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through sustainability

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HOW A VALUE CENTERED APPROACH TO CORPORATE SUSTAINABILITY CAN PAY OFF FOR SHAREHOLDERS *AND* SOCIETY

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ABOUT ECOS

helping business create value through sustainability

Ecos Corporation's mission is to drive change by creating value for business through sustainability — helping to raise the quality of life for all people while preserving ecological integrity.

We are a passionate group of business professionals and former social change campaigners who now work together as strategic advisors to large corporations — to help them convert Values to Value™.

Ecos develops business strategies that build value through delivering social and environmental solutions. We do so because we believe market forces can be leveraged to speed the transition to sustainability. Working with some of the world's most influential companies and business leaders over the past seven years led us to believe the key challenge is not the lack of desire to act, but rather the lack of understanding and tools with which to act.

In response, Ecos works with its clients to develop people-focused and business-compatible paths for companies to "operationalize" sustainability. This is the second in a series of discussion papers where we will share the results of these efforts. For more information about Ecos and our work, see www.ecoscorporation.com

acknowledgements

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- All present and former Ecos team members, with Rick Humphries, Mark Lyster and Cath Bremner playing particularly crucial roles in this paper.
- All of our clients over the last 7 years. Client work that was particularly relevant to the development of these concepts included DuPont (where Dr Paul Tebo has been a key thought partner for us), SC Johnson, Ford Motor Company and BHP Billiton.
- All reviewers of earlier drafts of this paper, including our friends and colleagues John Elkington and Geoff Lye at SustainAbility, Linda Descano from Citigroup Asset Management, Rob Day of Bain & Company, Matt Arnold from WRI, Simon Zadek of AccountAbility, and David Tepper.

introduction

This discussion paper argues for a shift in how sustainability is integrated into business. The shift is necessary for sustainability to move from the margins into mainstream business strategy.

- **Part 1** argues that a central focus on "value creation" is now a more effective way of creating business action on sustainability than a primary focus on the "moral imperative". More sustainability will be delivered faster by business if the profit motive becomes the dominant driver and framework for analysis rather than "corporate social responsibility" in its various manifestations.

- **Part 2** outlines how the idea can be applied by sustainability-focused companies targeting, delivering, measuring and communicating value creation. It also proposes some practical tools and frameworks that can be used in doing so.

It may seem odd that when even the President of the United States is talking corporate ethics and responsibility, we are arguing for a focus on value. The massive accounting frauds perpetrated by Enron, WorldCom and others have actually reinforced our view that sustainability should be considered and approached from a value perspective. There can be no greater value loss than your whole company going under. The fear this could happen is therefore the ideal motivator to address sustainability.

Whatever they claimed, Enron and WorldCom clearly did not have strong ethics and values integrated into the culture of their businesses. If they had, their fraudulent reporting would have been confronted internally before it ever reached the outside world.

In this way, the integration of values and ethics into business operations builds the critical foundation for sustainability. Only from this foundation, which is really a foundation of integrity, can companies build long-term, sustainable shareholder value (rather than the ephemeral variety recently witnessed).

Our paper has two main audiences in mind:

- **Business leaders**, on the grounds that focusing sustainability efforts on value creation is the best way to maximize the financial value created (good for the company) and also the best way to integrate sustainability concepts into a company (good for society)

- **Advocates of sustainability**, on the grounds that the world needs to achieve dramatic change in social and environmental outcomes globally and quickly, and that harnessing the power, adaptability and "can-do" culture of business is the best way to do this.

The authors have worked for many years with major corporations that are seeking to adopt, or "operationalize" sustainability. We do this work based on two simple assumptions:

- **The problem.** Our economy is not currently sustainable; in fact, its trajectory poses serious threats to the stability of our society and global eco-system. So we need to act – urgently, globally and dramatically – to transform the economy. And, we need to mobilize this global transformation in a world without effective global governance.

- **The solution.** We believe the only way to achieve the scale of transformation needed, at the speed required, is to mobilize global market forces. If we are to mobilize them, then the pursuit of sustainability must be aligned with the pursuit of growth, profit and competitive advantage. Nothing else will work quickly enough.

When investors and corporate boards believe action on sustainability will lead to the creation of value – not in a generic sense, but in a definable and measurable way, sector-by-sector and company-by-company – then the case for corporate action on sustainability will be unstoppable. That is our objective.

PART 1 – WHY VALUE SHOULD BE THE CENTRAL ORGANIZING BASIS FOR CORPORATE SUSTAINABILITY

the pursuit of value drives change

Creating value drives change in business. Innovators with passion are the sparks, but real change led by business doesn't happen until an idea helps a company succeed. Microsoft changed the world not because Bill Gates had the best computer operating system, but because he built a hugely successful business that served the needs of many customers and created enormous value for its shareholders. Sam Walton did not change the competitive landscape of retailing in the USA because he thought of offering lower cost goods to customers distant from urban centers, but because he made the formula succeed and built Wal-Mart into the world's dominant retailer.

