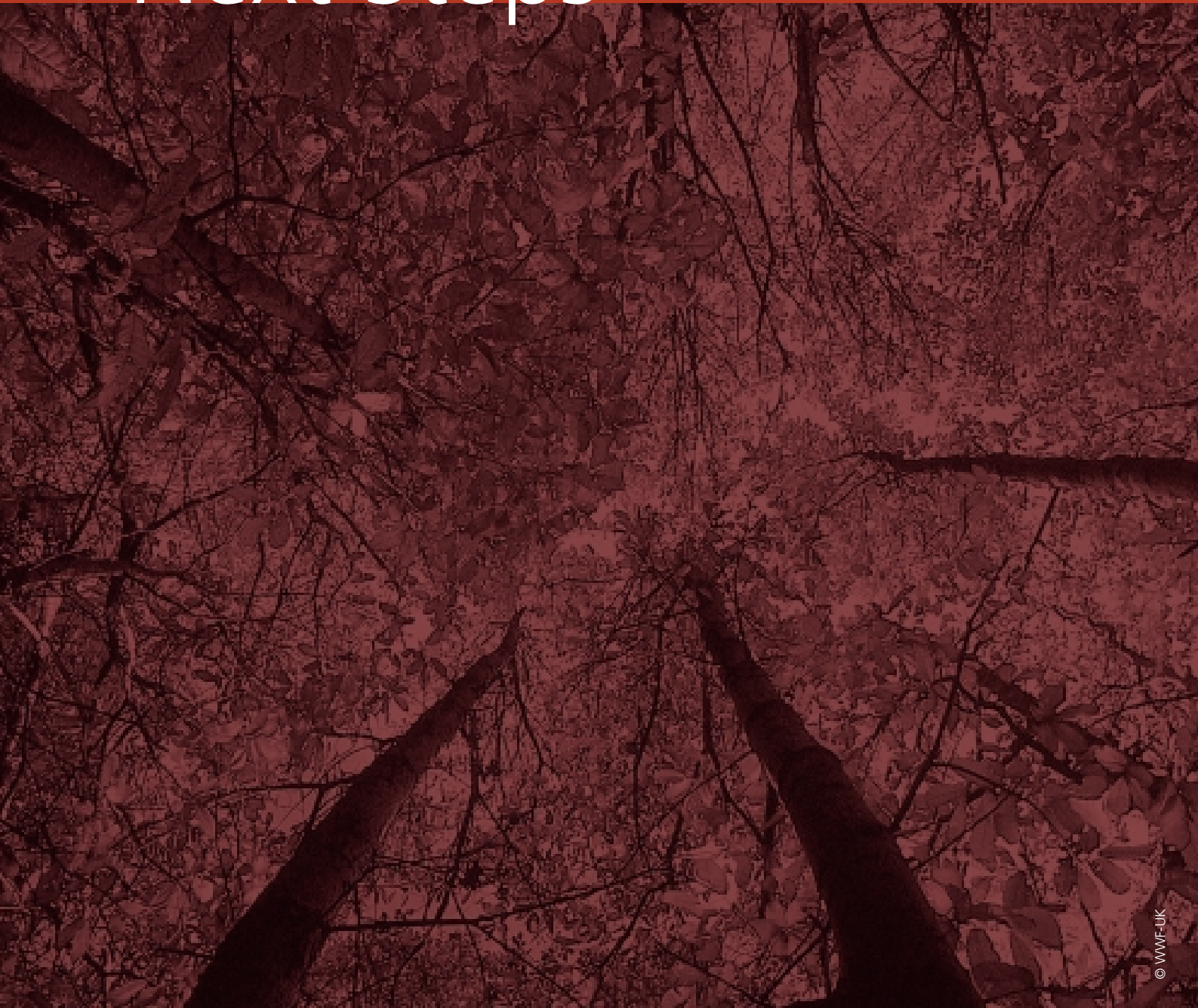
One important conclusion is that by focusing on opportunities in areas of strategic business concern, companies may be better placed to demonstrate the links between improved company performance in ethical, environmental and social dimensions and aspects of business performance.

The application of standard business evaluation and assessment tools may also help companies to communicate their proposed strategies to financial stakeholders in standard business terms. This may also prompt equity market managers to take wider account of the potential opportunities and threats associated with sustainability issues.

