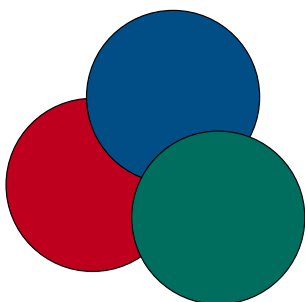


# THE ETHICAL ADVANTAGE

WHY ETHICAL LEADERSHIP  
IS GOOD BUSINESS



James A. Mitchell



CENTER FOR ETHICAL  
BUSINESS CULTURES®



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# PREFACE

**Ron James**  
**President & CEO**  
**Center for Ethical Business Cultures**

Can a business be both *ethical and profitable*? Recent headlines are filled with examples of companies whose ethical lapses have created short-term results and yet are now burdened with tarnished reputations, financial penalties and criminal sanctions.

The ethical lapses of Enron, Arthur Andersen and Global Crossing underscore the Center's fundamental premise:

*Organizations that build an ethical culture outperform organizations that don't and they reduce their exposure to ethical lapses that cause breakdowns.*

Today's business leaders have the enormous responsibility of balancing the short-term expectations of investors while building for the long-term and serving multiple stakeholders. Regardless of company size, the pressures are intense. And, when there are collisions between financial objectives and ethical practices, ethical cultures are uncompromising.

If a culture is right, employees have a context of norms and values that guide them in making the right choices. But why invest in building an ethical culture? Does it really help the bottom line? Or is this just something that "feels good" to do?

In 2000, James A. Mitchell, former Chairman and CEO of IDS Life Insurance Company, joined the Center to lead its Ethical Value Project. One goal of the project was to demonstrate empirically that *ethical leadership is good business*. We at CEBC are grateful to Jim for his work and his continued support of the Center.

As Jim asserts in *The Ethical Advantage*, leaders play a critical role in instilling ethical behavior into the day-to-day practices of an organization. Are you ready to begin the journey of creating *The Ethical Advantage*?

# INTRODUCTION

**James A. Mitchell**  
**Executive Business Fellow**  
**Center for Ethical Business Cultures**

Most senior executives are exposed to two kinds of arguments for acting ethically. The first is to do the right thing simply because it is right. I agree—but from reading the newspapers, this argument doesn't seem to be working all that well. The second argument is that, if you don't do the right thing, you will be fined or sued. The typical response to this—one we are seeing a lot of today—is to put in place a lot of mechanisms that help the company comply with laws and regulations but ignore whether it is acting ethically. This paper makes a third and more persuasive argument.

From personal experience, I know that a company can be both ethical and profitable. I had the privilege of being CEO of a company that, over a nine-year period, became the fastest growing and most profitable firm in its industry. Our profit grew at a compound annual rate of 23%, and our return on equity was consistently twice the industry average. We achieved these results by treating our customers and employees very well. We—all of us working together—created the kind of culture that demonstrated that ethical behavior is good business.

I wanted to find other companies who had demonstrated it too, and am grateful to the Center for Ethical Business Cultures for its support in this work. Now our job is to get the message of *The Ethical Advantage* out to CEOs, Boards and those who influence them. If you find the case persuasive, please tell others about it. Thank you.

# THE ETHICAL ADVANTAGE

## WHY ETHICAL LEADERSHIP IS GOOD BUSINESS

**James A. Mitchell, Executive Business Fellow  
Center for Ethical Business Cultures**

It has been commonly understood for at least a decade that most businesses are managed primarily for near-term profitability. While business leaders said they would like to put more emphasis on the longer term, pressures from Wall Street and institutional investors “forced” corporate leaders to emphasize next quarter’s earnings. What else would account for round after round of layoffs, reductions in capital spending and the like? And, especially in the wake of Enron, WorldCom and other corporate scandals, few people claim that ethical considerations occupy a top priority in most business decision-making. In fact, a Wall Street Journal/NBC News poll in July 2002 shows that one-third of Americans have “hardly any confidence” in big-company executives—the highest proportion in more than thirty years.