Market forces are driven by the pursuit of profit and growth. When an idea is commercially successful, market forces divert ever-greater resources to replicate it and trigger a self-reinforcing cycle.

Creating value – and reporting it at the financial bottom line using accepted accounting and reporting approaches – drives change in business further and faster than anything else. Crucially, in the sustainability context, this change can happen at a speed and a scale that quickly impacts the whole global economy and society. Enron, WorldCom and all those dot.coms that crashed and burned before them serve as a powerful reminder that value creation must be both genuine and sustainable, or the change is likely to implode and disappear even more quickly than it took shape (see page 7).

SUSTAINABILITY – MORAL IMPERATIVE OR SOURCE OF VALUE?

So value drives change, but does sustainability create value? The case that there is value at stake for most companies in most industries in their performance and positioning on environmental and societal issues is strong, measured and consistent with intuition (see Appendix for more detail and references on this). So the logic is clear – value is at stake in sustainability and therefore successful strategies to manage sustainability will create value.

Despite this logic, many advocates of sustainability – even many of those at the helm of major corporations – do not generally argue for sustainability on the grounds that it creates value. Sustainability is generally positioned as a *moral imperative* and obligation – a kind of modern corporate version of the medieval *noblesse oblige.*

In fact it is often presented as contrary to the pursuit of profit. Many argue that companies should not just be focused on the “ruthless pursuit of profit”, but should pursue other things **as well**. That effectively says those other things aren't profitable, and therefore positions sustainability *against* value.

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applying the moral imperative approach

The king and queen of ideas within "the moral imperative" framework are Corporate Social Responsibility and the Triple Bottom Line. The crown prince of both, and heir to the throne, is Sustainability Reporting.

All three have been genuinely valuable in the corporate sustainability debate. They are simple ideas that are easily picked up and communicated and have provoked widespread discussion and innovation, though often within limited areas of the businesses concerned.

CORPORATE SOCIAL RESPONSIBILITY

Corporate Social Responsibility immediately implies obligation to do things that are against what business wants to do. In other words, to do things that are against the flow or natural state. Business wants to create value, not incidentally or by surprise, but actively pursue it as the central focus of business strategy. That is the nature of the beast.

So anything that is not in harmony with the pursuit of value and growth will soon be relegated to a second or third tier priority for business. This is not where sustainability needs to be.

WHEN IT COMES TO BOTTOM LINES THERE IS ONLY ONE THAT REALLY MATTERS

The concept of the Triple Bottom Line (TBL), developed and popularized by one of the world's leading and most successful sustainability advocates, John Elkington of SustainAbility, delivered very significant benefits as an agent of change.

TBL is easy to communicate and to understand as a high level concept. It provides a useful framework for reporting performance in areas beyond company financials, and it challenges a sometimes obsessive focus on short-term profits that can be imposed by the Wall Street-led custom of quarterly financial reporting. TBL provoked new thinking and challenged the isolationist and narrow mindset of many in business. As an agent provocateur for sustainability, it has had few equals.

But now we need a revolution. Sustainability needs to move to center-stage for business decision-making and the TBL has fundamental weaknesses if companies try to use it as a framework for business strategy. The two key ones are:

- The self-reinforcing feedback loop for financial value creation is overwhelmingly powerful and fast, whereas the feedback loops for social and environmental performance are weak and slow. Thus the bias will overwhelmingly swing back to the traditional financial bottom line, making a TBL focus a slow change agent.
- The application of the idea tends to encourage a separation of environmental, social and economic performance, with the unspoken (and unintended) message to business being "we don't mind if you make money as long as you add social and environmental value while you're doing so". What's needed is a concept that integrates, not separates. It needs to clearly and simply say: "If you create more social, and environmental value the right way, you'll create *more* financial value as a *direct and measurable result*."

MONEY TALKS - WHY FINANCIAL REPORTING IS MORE POWERFUL THAN TBL REPORTING

Financial reporting drives behavior not solely because it is disclosure, but because of the positive and reinforcing feedback impact on shareholder value. It is this alignment between the interests of investors and management that makes financial disclosure powerful.

Investors invest because they believe there will be strong financial performance. Managers strive to produce strong financial performance because they believe their success will be rewarded. The financial reporting merely serves up the results so all the parties can know whether things are going according to plan. This alignment, or loop, is shown below.

Reporting without the reinforcing loop does drive change, but the force is much weaker. As a result, it drives less profound change less quickly. The potential for positive feedback from TBL reporting exists, but it lacks the impact of the synergies that result when the mutually reinforcing goals of shareholders and management are publicly shown to have been achieved.

The power of this feedback loop never has been more evident than with the outbreak of accounting fraud and deception that recently swept a number of high-profile companies. Once investors knew the financial disclosure was false, they rushed to the exits en masse. In the first day of full trading following WorldCom's announcement that it had falsely booked expenses as capital expenditures, the share price plunged 93 percent.

