J&J, a Credo and a reputation saved

Johnson & Johnson has shown how a corporate ethics constitution can foster reputation resilience

By **Nir Kossovsky**

This article is the first in a continuing series comprising case studies in corporate reputation and intangible asset management. The series is targeted to line executives who manage one of the intangible asset (IA) classes (ie, business processes and artifacts such as patents, trademarks and so on) from their organisational slots.

An organisation's reputation is an aggregate evaluation that stakeholders make about how well an organisation is meeting stakeholder expectations based on its past behaviour. More simply, corporate reputation is anticipated corporate conduct. Reputation risk emerges when the reasonable expectations of stakeholders are not met.

Organisations meet or miss reasonable expectations through their management and execution of business processes governing innovation, quality, ethics, safety, security and sustainability. They set expectations through their communication efforts, through non-traditional signalling channels and through their actions.

An organisation's reputation has a material impact on its financial health. Executives who are superior stewards of their companies' IA and meet reasonable stakeholder expectations help their firms to increase pricing strength, reduce operating costs, improve equity value and reduce overall cost of debt.

This first case study on risk and reputation management in this new series looks at Johnson & Johnson (NYSE: JNJ), one of the most iconic firms in the reputational pantheon of the past quarter century. Indeed, it was an event in 1982 that secured Johnson & Johnson's reputation for corporate ethics.

The company

Johnson & Johnson is a diversified healthcare holding company that operates in three segments through more than 250 operating companies located in some 60 countries. Its 120,000 employees are divided among a pharmaceuticals division that makes ethical drugs; a medical devices and diagnostics division that offers surgical equipment, monitoring devices, orthopaedic products and contact lenses; and a consumer segment that makes over-the-counter drugs and products.

Its family of companies comprises more than 250 entities and includes the world's premier consumer health company, the world's largest and most diverse medical devices and diagnostics company, the world's fourth-largest biologics company and the world's seventh-largest pharmaceuticals company. In 2008, worldwide sales were US$63.7 billion, making the company the 29th largest US firm on the Fortune 500 list. The company's headquarters are in New Brunswick, New Jersey.

The business

Pharmaceuticals represent the 26th largest commercial sector in the US by sales, with an industry-wide growth of 7% this past year and an increase in profits of 25%.

The industry provides life-enhancing, life-sustaining and life-supporting products and services. It operates in a heavily regulated environment overseen by the US Food and Drug Administration, the European Agency for the Evaluation of Medical Products and the Japanese Ministry of

Chart 1. **Risk and reputation management basics**

Create an ethical work environment	Ethics are the moral principles by which a company operates; integrity is the act of adhering to those moral principles. Ethics are an integral part of governance that combine with integrity to affect the reputation value of all other intangible assets. Additionally, ethics are the keystone intangible asset because they form the basis for trust and confidence.
Drive innovation	Innovation is the design, invention, development and/or implementation of new or altered products, services, processes, systems, organisational structures or business models for the purpose of creating new value for customers and financial returns for the firm.
Assure quality	Quality is the extent to which: • A product is free from defects or deficiencies. • A service meets or exceeds the expectations of customers or clients. • Products and services conform to measurable and verifiable criteria.
Uphold safety	Safety is the state of being certain that a set of conditions will not *accidentally* cause adverse effects on the wellbeing of people or the environment.
Promote sustainability	Sustainability means making, using, offering for sale or selling products and services that meet the needs of the present without compromising the ability of future generations to meet their own needs.
Provide security	Security is the degree of protection that a company offers against events undertaken by actors intentionally, criminally or maliciously, for purposes that adversely affect the firm. Because fear is the great disruptor of life and commerce, it is useful to think of security, the most ethereal of the intangible assets, as absence of fear.

Management of these key business processes by fostering enterprise-wide conformance with institutional standards is a necessary condition for creating, preserving or restoring reputation value

Health, Labour and Welfare. The safety and effectiveness of its products are controlled through research and manufacturing best practices codified as Good Laboratory Practices, Good Clinical Practices and Good Manufacturing Practices regulations.

Governments also affect revenue significantly by setting payment and reimbursement rates available through various socialised medicine, healthcare entitlement and private insurance programs.

Intangible asset and reputation issues facing the industry

With respect to IA challenges that affect reputation (see Chart 1), safety has always been a critical issue for the ethical pharmaceutical industry, and no less so for medical devices or over-the-counter products. Moreover, since the malicious poisonings involving Johnson & Johnson subsidiary McNeil Consumer Healthcare's Tyelenol products in 1982 and 1986, product security has also been a major area of concern.

The most recent large-scale security problem came to light in early 2008 and involved the widely used blood thinner heparin. The motivation, according to the US FDA, was economic fraud, involving the substitution at a Chinese manufacturing plant of the less expensive and pharmaceutically ineffective chondroitin sulphate for sodium heparin.

Further up the product pipeline, the industry is facing escalating R&D costs, patent expirations and potential changes in patent law. For purposes of this series, all of these fall under the heading of innovation risks.

