Building the Business Case

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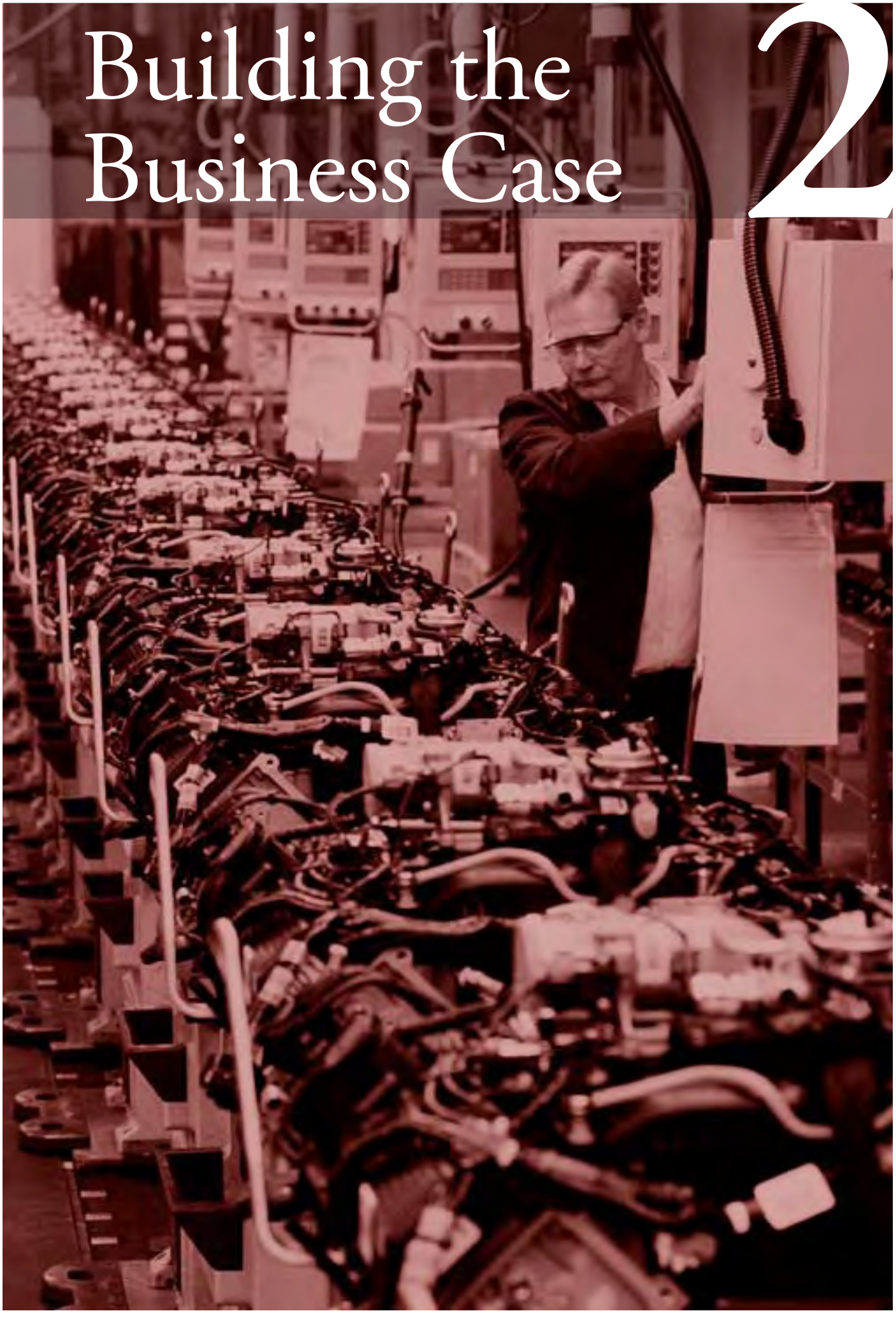

A Quick Look:
Labor Standards Performance Codes and Standards

Did growing this banana expose workers and their community to harmful pesticides? Was this apartment built using forced migrant labor? Were workers at this mine exposed to excessive working hours?

Stakeholders are more demanding than ever. Consumers have high expectations for price, quality, and convenience. And today consumers care just as much about working conditions and the environment. Investors are increasingly looking for similar assurance, knowing that news about child labor or worker mistreatment can be disastrous for a company and the value of its reputation. Investors look at non-financial and reputational risk. As they evaluate a company's performance, they are asking more and more questions: Are all workers covered for medical insurance? Do workers receive a pension when they retire? Does management respect freedom of association and the right to collective bargaining?