DEFINITIONS: TBL, CSR

The TBL has enjoyed considerable uptake since John Elkington first introduced the concept in his 1997 classic book *Cannibals with Forks*. Today, the website of his firm elaborates on what the TBL means:

> "At its narrowest, the term 'triple bottom line' is used as a framework for measuring and reporting corporate performance against economic, social and environmental parameters.
>
> "At its broadest, the term is used to capture the whole set of values, issues and processes that companies must address in order to minimize any harm resulting from their activities and to create economic, social and environmental value."

CSR is described by the World Business Council for Sustainable Development thus: "Corporate social responsibility is the commitment of business to contribute to sustainable economic development, working with employees, their families, the local community and society at large to improve their quality of life."

SUSTAINABILITY PERFORMANCE REPORTING IS NOT BUSINESS STRATEGY

Amidst all the confusion on what do about sustainability, many have gravitated to social and environmental reporting, and more recently sustainability reporting. This is hardly surprising, as reporting is a practical and specific action that brings significant benefits compared to the costs of doing it. Reporting teaches companies more about their own business, and thus often identifies opportunities for savings. It also sometimes opens up the company to new ideas and relationships. So reporting is a good starting point, but that is all it is.

Certainly if there were more consistency in reporting standards, and reporting were more widespread, it would be more useful. Projects like the Global Reporting Initiative (GRI) are seeking to make this so, and that is to be welcomed. However, it will still not drive large-scale change for the reasons cited above regarding feedback loops.

Too many companies now seem to view reporting as their strategy on sustainability, rather than as a starting point and a tool for self-awareness and education, both internally and externally. They seek out ways to show that what they're doing creates social and environmental benefits so they can tell the world about them. Reporting, however, rarely drives companies to aggressively seek new activities that create social and environmental value. Therefore reporting is predominantly a communications strategy – an important and effective one. But it is not business strategy and it won't drive change quickly.

IT'S TIME FOR CORPORATE SUSTAINABILITY TO GO MAINSTREAM

The moral imperative approach to sustainability drove progress on sustainability to this point. In the absence of a clear understanding of how sustainability could create value, and in the face of overwhelming evidence of the social and environmental challenges for society, the moral imperative provided a powerful base on which to build momentum for change. It is also the basis on which most sustainability advocates, inside and outside corporations, are personally motivated (including the authors of this paper).

But it's time for the sustainability debate to move on to the next stage. Business is, at its core, motivated by the creation of value and the pursuit of growth. The financial value on offer and at risk through sustainability is now crystal clear (as will be discussed later in the Appendix). Thus there is no longer any need to base the argument for business action primarily on the moral imperative. It's time to move the argument to the belly of the beast.

value-focused sustainability — the next stage

KNOW YOUR OBJECTIVE

Given that this paper is about strategy for driving corporate action on sustainability, we should be precise about the outcomes we would like to see those strategies achieve.

The shift towards sustainability we believe is most urgently required is of a quite "industrial" nature, and is needed quickly and globally. We refer here to the need for new houses, new types of cars, more wealth for the poor, new materials, new energy sources, more food in the right places, more clean water, clean industrial processes, and many other basic changes in the way we live our lives. These changes might not make the world perfect, but they would be a good start.

This is the objective for which a focus on value is proposed as the best strategy. That's because this is what the market, in the pursuit of value, does particularly well – marrying innovation with the investment support it requires to rapidly expand the application of a technology or an idea across the global economy.

WHAT WE ARE ADVOCATING

We understand most sustainability advocates are already well informed about how value can be created through action on sustainability and how corporate responsibility is "good for business". This area is well studied and the knowledge widely applied. This typically takes the form of "sustainability has a positive impact on business success" and "companies have value at stake across social, environmental and economic dimensions". These are both true.

What we are arguing, however, is this is still not sufficient because the argument is put in the wrong order – "focus on sustainability and you will then create value". We argue that:

A **primary** focus on the creation of value in advocating, designing and implementing corporate strategies on sustainability is a more effective way to encourage action by business than a focus on the "moral imperative" or social responsibility.

Part 2 of this paper describes the application of this idea.

WHY WE ARE ADVOCATING A PRIMARY FOCUS ON VALUE CREATION

Put simply, we believe a focus on value drives change more effectively and therefore drives more change. The logic of this has three key elements:

1. If a business focuses on value creation when undertaking actions and initiatives in the name of sustainability, it is far more likely to create value.
2. If companies consistently create, measure and report value from sustainability, then financial markets are far more likely to recognize it and reward the company.
3. If investor recognition occurs, it will create a positive, self-perpetuating loop encouraging more business action on sustainability, in turn making it more likely that corporate sustainability itself will succeed in the long term.

Using a value creation focus makes sustainability central to the mission of the organization. This is because:

- It is familiar and builds on systems already in place.

- It integrates sustainability with other issues the business is dealing with by allowing use of the same processes to measure and monitor performance.
- It focuses on the same motivation that enabled businesses to develop dramatic, world-changing innovations in other arenas.
- It broadens the potential support base for sustainability within the business to include those motivated by financial value creation.
- It draws on the historical strengths of business thus allowing it to approach the challenges of sustainability from a position of confidence.
- It creates alignment within the broader business system, including financial stakeholders.