Last, the industry faces mounting ethical challenges. In the United States in particular, the industry has been subject to media and political reputational attacks as various stakeholders seek to reshape the delivery of healthcare. The industry has compounded the problem through aggressive marketing activities that have triggered a slew of settlements and deferred prosecution agreements with regulators. As of this autumn, more than US$7 billion has been paid out in manufacturer settlements for off-label promotions. Other ethical breaches that have plagued the industry include undisclosed payments to clinicians and researchers who have subsequently endorsed products or generated favourable research, and incentives that have triggered charges under the Foreign Corrupt Practices Act.

Johnson & Johnson's approach to risk and reputation management

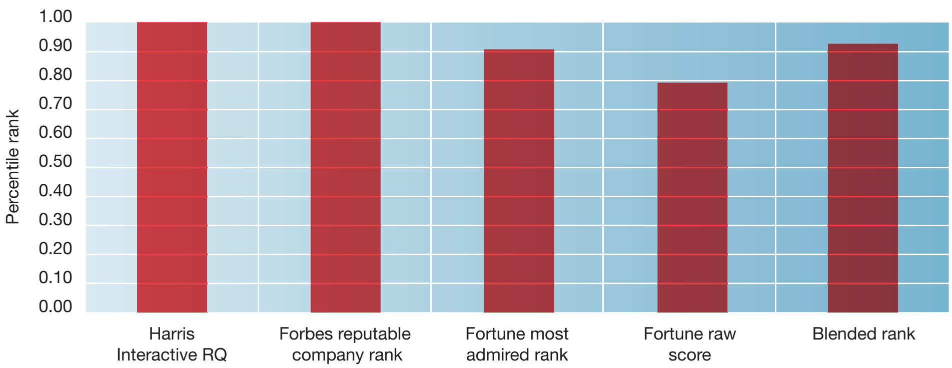
The company was founded in 1886 and was family-run for the first half of the 20th century. In 1932 Robert Wood Johnson assumed command. Two important events marked the war years. First, the company earned an E-medal from the US Navy for an innovative adaptation of its adhesive bandages into a water-resistant Duck fabric tape – a product known since the post-war period as Duct Tape. Second, General Johnson, who served as head of the Smaller War Plants Corporation, penned the company Credo – its ethical constitution. The company was listed on the NYSE in 1944.

Culture and values

The Johnson & Johnson Credo represents General Johnson's philosophy about running a business. The Credo is an active part of the corporate culture and is referenced repeatedly in the company's major operating and reporting documents. It is a statement of corporate social responsibility that was crafted some 40 years before the term was popularised.

The Credo is written in the first-person plural and recognises the company's

Chart 2. **The closely held impressions of stakeholders elicited by various surveys place Johnson & Johnson in very high rankings**



Data source: The respective surveys as published in Winter 2008/Spring 2009

obligations to its stakeholders. The first paragraph sets an unambiguous ethical tone: "We believe our first responsibility is to the doctors, nurses and patients, to mothers and fathers and all others who use our products and services. In meeting their needs, everything we do must be of high quality."

The Credo calls for the need to "reduce our costs in order to maintain reasonable prices" and to give suppliers and distributors "an opportunity to make a fair profit". Employees must be respected, treated with dignity and fairly compensated, and "we must provide competent management, and their actions must be just and ethical."

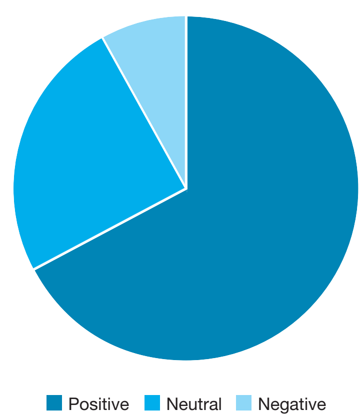
The Credo also acknowledges issues of sustainability and corporate citizenship. "Our final responsibility is to our stockholders. Business must make a sound profit. We must experiment with new ideas. Research must be carried on, innovative programs developed, and mistakes paid for." And in its last line, the Credo modestly addresses what many have argued is the primary obligation of business: "When we operate according to these principles, the stockholders should realise a fair return."

Processes

The Credo is part of the company's DNA and Johnson & Johnson's processes put the Credo into practice. Examples are:

- **Ethics** – the 1982 Tyelenol crisis allowed the company to show that it lived by the first line in its Credo by providing victims' families with counselling and financial assistance. More generally, the company gives each employee a set of handbooks comprising the Credo, Policy on Business Conduct and Health Care Compliance Guidelines. These documents communicate the company's commitment to putting patients first "by safeguarding medical decision-making from both the appearance and the fact of undue and improper financial influence".
- **Innovation** – intellectual property resulting from R&D is an important competitive advantage that can produce long-term economic returns. The company's decentralised operating structure helps to keep the innovation centres close to patients and customers, and is conducive to the modern, collaborative concept of open innovation. The risks in open innovation are well documented and involve generally the diluted economic value of jointly developed intellectual properties and the costs and risks of coordination. Although there are business models providing alternative means for capturing excess value, this industry has been long dependent on patents for that purpose, and it will take time for new legal protections to evolve.
- **Quality** – closely controlled by regulatory requirements. There are no differentiating processes for quality at Johnson & Johnson.
- **Safety** – closely controlled by regulatory requirements. There are no differentiating processes for product safety at Johnson & Johnson.
- **Sustainability** – the 1943 Credo foreshadowed the sustainability movement with the admonition: "We must maintain in good order the property we are privileged to use, protecting the environment and natural resources." In 2003, the company