The expansion of global trade and investment has meant growth for companies, new opportunities for workers, and a growing range of high-quality, affordable products for consumers. But globalization also brings new risks. Responsible companies risk unknowingly doing business with firms that violate the rights of workers, damage the environment and undermine national labor laws. The global media web means that today's remote factory scandal can instantly become tomorrow's worldwide headline.

The journey in this generation towards improvement in working conditions really began as a risk mitigation strategy by the famous brands and retailers. It started as a means of protecting brand reputation in response to activist and media attention on poor labor conditions in emerging market factories. US and European consumer-goods companies started to really take a look at what was happening in the factories making their products. In many cases, it was ugly. Clearly, they did not want to tarnish their brand image by being associated with images of gross labor violations. So to reduce the risk to their image, the companies that were under attack established and published corporate codes of conduct. Corporate codes vary widely in their rigor and their credibility.

At this point, many US and European companies have a corporate code of conduct. In fact, companies that are suppliers to the large buyers are frustrated with the number of corporate codes they have to deal with, and their differing requirements. A big exporter can have dozens of corporate code audits per year – a wasteful duplication of resources. The resources could be better spent on making improvements on the factory floor that will benefit the workers and the operation of the facility.

Partially in response to the proliferation of corporate codes, industry codes were born. Logical step. Get the big buyers in a given industry to agree on a labor standards performance code and audit suppliers against the industry code. Industry codes have emerged to seek to minimize the duplication of corporate codes. Examples are the International Council of Toy Industries (ICTI) CARE program, the Electronic Industry Code of conduct (EICC), Worldwide Responsible Apparel Production (WRAP) and the Council for Responsible Jewelry Practices. Despite these steps, one factory in India had 98 corporate and industry code compliance visits in one year. This situation is far from unique. Although an extreme case, the situation is pervasive. Many factories undergo dozens of audits a year.

A step in the right direction. Right? Partially right.

There are a couple of key problems. First, from a retailer's perspective it is actually a step backwards. Look at a mass merchandiser that sells apparel, toys, sporting goods, electronics and food. The corporate code was easy for them. It was theirs and they gave it to all of their suppliers to follow. Now they have to deal with five producer industry codes.

The other issue is that industry codes sometimes overlook the areas of labor standards performance that are most difficult for the particular industry to meet. For example, overtime hours at peak production season. So the toy industry code may allow long hours for the Christmas production season. Agricultural codes may similarly allow long hours during planting or harvest season.

In addition to the evolution of corporate and industry codes of conduct, there is a parallel track promoting the use of standards. What's the difference between a code and a standard? Good question. Basically, a code is generated by the entity itself, whether it is a company, in the case of corporate codes, or an association, in the case of industry codes. A standard is issued by an independent party. There are published requirements that standard-setting agencies must follow in developing the standard, such as the ISEAL Alliance's Code of Good Practice for Social and Environmental Standards.

Social Accountability International developed the Social Accountability 8000 (SA8000) labor standard and certification system in 1997. The SA8000 standard is based on international conventions of the United Nations and the International Labor Organization (ILO). It uses an underlying management systems approach, similar to that used by the ISO9000 or ISO14000 systems of the International Organization for Standardization (ISO).

The World Bank's International Finance Corporation (IFC) developed a series of Performance Standards with the goal of creating a comprehensive set of guidelines for the environmental and labor standards of IFC- invested companies. PS2, Labor and Working Conditions, is also based on the ILO conventions, as are most of the credible corporate and industry codes.

Now there is a lot of talk in the corporate responsibility field about the convergence of codes. Everyone is looking to reduce the duplication of audits and focus resources on helping their suppliers to improve their labor standards performance. Retailer-led code initiatives include the Business for Social Compliance Initiative (BSCI) and the Global Social Compliance Program (GSCP).

For you, the most important thing to remember is that management systems are the key to improving labor standards performance. This is true to meet PS2. This is true to meet the requirements of the various corporate and industry codes.

The policies and procedures of the management system help ensure that labor standards performance will be ongoing and that there are systems in place to address problems when they arise. It facilitates auditing by requiring records.

The companies that are considered leaders in corporate social responsibility are coming to a shared conclusion: management systems are the key to continual improvement and ongoing labor standards performance in the supply chain. It is also management systems that serve as the foundation for integrating corporate social responsibility with a company's core business activities.

Clearly, the increasing awareness will lead to an improvement in social policy among corporations over the next five years. However, the challenge will be in implementation. Awareness and good intentions are only the beginning. Policies are an important second step. But ultimately it is effective implementation that will make a difference. The key to effective implementation will be the use of management systems that link social and environmental performance with a company's core business activities. The goal is for all parties to understand the importance of each job and strive to recognize the equal dignity of each person involved in the supply chain – from the worker to the manager to the consumer.