WHAT A FOCUS ON VALUE WILL **NOT** ACHIEVE

Several reviewers of an earlier draft of this paper expressed the concern that not all actions in sustainability would in fact create value, so a focus on value had the downside that it could provide justification to companies for not acting on sustainability. This concern has been raised with us often, since we began advocating a value focus. So it is an important concern to respond to in this paper – what will a focus on value not achieve and what are the risks in such an approach?

In the desire for strong advocacy and in the well-intentioned search for win-wins, sustainability advocates often miss a key unpleasant reality. It is not always profitable or appropriate for a particular company to do the "right thing" with regard to sustainability. It could be the market conditions, the capital stock, customer preferences, the regulatory framework or any number of factors resulting in that conclusion.

A focus on value will not address this problem. But it will not exacerbate it, either. In this sense, it is no worse than a morally-inspired focus on social responsibility, which will not cause a company to pursue a strategy that is against its commercial interests either – at least not for long.

In these cases – where doing "the right thing" is unprofitable – what will drive change is primarily outside the control of the corporate sector. For example, shifts in regulation or in long-term consumer preferences can change market conditions. This type of change, though, is more within the scope of governments and activists, and is an area where the moral imperative can be a useful tool. (This is not to downplay the potential for corporations to be involved in shaping markets in this way, but they will not be the primary driver.)

The value focus raises the issue of the comparative financial performance of companies identified as sustainability leaders. This is a kind of sacred cow in the sustainability community that very few talk about publicly.

It is well accepted by an increasing number of business analysts that sustainability describes a very useful framework for management to think about their business and their marketplace. It is also increasingly clear that strong performance in sustainability, on average, is associated with stronger financial performance (see Appendix). However that does **not** mean a company focused on, or identified as a leader in sustainability will therefore do better financially. Sustainability is not a business strategy by itself. It is an addition to and perhaps an indicator of, but never a replacement for, high-quality leadership and management.

A company needs to understand and integrate sustainability themes and drivers where appropriate but also must know what the limits are to doing so in its market and business context. There have been several examples of so-called sustainability leadership companies damaging their basic business. In that context, their focus on sustainability may have in fact contributed to their failure by distracting them from running their business. Ironically, their enthusiasm for sustainability undermined the very cause they were advocating.

We would argue that a focus on value is the best way to avoid this risk of a potential disconnect between sustainability leadership and good basic business management. If creating value is the uniting principle, then it provides a framework for decision-making that can keep the business on track while it is pursuing sustainability.

IS THIS SUSTAINABILITY WITHOUT A SOUL?

We are not arguing that a focus on value in a "values-free zone" will achieve sustainability. The recent spate of accounting frauds among public companies laid bare the disastrous consequences of abandoning values in the pursuit of pumping up share prices. The outcome of that is neither sustainability nor lasting shareholder value. We are arguing that if a business decides to pursue sustainability (regardless of whether it is led to that decision by values or value), then it should use value as a framework for determining *what* to do and *how* to do it.

The foundations of the moral imperative argument – the values of the company (e.g. purpose, ethics, business principles, core beliefs) and the sustainability needs of society – are still central to both the reasons for acting and the way to act. They provide increased credibilty and trust, guidance towards opportunity, a principle-based context for decision-making, a basis on which to forge value-adding partnerships with other parties and a great motivation to individuals (internal and external) to want the company to succeed.

CONCLUSION – PART 1

There is no doubt sustainability frames a set of drivers that can create and destroy value for corporations. This is not new. The challenge is how to approach sustainability in ways that create the **most** value and therefore encourage the most active uptake of these ideas by the business community.

At the risk of stating the obvious, starting with a focus on value is an effective technique for value creation. That's why business does it as a matter of course and there is no reason to quarantine sustainability from normal business practice.

Part 2 of this paper outlines tools we find helpful in getting companies to apply this value-driven approach.

PART 2 – SINGLE BOTTOM LINE SUSTAINABILITY — THE APPLICATION

the guiding principles

While there has been lively debate on whether a value-centric approach to driving sustainability through companies is a good idea, there has been significantly less exploration of practical ideas about how to actually do it.

There certainly has been significant work in the value area, notably by Matt Arnold and Rob Day[1], Professor Stuart Hart[2], companies like DuPont[3] and several publications of the WBCSD[4]. Others have come at the question of how companies create value through sustainability from the vantage point of the financial markets, including most visibly SAM Sustainable Asset Management and Innovest. They have developed useful tools for measuring the value creation potential of sustainability performance, which in turn has led to indexes like the Dow Jones Sustainability Index and others. Likewise, the field of environmental and full-cost accounting at the firm level broke a path in this area, as have the handful of companies that have utilized those accounting techniques to describe the financial dimension of their environmental efforts, including IBM, Baxter International, British Telecom, and National Co-op Bank[5].

The practical tools discussed here draw on the efforts of these pioneers in the field and are rooted in our hands-on experience with large companies attempting to become more sustainable. Out of that experience, Ecos developed a set of straightforward principles that underlie the practical business tools we use to address the main questions corporate leaders have about value and sustainability.