At the Center for Ethical Business Cultures, we believe that *ethical leadership is good business*. The purpose of this paper is to demonstrate empirically that this statement is true—that ethical leadership is actually more, not less, effective. We will show that ethical leadership adds economic value to a corporation, “making the whole economic pie bigger” so that each of the key stakeholders—customers, employees, owners, and the community at large—can get a “bigger piece.” Thus, in the longer term, the ethical organization has a significant advantage over its competitors.

So the term “business ethics” is far from an oxymoron. The truth is that *companies that have the ethical advantage demonstrate better financial performance than companies that don’t*. As we will see, this hypothesis has been demonstrated in a large number of highly regarded academic

studies. When one takes into consideration the countless anecdotal cases that support it, our assertion takes on even more credibility.

All companies have a culture in some form. The question is whether you will simply allow your organization's culture to evolve, or whether your leadership will shape its development. If you intend to take the lead in shaping the culture of your organization, you would be well advised to put ethics at its heart. The *ethical advantage* can help your company achieve its highest potential.

Just what does it mean for a company to have the *ethical advantage*? It means having a productive and ethical culture with three main characteristics:

- 1) Balancing the interests of the various stakeholders
- 2) Leadership effectiveness
- 3) Process integrity



*Balancing the interests of the various stakeholders* involves taking the long view. The leaders need to see that the company is part of a larger “whole,” and that the relationships a firm has with its various stakeholders tend to be systemic, inter-connected and reciprocal in nature. Over time, all of the stakeholder groups need to benefit, so that they continue to support the organization. As the expression goes, “What goes around comes around.”

*Leadership effectiveness* has little to do with charisma, though the leaders must articulate the mission and values of the firm in a compelling way. Leaders must also embody the values they espouse—they must “walk the talk.” And they must set the ethical tone for all the processes of the organization.

*Process integrity* deals with how deeply the ethical culture is ingrained in a company's core processes. Do lower- and middle-level managers feel comfortable "doing the right thing," even though this may mean lower profits in the short term? Is the system of rewards and recognition aligned with the firm's core values?

Most companies want to be ethical. Most managers know intuitively that, in the long run, ethical behavior pays off. The penalties for getting caught misbehaving far outweigh the benefits. So why do people sometimes cut corners, or even violate laws, in hopes of not getting caught? Some people find themselves unable to resist perceived pressure to maximize short-term earnings. Some people are interested in advancing their own careers by making their own near-term results look good. An ethical business culture encourages people to resist these sorts of pressures, and instead to behave responsibly toward all the stakeholders. Let's look at why that is good business.

## THE STAKEHOLDER DIMENSION

As we said earlier, the case for balancing the interests of the various stakeholders is compelling. Consider the results described by Professors John P. Kotter and James L. Heskett of the Harvard Business School in their book titled *Corporate Culture and Performance*:

We found that firms with cultures that emphasized all the key managerial constituencies (customers, stockholders, and employees) and leadership from managers at all levels outperformed firms that did not have those cultural traits by a huge margin. Over an eleven-year period, the former increased revenues by an average of 682 percent versus 166 percent for the latter, expanded their work forces by 282 percent versus 36 percent, grew their stock prices by 901 percent versus 74 percent, and improved their net incomes by 756 percent versus 1 percent.<sup>1</sup>



Let's look at that final finding again: The companies that paid attention to customers, employees and stockholders outperformed those that didn't in growth of net income over the 11-year period by a factor of 756. Revenues grew four times as fast, employment increased eight times as fast, and stock prices increased twelve times as fast.

Having the *ethical advantage*—paying attention to more than just returning profits to stockholders—can have a huge payoff. The *ethical advantage* can help your company perform to its highest potential.