The Growing Importance Of Labor Standards Performance

The importance to consumers, investors and other stakeholders is growing. Recent surveys show that a large and growing number of people in all areas of business and civil society are influenced in their decisions by a company's social, labor and environmental performance.

Further, there is growing evidence that there is a link between a company's social, labor and environmental performance and its profitability.

As consumers and the media became aware of horrible labor conditions at emerging market factories, famous brands and retailers started to push their suppliers to improve their labor standards performance. Primarily the move was driven to minimize the risk to their brand's reputation. The tool they used with their suppliers was to threaten to withdraw orders. To date, labor standards performance has been largely imposed on suppliers through the use of "the stick."

This is starting to change.

The next decade will see a shift towards the use of "the carrot" for all types of companies to improve their labor standards performance. As companies integrate labor standards performance into their identities, and as consumers, investors and civil society increasingly incorporate CSR into their decisions, companies will see opportunities to generate more revenue through improved labor standards performance. So although the impetus to meet PS2 may have been in response to the "encouragement" (or demands) of IFC, we believe that you can use it as a competitive advantage.

Over the past decade, companies have focused on corporate social responsibility as a risk-management tool. They wanted to avoid the pain and damage of an incident. Companies tended to view labor standards performance as a cost, not an investment.

The next decade will see more mainstream companies start to proactively use their corporate social responsibility as a core element of their value and as a competitive advantage in the marketplace.

We will see companies view labor standards performance as an investment. It will be an investment that generates a measurable return, both through preventing damage to a company's reputation or through improving productivity and sales.

Reputational Risk

Reputational risk is broadly defined as events that undermine public trust in your company, project or product/service. More formally, the United States Federal Reserve issued the following definition: "Reputation risk is the potential loss that negative publicity regarding an institution's business practices, whether true or not, will cause a decline in the customer base, costly litigation, or revenue reductions (financial loss)."

Companies and investors are becoming more aware of the critical importance a company's reputation has on its performance. One large investment fund measures and tracks four types of risk as part of its investment strategy:

- → financial risk
- → operations risk
- → compliance risk
- → reputation risk

In part, the increased awareness of reputational risk it because the last decade has seen many cases of companies being destroyed by damage to their reputation.

In one of the more extreme cases, the accounting firm Arthur Anderson fell apart almost entirely due to its destroyed reputation from the Enron scandal in 2002. Arthur Anderson, who's customer was Enron, had been in business since 1913 and had revenue of $9.3 billion in the prior year. They were never able to recover from the damage to their reputation.

> "It takes twenty years to build a reputation and five minutes to destroy it.... If you lose dollars for the firm, I will be understanding. If you lose reputation, I will be ruthless."
>
> Warren Buffet,
> Chairman of Berkshire Hathaway

In the same way, a company's reputation can be harmed by its suppliers. We've already looked at that in relation to the development of corporate and industry codes.

Labor rights and working conditions are important elements in your company's reputation. Using management systems to meet PS2 will significantly reduce the risk to your reputation from labor problems in your workplace.

Clearly the labor standards in your company and your supply chain is a critical part of managing your reputational risk. Just to reinforce the point, according to Edelman's 10th Trust Barometer, 77% of respondents in the global survey refuse to buy from companies they distrust.

Just as there are clear dangers to having a bad reputation, there are clear benefits to having a good reputation. According to the Reputation Institute's 2009 Global Reputation Pulse, "Firms with strong positive reputations developed from well-articulated reputing strategies are better poised to improve in a number of ways: attract better talent; be perceived as providing more value, which often allows them to charge a premium; have customers who are more loyal and buy broader ranges of products and services; and, because the market believes that such companies will deliver sustained earnings and future growth, have higher market value and lower costs of capital."

It doesn't matter whether you start the process of improving your labor standards performance to avoid painful damage to your reputation, to improve the performance of your company, or improve the lives of your workers and the community – the important thing is to just start. Later in this section we hope to convince you that there are bottom-line business benefits to improving labor standards in your company.

Importance to Investors

Social and environmental issues are an important, stated condition for investment or lending by the International Finance Corporation (IFC). PS2 is now being used by export credit agencies around the world as a guideline for evaluating the labor standards performance of companies. A growing number of the world's largest private banks have adopted the Equator Principles as a benchmark to manage social and environmental issues in project finance.