Seven key principles frame our approach to making value the starting point in corporate sustainability. They are:

PRINCIPLE 1: Focus on value from the outset; be clear that value creation is the objective

It all begins with intention. If value creation isn't a priority, it is less likely to happen. Value is also less likely to be created if value considerations are applied as an afterthought or an attempt to justify existing efforts after the fact. Intent to create value leads to the design of sustainability initiatives so they create more value.

PRINCIPLE 2: Think of value broadly

It's easy to fall into the trap of thinking the value from sustainability initiatives will be measurable only in the form of current earnings. Plenty of initiatives that produce such

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[1] Matthew B. Arnold and Robert M. Day, *The Next Bottom Line: Making Sustainable Development Tangible*, WRI, 1998.

[2] Stuart L. Hart, in various publications, including *Beyond Greening: Strategies for a Sustainable World*, Harvard Business Review, January 1997.

[3] Chad Holliday, CEO DuPont, *Sustainable Growth the DuPont Way*, Harvard Business Review, September 2001.

[4] J. Blumberg, G. Blum, & A. Korsvold, *Environmental Performance and Shareholder Value*, Conches-Geneva, World Business Council for Sustainable Development, 1997 and *Eco-Efficiency: Creating More Value with Less Impact*, Conches-Geneva, World Business Council for Sustainable Development, 2000.

[6] See the annual environmental or sustainability reports of IBM, Baxter International, BT and National Co-op Bank.

current earnings gains do exist (particularly eco-efficiency improvements), but many sustainability efforts create value in the form of intangible assets or flexibility, and that will be realized – in part or wholly – in the future.

Intangible assets, also called intellectual property or knowledge assets, are a tricky but increasingly important part of overall corporate valuations and are particularly important in corporate sustainability in the form of reputation, customer loyalty, and knowledge that can be leveraged into future offerings.

Corporate sustainability strategies create flexibility to accommodate an uncertain future in which social and environmental drivers become increasingly important. Thus, many sustainability strategies can be seen as:

- Providing flexibility to accommodate stricter environmental and social regulations in the future,
- Building product platforms that serve as the basis for a range of new products with sustainability attributes,
- Preserving reputation and brand integrity that will give the company added leeway with stakeholders, and/or
- Protecting a company's right to operate and renewing the license to grow.

While there are significant challenges in valuing intangible assets and flexibility – whether related to sustainability or otherwise – that should not prevent their being measured for the value they *do* create. Intangible assets and flexibility are not magic, but they are critical precursors to conventional value.

PRINCIPLE 3: Identify the value case; understand the value at stake in sustainability first generally, and then for your company in your industry and marketplace

Most discussions of the business case for sustainability emphasize case studies and academic studies of statistical correlation. This is a first step and useful guidance, but no more. It only shows that on average companies focusing on sustainability create more value than those which don't.

The essential step is to get specific – understand how your business creates value in your particular context, and then understand how sustainability could influence that.

This can lead to dramatically different actions in different companies. Sustainability principles based on the moral imperative are fairly consistent across geographies and sectors. However, business strategies on sustainability, when they are based on value creation, are very different in each situation because they depend on a company's particular context.

Corporate sustainability **can** create value. In some areas this is tangible and in some more intangible, but they all ultimately translate into conventional financial performance, and that is where they will be judged: in their capacity to increase margins, grow revenue, reduce risk and increase capital efficiency.

PRINCIPLE 4: Reach beyond your traditional value chain to find greatest value

Many of the greatest opportunities to create value lie beyond what your existing customers or suppliers can tell you. A focus on creating the greatest value should inherently lead you to explore new offerings (e.g., substituting service for product) and therefore to consult not only with existing customers and suppliers, but also with those who are not yet your customers or suppliers, and may never become them.

Customers rarely ask for transformational changes, which are often outside their frame of reference as customers. Alternatively, customers of customers and critics of various parts of the entire value chain may be the source of the most provocative insights into new offerings that can reach new customers with unique value propositions.

PRINCIPLE 5: Evaluate possible strategies against their potential to create or protect significant value for your business

Once you establish sustainability does put value at stake for your company and you understand how and why, you need to evaluate specific potential actions against their capacity to capture that value and then adapt them to do so more effectively. The key consideration is the analysis must be specific to the strategy and the company.

Size matters. Not every idea that creates value is worth pursuing. It is important to develop an understanding of how large the opportunity to create or destroy value is in each situation.

PRINCIPLE 6: Apply simple rigor to the process

There are a lot of excuses for not measuring the value created by sustainability strategies, but none of them are valid. True, it does require some upfront planning and discipline, but it is not really all that daunting. Most business decisions involving new ideas are based on estimates made with imperfect information. A good example is the rise of the quality movement, which is now an industry staple. So the approach should be:

- Measure what you can,
- Estimate what you can't measure, *and*
- When you don't know how to estimate the value, carefully describe where the value will come from, how big it can reasonably be expected to be, and what the implications of pursuing this opportunity are for the company.