Many firms take account of the interests of stakeholders beyond customers, employees and owners. Typically, the community as a whole is thought of as a stakeholder. (Some firms also include suppliers and competitors when they think of stakeholders.) At the Center for Ethical Business Cultures, we believe that taking explicit account of the community is important to achieving a proper balance of the stakeholders' interests over time. The extent to which a company takes account of its community has come to be known as the company's "Social Performance."<sup>2</sup>

The business results of companies that explicitly consider the community as a stakeholder are quite consistent with Kotter and Heskett's findings. In fact, as recently as 1999 a survey of 52 academic studies of the relationship between Corporate Social Performance and Corporate Financial Performance showed that:

- 33 studies found a positive relationship between Social and Financial Performance;
- 5 found a negative relationship; and
- 14 found no relationship or were inconclusive.

Thus almost two-thirds of these studies found an ethical advantage of some significance, whereas less than one-tenth found the converse.<sup>3</sup>

Further, a 1997 paper on “The Corporate Social Performance-Financial Performance Link”<sup>4</sup> provides compelling evidence that Social Performance and Financial Performance are indeed linked. The authors concluded, “...that Corporate Social Performance is both a predictor and consequence of [a company’s] financial performance. That is, there is a simultaneous relationship, or a kind of ‘virtuous circle’.”

This notion of a “virtuous circle” is entirely consistent with the reciprocal nature of the relationship that a firm has with its stakeholders. For example, when we treat our customers well (as by providing quality products that perform at least as well as advertised), they will tend to reciprocate by treating us well (as by making larger and repeat purchases and referring other prospects to us.)

Let’s look next at the role of leaders in creating a larger economic “pie.”

## THE LEADERSHIP DIMENSION

*“Leadership is a matter of how to be; not how to do it.”*

FRANCES HESSELBEIN

Effective leaders need to articulate the organization’s mission and values in a way that is compelling for their employees—that helps give them a sense of purpose. Employees need a reason to get out of bed every morning and come to work, but most of them don’t seem to have a very good reason. According to a recent survey<sup>5</sup>, only 26% of American workers say they are “engaged” (loyal and productive). Some 55% of employees are “not engaged” (just putting in time). Worst, 19% are “actively disengaged” (unhappy and spreading their discontent). What a waste. What an opportunity!

The most valuable employees want to make a contribution to their customers and to society, and to learn and grow themselves in the process. An effective and ethical leader can give them chances to do so. Since most firms these days are engaged in a “war for talent”, having the *ethical advantage* can be decisive in attracting and retaining the most productive employees.



The *ethical advantage* becomes even more important in an economic downturn or a time of crisis. When your customers, employees and the community can trust your company to behave in an ethical manner, they will stand by you and favor your firm over a less-trustworthy competitor.

Effective ethical leaders must also do their very best to “walk the talk” themselves, i.e., to live the values of the firm. If they do not, all their good words will be viewed as hypocrisy. You may say you believe that “customers come first”, but how much time do you personally spend actually listening to customers? You may say you believe that “employees are our most important asset,” but when was the last time you left a group of “assets” waiting outside your office for a half-hour? What you *do* speaks so loud, it often doesn’t matter very much what you *say*.

Leaders need to build ethical behavior into the processes of the firm, so that all the employees live the firm’s values. In many cases, it is the job of the leader to be a good “steward” of an already existing ethical culture. Such leaders strive to improve the performance of the organization while at the same time carrying on the traditions and values that made the company strong in the first place. In other cases, a leader has to start building a culture from the ground up, whether in a turn-around situation or in a relatively new organization. In all cases, the leader will be a “role model”, and the effective ethical leader must model the desired behaviors consistently and persistently.

As mentioned above, leadership has little to do with charisma. Jim Collins, author of the best-selling business book Good to Great, has looked at companies that have gone from “a long period of being nothing special” to “sustained greatness”, to determine what characteristics these companies had in common. One of his findings is that in all these turnarounds, the CEOs “display a compelling modesty, are self-effacing and understated.” Collins says that this type of leader builds enduring greatness through a paradoxical combination of personal humility plus fierce professional will.<sup>6</sup>