The next step relies on participation by companies themselves. The business benefits undoubtedly exist, they just need to be found.



# 7 Next Steps





## Next Steps

The project partners are encouraged by the wealth of evidence pointing towards a positive link between sustainable development performance and overall business performance. By making this publication and its supporting research available to others, WWF-UK and Cable & Wireless hope to move the debate forwards from principles to practice.

The publication has outlined the conceptual framework relating to sustainable development from a business perspective, and has given an indication of the implications for business in the 21st century. We firmly believe that the guidance described in Chapter 5 will help others to start the process of developing their own business cases for improved performance in ethical, environmental and social dimensions.

Both WWF-UK and Cable & Wireless intend to build on this venture by participating in the next steps. These will be to:

- participate in feedback from senior managers and equity market managers making use of the guidance and who may suggest improvements
- participate in debate within businesses and between the business and equity market sector about their experiences, the problems they encounter and potential ways forward
- encourage the wider integration of sustainability issues into business practice, focusing on the opportunities to *create* value through improved company performance in these areas.

# 5 Appendices



Appendix 1: Stakeholder Issues and Concerns

Appendix 2: Ethical-Rating and Information Organisations and Sources of Further Information

Appendix 3: Guidance for Completing WBSD Issues/ Stakeholder Matrix (adapted)

Appendix 4: Comparative Illustration of Operating Strategies for Low-Cost and Differentiation Scenarios

Appendix 5: Bibliography and Sources of Further Information

## Appendix 1: Stakeholder Issues and Concerns

The range of issues and concerns that external stakeholders now expect businesses to address varies considerably, depending on the priorities and objectives of the group concerned. The status of each issue at individual company level will also vary, both in terms of relevance and importance. Potential issues and concerns identified from a variety of research sources<sup>68</sup> include:

### Potential Stakeholder Issues and Concerns

- Access to drugs
- Acidification of soils and surface water (acid rain)
- Air quality and public health
- Alcohol
- Animal testing
- Biodiversity
- Child labour
- Climate change (global warming)
- Coastal zones and marine waters
- Data protection and privacy
- Desertification
- Discrimination
- Energy use and sources
- Environmental degradation
- Gambling
- Genetic modification
- Health and safety
- Human rights
- Inland water resources
- Intensive farming
- Labour practices (including child and slave labour and sweatshops)
- Land use planning
- Military production
- Nature conservation
- Nuclear power/weapons
- Ozone depletion
- Pesticide use
- Politically abusive regimes
- Pollution
- Pornography
- Poverty and famine
- Public health
- Quality of life
- Soil quality
- Third world debt
- Tobacco production
- Toxic chemicals use/disposal
- Transport and accessibility
- Waste management
- Wildlife habitat degradation

68 eg WBCSD, 2000

## Appendix 2: Ethical-Rating and Information Organisations and Sources of Further Information

### 2.1 Commonly Used Screening Criteria

**Corporate Commitment and Values:** Consideration of the strength, or indeed existence, of stated environmental, social and/or ethical policies. The existence of Board-level leadership and responsibility for these policies may also be assessed.

**Management Systems:** The extent to which policies are implemented through management systems, particularly for environmental issues. Aspects may include environmental training, performance monitoring, and target setting. For environmental management systems (EMS), BE EN ISO 140001 or EMAS accreditation may be considered, together with the frequency of the auditing cycle to support this accreditation.

**Environmental Impacts and their Solutions:** A number of ratings assess specific environmental impacts in the form of, for example, carbon dioxide emissions, energy consumption, water consumption, waste generation, extent of business travel and goods transport, use of tropical hardwoods and production of ozone-depleting chemicals. The extent and type of solutions implemented to mitigate these impacts may also be assessed, including recycling, 'end of pipe' mechanisms (eg air scrubbers) and 'clean technology'.

**Disclosure, Transparency and External Focus:** Rating organisations frequently assess the extent to which companies are open and inclusive in their strategy and performance. This assessment may be based upon the quality and verification of environmental, social or sustainability reporting, and the extent to which stakeholders are engaged on issues affecting them.