The investment community is increasingly seeing that corporations must consider environmental, social and governance issues as key elements of any long-term growth strategy. This belief has spawned the field of socially responsible investing. Originally a boutique part of the business, major multi-national banks and investment firms are now setting up business units to focus on socially responsible investing and/or factoring social responsibility into their investment and lending decisions. There is an estimated US$5 trillion in these targeted funds.

Of equal importance, the ideas of sustainability and reputational risk are starting to work their way into all investment analysis.

- 80% see the existence of high performing CSR programs as a proxy for how effectively a business is managed
- 74% believe that labor standards performance will add long-term shareholder value
- 82% of European and 59% of North American companies somewhat or fully integrate environmental, social and governance into all corporate project evaluations

McKinsey Quarterly (Feb. 2009) survey of 238 CFOs, investment professionals and finance executives.

In a May 2007 interview published by McKinsey Quarterly, David Blood, previously the head of Goldman Sachs Asset Management, and current partner at Generation Investment Management, said, "Sustainability investing is the explicit recognition that social, economic, environmental, and ethical factors directly affect business strategy—for example, how companies attract and retain employees, how they manage the risks and create opportunities from climate change, a company's culture, corporate-governance standards, stakeholder-engagement strategies, philanthropy, reputation, and brand management. These factors are particularly important today given the widening of societal expectations of corporate responsibility."

Lending and investment decisions are based on assessing the risk, and it is clear that a company faces performance risks based on its corporate social responsibility performance. The risks to a corporation's performance are both short-term and long-term. Labor strikes, media exposés, product recalls, serious accidents are all examples of events that can have an immediate negative impact on a company's sales and its related value to shareholders.

There appear to also be long-term risks that can be mitigated through improved corporate social responsibility performance. Better worker-manager relations reduce worker turn-over. Integrated labor standards performance and productivity systems reduce defect rates. The sustainable sourcing management of raw materials helps ensure supply and stabilize prices. Intelligent product design minimizes waste in production and packaging.

Although environmental compliance and sustainability has taken the lead in gaining media and corporate attention, the growing attention is beneficial to labor standards performance. Academic

research is underway seeking to identify links between high-level CSR performance and financial performance. Results from these early studies are likely to cast more of a spotlight on the topic.

Increasingly, the investment research community is interested in the environmental, social, and governance factors that affect the company and how management is adjusting their strategy to account for them. These newer measurements are starting to be incorporated into traditional mainstream financial research. Early results from traditional finance companies are encouraging. In a multi-industry review, Goldman Sachs found that companies that have environmental, social and governance (ESG) policies in place have outperformed the general stock market by 25% from August 2005 – December 2007. As we know, having a policy in place is a pretty low bar, but it is a step in the right direction.

Companies consistently participating in the Corporate Responsibility Index outperformed the FTSE 350 on total shareholder return 2002 – 2007 by between 3.3% and 7.7% per year and demonstrated decreased share volatility, according to an article titled “Now is the Time” published in Business in the Community.

Bottom-line Business Benefits

Enhancing Business Performance

The message is getting the attention of CEOs and business executives. A recent survey by McKinsey & Company released at the UN Global Compact Leaders Summit found that 90% of surveyed CEOs were doing more on environmental, social, labor and governance issues now than five years ago. The CEOs increasingly see their business' performance linked to their environmental and labor standards, as the CEOs project that consumers will soon become the most influential stakeholder in shaping corporate policy.

Despite a growing awareness of labor standards performance issues, there is still a significant gap between awareness, policy and performance. The McKinsey survey found that only 27% of the companies have a policy that addresses social, labor and environmental performance in their supply chains, despite the fact the 59% of the CEOs said they should.

In another recent survey, Grant Thornton International reported that company executives believe that corporate responsibility programs can positively impact their business and help achieve strategic goals. Of the more than 500 business executives surveyed, 75% believed corporate responsibility could enhance profitability. As a result, 77% said they expected corporate responsibility initiatives to have a major impact on their business strategies over the next several years.

"Corporate responsibility has begun to move from a defensive to an offensive position," said Jack Katz, managing partner of Grant Thornton's Financial Services industry practice. "It is not simply about complying with government regulations. It's about reducing costs, marketing products and services, raising capital, and winning talent."

What are the main business benefits to your organization of having a defined corporate-responsibility policy?

Having a better brand reputation	52%
Making decisions that are better for our business long term	41%
Being more attractive to potential and existing workers	38%
Meeting ethical standards required by consumers	35%
Having better relations with regulators and lawmakers	28%
Our revenue is higher than it would be otherwise	7%

A survey by the Economist Intelligence Unit released in January 2008

A Grant Thornton survey released in September 2007 found that 75% of respondents said that improved CSR would increase their companies' profits. The survey was of 500 senior executives from large and midsize companies who are members of the Business Week Market Advisory Board.