The leader is also responsible for setting the ethical tone of all the systems of the organization, including a specific ethics program. A values-based approach focuses on the desired, rather than the undesired, behavior. An approach based solely on achieving compliance emphasizes the negative, concentrating on preventing and punishing wrongdoing<sup>7</sup>. A recent study indicates that the values-based approach works better.<sup>8</sup> In fact, if employees perceive the ethics program exists only to protect senior management, it can result in “more unethical conduct than if [the organization] had no ethics program at all.”<sup>9</sup>

[Values-based programs] produce highly committed employees who are aware of ethics and compliance issues, who seek advice within the organization, and who are willing to deliver bad news to their managers or report ethical/legal violations. Results also include less unethical/illegal behavior in the organization and better decision-making because of the organization’s ethics/compliance efforts.<sup>10</sup>

Jay W. Forrester, MIT professor emeritus and one of the leading experts in the dynamics of human systems, suggests that most organizations waste some two-thirds of their energy! What if your organization were to waste only one-third of its energy? That seems a very modest goal and yet, if we achieved it, we would be twice as effective as our competitors! How can we eliminate waste and increase our firm’s effectiveness? Forrester states that more than 90% of the effectiveness of an organization is attributable neither to physical

variables like assets or inventory nor to the vagaries of marketplace demand or economic cycles. Rather, over 90% of a firm's effectiveness is attributable to top management's leadership behaviors, the influence structure of the company, how goals are created, and how the past traditions of the organization determine its decision-making and its future.<sup>11</sup> In other words, over 90% of a firm's effectiveness is attributable to its culture. Ethical leadership is the way to create and maintain a productive and ethical culture. As we have seen earlier, the *ethical advantage* is quite real and can be very large.

## THE PROCESS DIMENSION

It is not sufficient for a firm to attempt to balance the interests of the various stakeholders, to have a compelling mission and values, and to have leaders who work hard to “walk the talk.” If these elements are not systematically built into the processes of the organization, they will not be effective. Conversely, if all of the business processes of the organization are aligned in manifesting these elements, the firm will almost surely be successful. We call this concept “process integrity.”

We spoke earlier of the reciprocal behavior of well-treated customers both buying more from us and referring others to us. But the process for serving customers does not operate in a vacuum. It is virtually impossible, for instance, to treat our customers well over time if we treat our employees badly; the customer and employee processes need to reinforce one another. And a change in one part of the system will “feed back” and cause a change in another part of the system, so alignment is critical. We need to have the right metrics for each part of the system, and to hold people accountable for their results. The processes must have integrity, both individually and collectively.

Sears' recent experience provides an excellent example of the relationships among various processes. Led by CEO Arthur Martinez, a group of more than 100 top-level Sears executives spent 3 years



rebuilding the company around its customers. The managers developed a business model of the company<sup>3/4</sup>the employee-customer-profit model<sup>3/4</sup>and an accompanying measurement system that tracks success from management behavior through employee attitudes to customer satisfaction and financial performance. In one of the more powerful examples, the model shows

that a 5-point improvement in employee attitudes will drive a 1.3-point improvement in customer satisfaction, which in turn will drive a 0.5% improvement in revenue growth. These numbers are as rigorous as any others at Sears, and every year, their accounting firm audits them as closely as it audits their financials.<sup>12</sup> Sears' top 200 managers now receive one-third of their compensation based on employee satisfaction, one-third based on customer satisfaction and one-third based on financial performance.

Some large companies, such as General Electric, employ highly technical processes that strive for total quality and "Six Sigma." Ethical behavior needs to be built into these processes, which are integral to the fabric of the organization. For smaller, less structured environments, a more intuitive and less rigorous approach is likely to be more effective, but again, it needs to be built into the fabric of the firm.

Process integrity means that the ethical culture permeates throughout the entire organization. Process integrity might require that any assembly worker has the authority to stop production if she notices a quality problem. It certainly requires that the firm's behaviors reflect its values. One classic example of process integrity is the Johnson & Johnson Tylenol case. When it was discovered that some bottles in the Chicago area had been tampered with and the capsules laced with cyanide, the company immediately pulled all Tylenol capsules from the entire U.S. market—at a cost of about \$100 million.