**Labour Issues:** Rating companies with a social or sustainability slant may employ performance criteria taken from a wide range of labour-related issues. These issues may include diversity (ie gender, racial, ability and sexual-orientation equality), health and safety, employee development and training, policy on child labour, composition of Board of Directors, family benefits (eg part-time arrangements and maternity leave). Working hours and remuneration may also be assessed, focusing on adequate remuneration and stock options for employees, and also checks for excessive remuneration of the Board of Directors.

**Social and Community Issues:** Ratings may look beyond labour issues to wider community and social issues, including treatment of indigenous peoples (particularly relocation), community relations, extent of stakeholder engagement and product safety.

**Ethical Business Involvement:** Involvement or investment in unethical business areas is a common focus for SRI fund screening. Business areas deemed to be unethical might include animal testing, the military, gambling, tobacco, alcohol, pornography and nuclear power. Checks for corporate activity in geographical areas of concern may also feature in the screening process.

**Charitable Sponsorship:** Evidence of sponsorship or support of environmental initiatives, local communities, sport and/or the arts.

**Risk Management:** Evidence for the use of sustainability strategies as risk management tools.

**Overall Business Strategy and Financial Performance:** Some rating organisations, particularly financial institutions and indices, combine 'soft' sustainability criteria with more traditional 'hard' indicators of business success in the form of business strategy and financial results.

## 2.2 Recommended Websites for Further Information

Arese (France)	<a href="http://www.arese-sa.com">www.arese-sa.com</a>
Avanzi (Italy)	<a href="http://www.avanzi.org">www.avanzi.org</a>
CaringCompany (Sweden)	<a href="http://www.caringcompany.se">www.caringcompany.se</a>
Council on Economic Priorities (USA)	<a href="http://www.cepnyc.org">www.cepnyc.org</a>
Domini 400 Index (USA)	<a href="http://www.domini.com">www.domini.com</a>
Dow Jones Sustainability Group Index (USA)	<a href="http://www.sustainability-index.com">www.sustainability-index.com</a>
Eco-Rating International (Switzerland)	<a href="http://www.eco-rating.com">www.eco-rating.com</a>
Ethical Investment Research Service (EIRIS) (UK)	<a href="http://www.eiris.org">www.eiris.org</a>
IMUG (Germany)	<a href="http://www.imug.de">www.imug.de</a>
Innovest EcoValue'21 Fund (USA)	<a href="http://www.innovestgroup.com">www.innovestgroup.com</a>
Investor Responsibility Research Centre (IRRC) (USA)	<a href="http://www.irrc.org">www.irrc.org</a>
Kinder, Lydenburg, Domini & Co (USA)	<a href="http://www.kld.com">www.kld.com</a>
MHC International (UK)	<a href="http://www.mhcinternational.com">www.mhcinternational.com</a>
Oekom Research (Germany)	<a href="http://www.oekom.de">www.oekom.de</a>
Oxford Economic Research Associates (OXERA) (UK)	<a href="http://www.oxera.co.uk/environmental">www.oxera.co.uk/environmental</a>
Pensions Investment Research Consultants (PIRC) (UK)	<a href="http://www.pirc.co.uk">www.pirc.co.uk</a>
Safety & Environmental Risk Management (SERM) (UK)	<a href="http://www.serm.co.uk">www.serm.co.uk</a>
Sustainability Intelligence Services (Netherlands)	<a href="http://www.fairventures.com/sis">www.fairventures.com/sis</a>
Sustainable Asset Management (Switzerland)	<a href="http://www.sam-group.com">www.sam-group.com</a>
Financial Times Stock Exchange (FTSE4GOOD) (UK)	<a href="http://www.ftse4good.com">www.ftse4good.com</a>

NB All websites quoted are correct at the time of going to print



### Appendix 3: Guidance for Completing WBCSD Issues/Stakeholder Matrix

Based on and adapted from the WBCSD report *Corporate Social Responsibility: Making Good Business Sense*