PRINCIPLE 7: Don't argue the value case; create value, demonstrate how you did it, and explain how you will do it in the future

Many companies have a nearly compulsive desire to "sell Wall Street" on the value they are creating through sustainability before they've done a thing. It won't work. Wall Street is a "show me" sort of place where stories without demonstrable results don't get traction.

What Wall Street needs to see is more action and more results, not more argument and theory. Value is clearly at stake in sustainability. The challenge for business, and for all advocates of corporate sustainability, is to demonstrate how it is accessed and how it can be measured, and then to report it at the single bottom line year after year.

practical tools

In our experience, companies have the following practical questions about how to create value through sustainability:

1. **Generating Ideas:** What are the business opportunities and actions within a sustainability framework that may help our company create value?
2. **Making value-generating decisions:** How do we make decisions on what plans should be pursued, so that we really create value through sustainability?
3. **Implementing Plans:** How do we know we are creating value through our sustainability efforts?
4. **Communicating Results:** How should our company articulate the value we're creating through sustainability?

The first generation of tools and approaches Ecos developed address these questions.

generating ideas

In large part, corporate sustainability is about aligning the business and its products (and therefore the creation of shareholder value) with society's values. These values, of course, are not fixed or, for that matter, constant across all communities. Therefore a dynamic process is required to reach the most relevant players in the "value web" surrounding each company. Valuable insights into new offerings with unique value propositions for new customers can come from many sources. Such insights are as likely to be provided by more indirect stakeholders — such as customers' customers, suppliers' regulators and critics of various parts of the entire value chain — as they are to come from more obvious sources such as customers and suppliers themselves.

With this in mind, Ecos developed the first tool we apply called the Sustainability Strategy Guide — a framework for guiding strategy development. The objective is to develop business strategies that align Societal Value Added and Shareholder Value Added. The point of doing so is that such strategies are inherently more robust because, when aligned, the two SVAs are mutually reinforcing:

- **More societal value leads to more value for shareholders** because the increased societal value builds more support from customers, regulators and the community for the company's success.
- **More shareholder value leads to more value for society** because the increased shareholder value builds the company's capacity to replicate the creation of societal value.

This process helps companies review both their current business activities and proposed sustainability initiatives to ensure strategy is more robust across the board.

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making value-generating decisions

THE SUSTAINABILITY VALUE SCREEN

Once a suite of possible sustainability initiatives is generated, the next step is to screen them for their value-creation potential. This is done using Ecos' second tool, the Sustainability Value Screen. Initiatives that pass this screen can be more fully researched using traditional financial analysis.

The Sustainability Value Screen provides a value-creation framework against which sustainability initiatives can be assessed. Our work indicates sustainability initiatives should create value in one or more of four primary drivers of shareholder value:

- Margin Improvement
- Risk Reduction
- Growth Enhancement
- Capital Efficiency

It is also important in evaluating potential initiatives to think through how much value they will create and when that value will be measurable in conventional financial terms. As mentioned above, the creation of intangible assets and flexibility is very important, but it is essential to know how they will be converted into present financial value.

The purpose of the screen is to aid more detailed analysis of sustainability initiatives by identifying where they are likely to generate value. The following is Ecos' interpretation of how sustainability can influence these four primary drivers of shareholder value.

- **Margin improvement.** Operationalizing sustainability can raise operational effectiveness by:
  - Driving process and product improvements that reduce energy use, waste and costs, and
  - Creating premium pricing opportunities by building customer loyalty, offering product differentiation, and improving access to niche markets

- **Risk reduction.** Sustainability can reduce risk and protect corporate (and brand) reputation by:
  - Creating new stakeholder relationships and improving existing ones,
  - Improving the company's capacity to anticipate and prepare for different futures,
  - Reducing liability exposure,
  - Reducing the risk of delay in new projects or product introductions,
  - Reducing financial risk by making a business less cyclical, and
  - Generating greater community support.

- **Growth enhancement.** A sustainability focus can help companies realize growth opportunities by:
  - Supporting new-product innovation,
  - Increasing sales of existing products and services,
  - Supporting expansion into new markets,
  - Attracting and motivating employees,
  - Providing access to new resources for creativity and innovation, and

- Helping build a leadership framework.

- **Capital efficiency.** Operationalizing sustainability can improve return on investment by:
  - Reducing working capital requirements,
  - Substituting knowledge for material, and
  - Replacing products with services.

AN EXAMPLE FROM DUPONT

DuPont Performance Coatings redefined its offering for painting automobile bodies from selling paint to selling the service of painting the vehicles. This significantly reduced the volume of paint needed per vehicle. In the planning phase, the application of the screen might have looked something like this:

- **Should increase margins; we'll have the incentive to minimize waste and capture unused product;**
- **If we are right that we can apply our knowledge of the paint product to do a superior job, we should be able to enhance our growth by offering superior value to customers;**
- **This will probably require incrementally more capital for the equipment to apply and capture the paints (depending on who owns it) and for working capital for the paint itself which would otherwise not be on our books; therefore, the increased margin needs to first cover that cost of capital.**

TRADITIONAL FINANCIAL ANALYSIS: APPLY IT TO SUSTAINABILITY

Companies use financial analysis to make a variety of different business decisions including capital expenditures, new product development, research and development, marketing expenditures, and many more.