Because Johnson & Johnson's long-standing credo, "*The first responsibility is to the customer,*" was so deeply ingrained in the corporate culture, the company was able to immediately activate processes to protect and communicate with its customers, to react to their fears, and to provide what consumers needed. "Johnson & Johnson's creed and mission statement, plus a solid reputation and immediate action, enabled it not only to survive the catastrophe but to enhance its image with the public."<sup>13</sup>

Another example of a firm's behavior reflecting its values is the decision by Aaron Feuerstein of Malden Mills in Massachusetts to keep all of his 1,000 employees on the payroll following a 1995 fire that destroyed his factory. Feuerstein was being neither foolish nor saintly; he knew that his high-quality workforce was the key to his business strategy of customizing his Polartec and Polarfleece products to provide superior value. By retaining his entire workforce, he preserved the integrity of his value proposition and work processes.<sup>14</sup> Today, the employees are reciprocating. With Malden Mills in financial difficulty, the Associated Press reports that nine hundred union workers have agreed to give up paid personal days and freeze their wages until 2003. Massachusetts' members of Congress are interceding to help Malden Mills win more military contracts, and the state's governor has helped with financing. It really is true that a company's relationships with its stakeholders are reciprocal; what "goes around" really does "come around."

## **THE ETHICAL ADVANTAGE AND THE BOTTOM LINE**

Ethical leadership is not *sufficient* to be an effective business leader. There is no protection, for example, against a badly flawed corporate strategy. But we believe we have demonstrated clearly that ethical leadership is *necessary* for sustaining superior business results over time. (We also believe that the corporate strategy is less likely to be flawed if it results from listening to the firm's various stakeholders.)

By ethical leadership, we mean creating a framework for the organization that attempts to balance the interests of all its key stakeholders—customers, employees, owners and the community at large—and to maintain that balance in both the short term and the long term. We mean articulating a mission and values for the organization that motivate employees to get engaged—to “bring their whole selves to work” and unleash their creative efforts. We mean developing leaders who constantly try to “walk the talk” by living the firm’s values. And we mean having systems and processes throughout the firm that reflect its values and reinforce the kinds of behaviors that are desired.

Businesses that have this kind of ethical culture can, in fact, “make the whole economic pie bigger, so that each of the stakeholders can get a bigger piece.” In fact, as Kotter and Heskett showed, the pie may grow as much as 755 times faster! The *ethical advantage* can be enormous.

The concepts of ethical leadership are simple, though executing them is not easy. But what better way to differentiate your company from your competitors. Are you ready to begin?

## Endnotes

<sup>1</sup> *Corporate Culture and Performance*, by John P. Kotter and James L. Heskett; The Free Press; 1992.

<sup>2</sup> According to Margolis and Walsh in their recent book, “theorists have gradually developed a comprehensive definition of corporate social performance (Wood, 1991),” that is: “a business organization’s configuration of principles of social responsibility, processes of social responsiveness and policies, programs, and other observable outcomes as they relate to the firm’s societal relationships.” *Source: People and Profits?: The Search for a Link Between a Company’s Social and Financial Performance* by Joshua Daniel Margolis and James Patrick Walsh; Lawrence Erlbaum Associates; New Jersey; 2001.

<sup>3</sup> “The Relationship Between Social and Financial Performance: Repainting a Portrait,” by Ronald M. Roman, Sefa Hayibor, and Bradley R. Agle; *Business & Society*, Vol. 38, No 1, March 1999, pp. 109-125.

<sup>4</sup> “The Corporate Social Performance-Financial Performance Link,” by Sandra A. Waddock and Samuel B. Graves; *Strategic Management Journal*, Vol. 18:4, pp. 303-319 (1997).

<sup>5</sup> “Marcus Buckingham Thinks Your Boss Has An Attitude Problem,” by Polly LaBarre; *Fast Company*; Boston; August 2001.

<sup>6</sup> *Good to Great*, by Jim Collins; Harper Business; 2001.