Issue Groupings	Stakeholders			
	Company Owners	Employees	Customers	Business Partners
Values and Governance	<b>Reputation strategy</b> – profile and turnover of shareholders; investor perception	<b>Adherence to values</b> – number of calls to hotline; employee perception	<b>Transparent about values</b> – customer awareness/satisfaction	<b>Formalisation of values in relationships</b> – occurrence of values clauses in contracts
Regulation and Controls	<b>Conflicts between controls and values</b> – trends in shareholder feedback	<b>Use/abuse of perks</b> – incidence of disciplinary procedures	<b>Meeting specifications</b> – incidence of customer complaints	<b>Open/covert dealings</b> – partner perception
Business Operations	<b>Alignment of operations with values</b> – shareholder perception	<b>Performance appraisal</b> – % of employees assessed on corporate social responsibility criteria	<b>Images portrayed in advertising</b> – number of investigations by advertising standards bodies; number of ads withdrawn	<b>Treatment of intellectual property</b> – claims and litigation
Accountability and Disclosure	<b>Rigour of reporting</b> – trends in shareholder feedback; % of information sent asking shareholders' opinion	<b>Data protection</b> – incidence of employee complaint; claims and litigation	<b>Appropriate information</b> – customer satisfaction; demonstrated reduction in customer requests/concerns	<b>Openness</b> – partner satisfaction; breaches of contract
Human Rights	<b>Compliance with international codes</b> – existence of policy statement; stakeholder perception	<b>Respect for ethnic/local culture</b> – license to operate withdrawn; protest incidents; boycotts	<b>Monitoring human rights in the supply chain</b> – customer perception/boycotts; third party review in supply chain	<b>Partnership standard concerning human rights</b> – compatibility rating
Employee rights/Working conditions	<b>Relativity of pay</b> – earnings ratios	<b>Freedom of association</b> – frequency of works committee meetings, training & development	<b>Child labour</b> – number of employees under 15, 18 if hazardous work (ILO convention 138); numbers enrolled in remediation programme	<b>Relative standards</b> – performance of partners against corporate benchmarks
Business context	<b>Types/quality of alliances formed</b> – satisfaction of non-executive directors	<b>Clarity of contractual terms</b> – stakeholder perception/satisfaction	<b>Contract terms</b> – customer satisfaction; customer retention	<b>Use/abuse of power</b> – partner satisfaction; longevity of partnerships
Product impact	<b>Unethical products</b> – inclusion rate in ethical funds	<b>Harmful processes &amp; substances</b> – accident rate; lost time due to injury, H&S procedures	<b>Labelling</b> – customer satisfaction; breaches of government/industry regulations; market share	<b>Product recall</b> – efficiency, speed and success of product recalls and service suspension
Social impact/investment	<b>Meeting guarantees</b> – complaint level	<b>Employee involvement</b> – % of employees volunteering for corporate community investment projects	<b>Cause related marketing (CRM)</b> – spend on CRM; customer loyalty; market share	<b>Disclosure/discussion of issues eg impact of site closure</b> – partner satisfaction/complaints
Impact on other species	<b>Impact of investment</b> – impact assessment	<b>Ethics of animal testing</b> – monitored level of employee concern	<b>Appropriateness of farm practices</b> – number of campaigns/boycotts; quantity of organic products sold	<b>Values shared</b> – number of partnerships accepted, sanctioned or rejected re impact on other species
Impact on Environment	<b>Disaster planning/risk assessment</b> – incidence of disasters/near misses; % of employees trained	<b>Resource consumption</b> – quantity of resource saved through employee action	<b>Customer awareness about product use/disposal</b> – trends in customer behaviour	<b>Environmental standards</b> – % of partners with external certification of EMS recognised against independent standard