This is big. This is worth repeating. 75% of surveyed executives said that improved CSR would improve their profitability. Seems like the shift from thinking of CSR as a cost to an investment has started.

The real-world results since that survey have proven them to be right about enhancing profitability. The results are eye-opening.

A 2009 A.T. Kearney study found that in the face of the economic crisis, in 16 of 18 industries, companies committed to sustainability outperformed industry averages including profitability by 15% as compared to peers who maintained or cut back sustainability initiatives.

In the UK, companies that implemented socially responsible employee management systems experienced a return on capital double the national average and pre tax profit margin that is 50% higher, according to "The Business Case for CSR" published by MHC International Ltd.

Productivity Benefits

It seems to be a widely held perception that when a company improves its labor standards performance, the cost of its operations, products or services goes up. We hear this from a lot of companies. We hear this from senior management. We hear this from finance departments. We hear this from procurement and sourcing departments.

So we set out to find research on this topic. For better or for worse, it is important to know whether or not this is always true, and if so, why? What did we find? Very little. Most of what we found was anecdotal and inconclusive.

You may say, if I pay the workers 15% more and labor is 30% of the direct cost of my operations, the cost of my product/service must go up. Seems logical.

Benefits from Improved Labor Standards
Documented examples

Cambodia ILO Better Factories Project	Product Rejection rate reduced by 44% overall
China Chai Da/Ying Xie	Annual worker turnover decreased from 78 to 32% in three years
Turkey Yesim	37% Decrease in lost time from accidents and sickness
Turkey Topkapi	Receives 2.5% larger discount on insurance premiums for casualty and goods in transit
India Esstee	Worker Turnover reduced from 75% to 35%

But what if I am a manufacturer and the production defect rate goes down from 10% to 2%? What if I am a bank and my customer service representatives can handle 25% more calls per hour? What if I am a farm and the average output per worker hour goes up from 6 crates to 7 crates because experienced workers stay at the farm longer or because workers are not constantly exhausted? What if worker retention improves from 60% per year to 80% per year and you spend less money on recruitment and training?

These are direct cost savings. They may or may not eliminate the impact of paying the workers more money. But they clearly help to offset it. In some cases, they may actually reduce the cost of delivering the product or service.

When quality management systems were first introduced to business, there was resistance. At the time, people said it was a waste of time and money - "why do I need to document what I already do?" But now in a wide range of industries, quality management systems have been completely integrated into day-to-day operations. The management systems that are now considered essential to managing quality can also incorporate social, labor and environmental standards performance. The table on the left gives examples of how improved labor standards leads to effective human resource management and direct business benefits.

Business-to-Business Marketing Benefits

Clearly improved labor standards performance is an asset in business-to-business marketing. Multi-national companies have developed supplier codes of conduct. Many companies conduct a pre-audit before they start buying from you. Many supplier contracts now mention adherence to a code of conduct as a requirement. They audit suppliers. They use labor standards performance as a criterion in selecting some as "strategic suppliers," while eliminating others. Some companies are setting annual targets for improving the aggregated labor standards performance of their supply base. Some retailers are running electronic auctions to purchase certain commodity items – only companies meeting a certain labor standards performance level are allowed to participate.

In 2009, the IBM Institute for Business Value surveyed 224 worldwide business leaders and found that 60% believe corporate social responsibility has increased in importance over the past year (a year with tremendous economic downturns). Only 6% consider it a lower priority.

So it is safe to conclude that improving your labor standards performance is a valuable part of becoming a supplier to multi-national companies. Of course, your labor standards performance by itself won't get you the business, but it helps. It helps now, and it will help more in the future.

The next decade will see an upward spiral of labor standards performance in companies that is business-driven.

There are also some examples of successful business-to-business labels. The Forest Stewardship Council (FSC) has certification programs that include chain of custody requirements. The thrust of the marketing for their FSC certified label has been towards major corporations to change their internal purchasing to use FCS certified paper products. This business-to-business approach has been successful as paper mills, paper converters and printers now offer FSC certified papers. Corporations such as Coca-Cola and Disney, use FSC certified paper in some of their corporate publications.

The Cotton Made-in-Africa program helps African farmers produce cotton in a more sustainable, socially-responsible and profitable way. The program promotes the use of the Cotton Made-in-Africa brand among apparel companies, increasing market access for the farmers in the program. The program has been successful in attracting over 30 companies to use Cotton Made-in-Africa in their products and to feature the label in their marketing communications.

The next decade will see an upward spiral of labor standards performance in companies that is business-driven.