<sup>7</sup> “Twelve Steps to an Effective Ethics and Compliance Program,” by Lisa H. Dercks, Center for Ethical Business Cultures.

<sup>8</sup> Klebe Trevino, Linda; Weaver, Gary R.; Gibson, David G.; Toffler, Barbara Ley, “Managing ethics and legal compliance: What works and what hurts,” *California Management Review*, Berkeley; Winter 1999, Volume 41, Issue 2, page 131; © University of California, Walter A. Haas School of Business. (cited in this paper as “Klebe Trevino”).

<sup>9</sup> Arthur Andersen News Release, “Arthur Andersen Study First to Identify and Measure the Effect Ethics/Compliance Management Programs Have on Ethical Behavior,” 25 January 1999, New York.

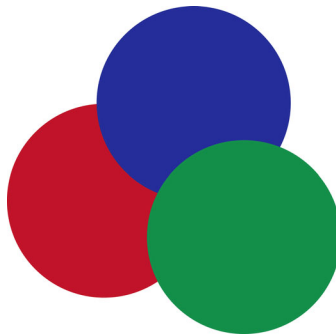
<sup>10</sup> Klebe Trevino, op. cit.

<sup>11</sup> *Industrial Dynamics*, by Jay W. Forrester; Pegasus Communications; Waltham, MA; 1961.

<sup>12</sup> “The employee-customer-profit chain at Sears,” by Anthony J. Rucci; Steven P. Kirn; Richard T. Quinn; *Harvard Business Review*, Boston; Jan/Feb 1998.

<sup>13</sup> “Lessons from the Tylenol Tragedy on Surviving a Corporate Crisis,” by Eileen Murray and Saundra Shohen; *Medical Marketing and Media*; Boca Raton; Feb 1992.

<sup>14</sup> “Not a Fool, Not a Saint”, by Thomas Teal; *Fortune*; November 11, 1996.



# About the Center for Ethical Business Cultures

## Mission

**CEBC assists business leaders in creating ethical and profitable business cultures at the enterprise, community and global levels.**

The Center for Ethical Business Cultures (CEBC), a non-profit 501(c)3 organization, adds value for its member companies and the community by

- *Promoting Awareness* – through research, publications and public forums – of the critical importance of business ethics and corporate citizenship;
- *Generating Products and Services* that assist companies in building ethical cultures; and,
- *Educating and Developing the Next Generation of Business Leaders*, in collaboration with its university partners.

The Center's products, services and research are focused in three areas:

- Ethical Leadership, Management and Culture
- Corporate Citizenship
- The Critical Employer-Employee Relationship

In a unique partnership, CEBC is closely affiliated with two outstanding schools of business – the **University of St. Thomas (UST) College of Business** and the **University of Minnesota (UMN) Carlson School of Management**. These critical relationships flow through the Koch Endowed Chair in Business Ethics at UST and the Andersen Chair at the UMN. In this way, the Center integrates the practical concerns and challenges of business and the research and educational talents of its academic partners.

## About the Author

James A. Mitchell is an Executive Business Fellow with the Center for Ethical Business Cultures (CEBC), where he brings his senior executive experience and perspectives to the design and implementation of CEBC programs and services. In particular, Mitchell brought the concept of Leading with Integrity to CEBC and oversees a series of CEO roundtables and a research effort to determine how ethical leadership adds value to the business bottom line.



Mitchell recently retired as Executive Vice President of Marketing and Products for American Express, with responsibility for \$180 billion in assets and \$750 million in net income. He was also Chairman of the Board of IDS Life Insurance Company, the nation's 14th largest life insurance company.

During his tenure as Chairman and CEO of IDS Life Insurance, the company became the fastest-growing and most profitable large life insurance company in the United States. Over this nine-year period, net income grew at a compound annual rate of 23%, and ROE improved to 21% (after tax).

A graduate of Princeton University, Mitchell is a Chartered Financial Consultant, a Chartered Life Underwriter and a Fellow, Society of Actuaries.



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