Suppliers	Competitors	Government/Regulators	NGOs, Pressure Groups, Influencers	Communities
<b>Code of conduct</b> – incidence of code breaches	<b>Integrity</b> – Supplier satisfaction	<b>Values being part of governance</b> – stakeholder perception	<b>Disagreements over responsibility</b> – complaints; public comment through press	<b>Ethical imperialism</b> – stakeholder perception
<b>Presence of bribery</b> – incidence of disciplinary procedures	<b>Restrictive practices</b> – incidence of referrals to monopolies investigations bodies; claims and litigation	<b>Compliance/non-compliance</b> – incidence of fines; regulatory audits	<b>Use/abuse of legal protection</b> – stakeholder perception; public comment through press	<b>Compliance/non-compliance eg with planning regulations</b> – incidence of infringements
<b>Method of pricing</b> – supplier satisfaction; price differentials	<b>Adherence to industry standards</b> – receipt of awards; stakeholder perception	<b>Commercial espionage</b> – claims and litigation	<b>Price dumping</b> – claims and litigation; public comment through press	<b>Safety of processes</b> – incidence of near misses/accidents; H&S audit results
<b>Clarity about ongoing relationships</b> – stakeholder perception	<b>Use of media</b> – stakeholder perception	<b>Reporting complaint standards</b> – standard certifications	<b>Appropriateness of measures/indicators</b> – stakeholder acceptance	<b>Disclosure of information</b> – clarity and accessibility of information (by fact/surveys/awards)
<b>Equity of opportunity</b> – profile of suppliers (by size; gender; ethnic origin, etc)	<b>Competitive behaviour</b> – adherence to industry standards	<b>Investment criteria</b> – level of adherence to human rights regulations	<b>Giving a voice to pressure groups</b> – stakeholder perception	<b>Adequacy of disaster planning/response</b> – number of incidents/accidents; results of third party audit
<b>Tied contracts</b> – incidence of complaints	<b>Bonded labour</b> – certification against standard that prohibits bonded labour (eg SA 8000)	<b>Adherence to standards</b> – incidence of breaches	<b>Sweat shops</b> – pressure group survey	<b>Support for community education programmes</b> – level of investment (time and/or money)
<b>Payment terms</b> – complaints, surveys of supplier satisfaction	<b>Cartels</b> – incidence of industry investigations	<b>Use/abuse of monopoly</b> – stakeholder perceptions; incidence of investigations	<b>Ethical sourcing</b> – adherence to voluntary code (eg ETI)	<b>Market power in local community</b> – market share; market profile
<b>Involvement in R&amp;D/innovation</b> – results of supplier element of life cycle analysis and use of results in design process	<b>H&amp;S performance</b> – performance against industry benchmarks, eg Responsible Care – chemicals process	<b>Product stewardship</b> – quantity of hazardous NPO returned to process or market by re-use/recycling	<b>Safety of products</b> – incidence of NGO/regulatory targeting	<b>Harmful substances</b> – GHG emissions; releases to land and water of Non-Product Output
<b>Use of local suppliers</b> – proportion of local suppliers/contractors	<b>Disclosure/discussion re impact of divestment</b> – re-employment levels	<b>Joint programmes</b> – stakeholder perception	<b>Adequacy of measures, indicators and monitoring</b> – stakeholder perception	<b>Long term commitment to community investment</b> – trends in local investment
<b>Conditions of animal husbandry</b> – breaches of government/industry regulations	<b>Transparency about research findings</b> – stakeholder perception	<b>Quality of research controls</b> – compliance with government standards	<b>Quality of conservation programmes</b> – stakeholder perception; comments of independent expert	<b>Quality of impact assessment</b> – third party review results
<b>Promoting high standards in suppliers</b> – % of suppliers achieving environmental standard	<b>Commercial exploitation</b> – market share; monopoly investigations; complaints	<b>Meeting standards</b> – third party ratings and awards	<b>Effectiveness of use of expertise</b> – stakeholder perception; investment in environmental research	<b>Impact on local environment</b> – air pollution

**Key:** In each cell the issue is shown in bold, followed by one or more suggested indicators for monitoring performance against that issue.

Appendix 4: **Comparative Illustration of Operating Strategies for Low-Cost and Differentiation Scenarios**