We propose this financial analysis also be applied to sustainability initiatives. The starting place is the conclusions reached about the initiative relative to the Sustainability Value Screen. If the initiative would increase margins, by how much? If it would increase revenues, by how much, and by when? There are some areas that need new tools or skills developed, such as the valuation of risk avoided, but this does not mean financial analysis cannot be done.

implementing plans: how do we know we are creating value through our sustainability efforts?

Having generated ideas, developed plans and evaluated them using the techniques described, a company should have a suite of sustainability initiatives that are likely to produce shareholder value. Throughout implementation, it is crucial to measure the actual results of sustainability initiatives in practice. The company can compare the results with those anticipated in the planning stage to learn how to improve its ability to estimate the value created. It can also use this measurement of results in turn to produce more value from an initiative through refining its implementation in light of new information.

Some of the same principles used in the evaluation phase apply to measuring the results. Measure actual results where possible. Estimate what you can't measure. For that which you can't estimate, understand and describe the source of value carefully and gauge its order of magnitude and direction.

Measurement can apply to specific financial results – how much was the cost of energy reduced, how much did our margins improve, how much did this market grow – or it can apply to measuring operating indicators the company believes are linked to value creation. These might include quality, customer satisfaction, reputation, employee morale and new product development. It is important, however, to understand these indicators don't create value until and unless they affect margins, growth, risk, or capital efficiency.

AN EXAMPLE FROM BRITISH TELECOM

British Telecom has a well-established leadership position on corporate sustainability in the UK and the telecommunications sector generally. BT set out to explain the value of its sustainability effort to investors in a way that was:

- Forward looking,
- Quantitative (dealing with its significance relative to other aspects of the business), and
- Expressed in terms of business strategy

BT's CEO, Ben Verwaayen, condensed his objectives for the company down to two, contained in a single sentence: "My primary objectives are to enhance BT's customers' satisfaction and to grow BT's business."

BT used its own historical data on customers to calculate how much its sustainability (expressed as "corporate social responsibility") efforts contribute to the "image and reputation" component of customer satisfaction. (The other components of customer satisfaction at BT are products and services, contact and experience, and price and value.)

The findings were that sustainability made up greater than 25 percent of the "image and reputation" component, and that every one percent drop in "image and reputation" rating would bring about a 0.42 percent drop in customer satisfaction. When it checked its model around this analysis, it found a very high correlation between actual and projected scores over the period January 1999-September 2001.

communicating results: how should our company articulate the value we're creating through sustainability to investors?

At this stage, a company following the suggestions here would have measured results of the value their sustainability efforts are producing, and have estimates of what their future initiatives might generate, based on this real-world experience. This is a suitable base from which to begin communicating the approach to financial stakeholders, particularly investors.

While there have been some novel ideas about how to communicate the value of sustainability efforts to investors, we favor an approach that is built around the ability to quantify the value created. That moves the conversation with investors onto familiar terrain. Are the estimates of value created credible? Are the plans for creating value this way in the future robust and can this team achieve that value according to the plan?

The other advantage of this approach is the company can aggregate the value across the whole company or break it out by smaller units or products. Six Sigma benefits from this same advantage with investors. Internal and external analysts can track the sources of value creation as well as understand the scale. This is powerful for several reasons. It enables internal analysts to emphasize and learn from particular initiatives with the greatest contribution to value. At the investor level, external analysts can judge whether or not it is a significant contributor to overall value and therefore worthy of more in-depth analysis.

Expect at least modest scepticism. Begin by explaining how sustainability is a source of financial results as measured by conventional means. Detail what those sources of value are for the specific company and in its particular industry. Explain how the sustainability strategy being implemented fits with and reinforces the company's strategy that investors already understand. It is important the financial markets don't see this work as a distraction from your current business, but rather as a reinforcement of your strategy.

conclusion

Single Bottom Line Sustainability describes our efforts to develop a framework and practical tools for creating value through sustainability by blending it directly into business decision-making. It puts sustainability squarely in the center of what business does best – making money and growing.

Part 1 describes *why* focusing on value is so important to driving sustainability, while *Part 2* explores *how* this can be done.

The sustainability challenge continues to increase in scale and urgency. Society needs to move quickly to begin the process of transforming our economy. Time is slipping away and the power of market forces is our best hope for rapid, dramatic and global change.

As a result, it's time to move beyond the moral imperative models – Corporate Social Responsibility, the Triple Bottom Line and sustainability performance disclosure – as the *primary* vehicles to drive change in business. The moral imperative driver will continue to be an important part of the puzzle, but it will never be the sweeping transformational agent we need. It will drive modest change, but will continue to leave many business leaders and investors confused and less than fully committed.

The basis of the moral imperative argument - the values of the company (e.g. ethics, business principles, core beliefs, purpose) and the sustainability needs of society - are still central to both the reasons for acting and the way to act under a value-driven approach. They provide:

- Increased credibility and trust (for example, with investors and customers in the face of recent examples of unethical and fraudulent corporate behavior),
- Guidance towards opportunity,
- A principle-based context for decision-making,
- The basis for (value-adding) partnerships with other parties, and
- A great motivation to individuals (internal and external) to want the company to succeed.

It is worth repeating we are not arguing that a focus on value will achieve sustainability. What we are arguing is if a business decides to pursue sustainability, then using value as a framework is the most effective method to determine what to do and how to do it. A value focus will also speak clearly to financial markets, which have the power to accelerate change. This approach will simply work better and as a result will drive more positive change faster.

APPENDIX: THE GENERIC VALUE CASE FOR SUSTAINABILITY

Many companies make their first foray into understanding value creation through sustainability by asking, "What is the value case for this?" This is obviously a critical question, but many fail to break it into three component questions:

1. Is there generally value at stake in sustainability?
2. Is there value at stake in sustainability for **our** company?
3. What are the financial merits of specific sustainability strategies we might pursue?

The process this paper addresses answers the latter two questions. The first question is important only because it answers whether it is worth investigating the next two questions.

That question *"Is there value at stake generally in sustainability?"* is the subject of considerable research which we describe briefly here.

The preponderance of evidence supports the argument that companies that produce more social and environmental value also produce more financial value. That conclusion is supported by research using several different analytical approaches and streams of data over different time periods. Beyond that, the research reveals virtually no evidence to support the contrary proposition that sustainability has a negative impact on financial performance.

Business school professors at University of Michigan and Harvard recently summarized the empirical work in the field and found that of 95 studies of the relationship of social and environmental performance to financial performance, three-quarters showed this relationship to be neutral to positive[1]. Most of these studies are regression analyses measuring statistical correlations. There are also a variety of other types of studies. Event studies measure the response of equity markets to social and environmental news about companies. Model portfolios compare the performance of hypothetical portfolios of stocks that are carefully matched except the stocks in one portfolio have superior sustainability performance while those in the other portfolio do not. One study attempts to add an environmental management variable to a mathematical stock valuation model and concludes the inclusion of the variable adds to the ability of the model to determine market values.

These empirical works use different data sets to measure the social and/or environmental performance of companies. But even though we lack standard measures, which raises questions about the strength of the results of the individual studies, it is important that the majority of these studies reach similar conclusions. They consistently find a statistically significant, positive relationship between crude measures of social and environmental performance and financial performance.

For more on these empirical studies see the following websites: *http://www.sristudies.org* and *http://web.mit.edu/doncram/www/environmental/envir-fin-literature.html*.

[1] Joshua Daniel Margolis and James P. Walsh, *People and Profits?: The Search for a Link between a Company's Social and Financial Performance*, Mahway: Lawrence Erlbaum Associates, 2000.

ABOUT THE AUTHORS

Paul Gilding assists in formulating sustainable business strategies for some of the world's leading corporations. As a former Executive Director of Greenpeace International, his 20-year involvement with social change organizations gave him a comprehensive insight into the processes of transformation, enabling him to assist business in forecasting and taking advantage of emerging trends. He has a thorough understanding of the challenges sustainability poses for companies, as well as the commercial opportunities it presents. Since establishing Ecos Corporation in 1995, Paul has advised leading international corporations including DuPont, SC Johnson, the Ford Motor Company, Placer Dome, BP (formerly BP Amoco) and Suncor Energy as well as Australian corporations including IAG, BHP, Lend Lease, Pacific Power and Western Mining Corporation. In 1997, Paul received the prestigious *Tomorrow Magazine* Environmental Leadership Award. In December 1994, he was listed by Time International in its "Time's Global 100 Young Leaders for the New Millennium" and in 1993 the Australian Prime Minister presented Paul with an Australia Day Award for Outstanding Achievement for services to the environment. In 1992, the influential World Economic Forum (WEF) appointed him a Global Leader for Tomorrow at its annual meeting in Davos, Switzerland. Paul can be reached at: paul.gilding@ecoscorp.com

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Don has worked in both the financial service and non-profit worlds. As Director of Research at The Carson Group in New York, he provided a range of capital markets consulting services to many of the world's largest publicly traded corporations. As co-founder and VP of Excelsior Capital Corporation, Don collaborated with leading pension funds to design, develop and implement new institutional investment products with positive economic development benefits.

In his NGO career, Don was Director of the Corporate Engagement Program and Deputy Director of the Management Institute for Environment and Business at the World Resources Institute (http://www.wri.org/) where he concentrated on questions of how investors should value sustainable business strategies and helped corporate partners enhance shareholder value through sustainable strategies. He also worked for an environmental lobbying group and a progressive coalition in his home state of Montana.

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HOW A VALUE CENTERED APPROACH TO CORPORATE SUSTAINABILITY CAN PAY OFF FOR SHAREHOLDERS *AND* SOCIETY

by Paul Gilding,
Murray Hogarth
& Don Reed, CFA

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