Low-Cost Strategy	Differentiation Strategy
<p><b>Sales growth rate</b></p> <ul style="list-style-type: none"> <li>• Maintain competitive prices</li> <li>• Pursue market-share opportunities to gain economies of scale in production and inbound/outbound logistics.</li> </ul>	<p><b>Sales growth rate</b></p> <ul style="list-style-type: none"> <li>• Command premium prices</li> <li>• Pursue growth in markets where customers are prepared to pay a premium for differentiation.</li> </ul>
<p><b>Profit margin</b></p> <ul style="list-style-type: none"> <li>• Introduce mechanisms to improve the rate of learning, eg standardisation, product design modifications, improved scheduling etc</li> <li>• Search for cost-reducing linkages with suppliers based on suppliers' product design, quality, packaging, order processing etc</li> <li>• Search for cost-reducing linkages with distribution channels</li> <li>• Eliminate overhead that does not add value to the product.</li> </ul>	<p><b>Profit Margin</b></p> <ul style="list-style-type: none"> <li>• Choose combination of value activities that achieve the most cost-effective means of differentiation.</li> <li>• Eliminate costs that do not contribute to customer needs.</li> </ul>
<p><b>Working capital investment</b></p> <ul style="list-style-type: none"> <li>• Minimise cash balance</li> <li>• Manage accounts receivable to reduce average number of days outstanding</li> <li>• Minimise inventory without impairing required level of customer service.</li> </ul>	<p><b>Working capital investment</b></p> <ul style="list-style-type: none"> <li>• Minimise cash balance</li> <li>• Link accounts receivable to differentiation strategy</li> <li>• Maintain inventory level consistent with differentiating level of service</li> <li>• Obtain best terms with suppliers for accounts payable.</li> </ul>
<p><b>Fixed capital investment</b></p> <ul style="list-style-type: none"> <li>• Promote policies to increase utilisation of fixed assets</li> <li>• Obtain productivity increasing assets</li> <li>• Sell unused fixed assets</li> <li>• Obtain assets at least cost, eg lease versus purchase.</li> </ul>	<p><b>Fixed capital investment</b></p> <ul style="list-style-type: none"> <li>• Invest in specialised assets that create differentiation</li> <li>• Buy assets for optimal utilisation</li> <li>• Sell unused fixed assets</li> <li>• Obtain assets at least-cost.</li> </ul>
<p><b>Cost of capital</b></p> <ul style="list-style-type: none"> <li>• Target an optimal capital structure for competitive advantage period</li> <li>• Select least-cost debt and equity instruments</li> <li>• Reduce business risk factors in a manner that is consistent with strategy.</li> </ul>	<p><b>Cost of capital</b></p> <ul style="list-style-type: none"> <li>• Target an optimal capital structure for competitive advantage period</li> <li>• Select least-cost debt instruments</li> <li>• Increase differentiation, thereby reducing dependence on general economy.</li> </ul>
<p><b>Cash tax rate (adapted)</b></p> <ul style="list-style-type: none"> <li>• Highlight tax incentives and benefits.</li> </ul>	<p><b>Cash tax rate (adapted)</b></p> <ul style="list-style-type: none"> <li>• Highlight tax incentives and benefits.</li> </ul>

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## WHO CARES IF IT WARMS UP

## A COUPLE OF DEGREES?

Global warming is caused by burning fuels such as oil, coal and gas. This affects our climate, leading to more extreme and violent weather.

Unless we change our behaviour, there could be more floods at home and abroad, and species that can't adapt will die out.

WWF is lobbying government and industry to take action, but everyone can make a difference. To find out what you can do, call 01483 426333 or visit [www.wwf.org.uk/whocares](http://www.wwf.org.uk/whocares)



**TAKING ACTION FOR A LIVING PLANET**



# To Whose Profit?

## Building a Business Case for Sustainability

Companies today face increasing pressure to achieve higher standards, not only in terms of financial performance, but also in relation to ethical, environmental and social considerations. Additionally, a growing number of companies believe that sustainability issues will have an increasingly important bearing on the way in which economic activities are managed in the future.

Whatever their starting point, *To Whose Profit?* will help companies to examine how they might integrate sustainability principles with their business practice. It builds upon the premise that, while most companies already have systems and procedures in place for managing the operational risks and impacts, few have started to view sustainable development issues as a source of potential opportunity. It also builds on the premise that in determining what amounts to a strategic business benefit, financial stakeholders, and equity markets in particular, play an important stakeholder role.

Using standard business tools and an accessible, step-by-step format, the publication aims to:

- raise awareness of the key drivers for change in business sustainability and responsibility
- provide a means of helping to change common perceptions of sustainability issues from threat to opportunity
- encourage the treatment of sustainability issues as a strategic business concern
- identify a possible 'route map' for companies to follow when developing their own internal business cases for improved performance in these areas
- encourage companies and the equity market to apply common terminology and evaluation techniques to their understanding of sustainability and responsibility issues.



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