Chart 3. **Analysis of the 167 articles appearing in the business media during the 12 months preceding 15th May 2009 concerning Johnson & Johnson and reputation show an overwhelming positive sentiment, with a positive-to-negative ratio of 8.38**



Data source: Financial Times Newssift.com.

Chart 4. **Reputation creates a set of expected behaviours among stakeholders. The Steel City Re Corporate Reputation Index captures the financial implications of those behaviours as recorded in forward-looking decision markets. Johnson & Johnson's ranking among 84 companies in the pharmaceutical sector, shown in red, tops the chart. Also shown are the returns on equity for the company, the median return for the pharmaceutical sector and the return of the S&P500**

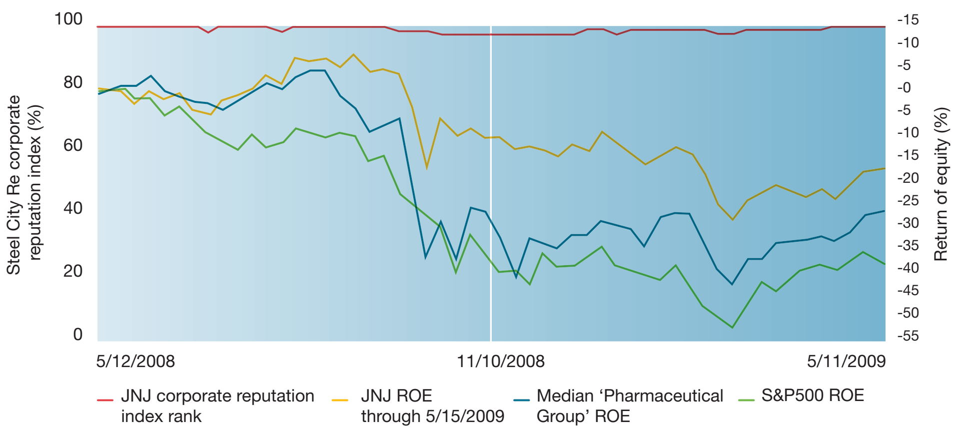
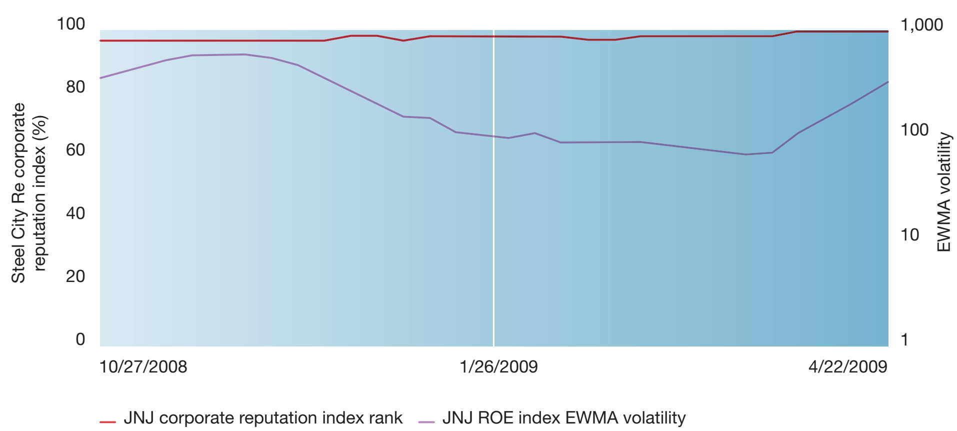


Chart 5. **The exponentially weighted moving average (EWMA) volatility of the Steel City Re Index affirms the stability and resilience of Johnson & Johnson's reputation, even during the recent period of unusual market volatility**



Data source: Steel City Re

adopted a climate-friendly energy policy with specific measureable commitments for greenhouse gas emission reductions.

- **Security** – responding to a glaring security vulnerability in its supply and distribution chains, in 1982 Johnson & Johnson adopted "triple safety seal packaging" – a glued box, a plastic seal over the neck of the bottle and a foil seal over the mouth of the bottle. Tylenol became the industry's first product to use the new tamper-resistant packaging just six months after the crisis occurred. The company also introduced random inspection procedures before shipping Tylenol to retailers. Besides mitigating overall risk, these actions helped Johnson & Johnson to segment its supply chain so the company could better prevent or contain future adverse events. The value of this containment strategy, and the tamper-resistant packaging, became obvious during the Brooklyn poisoning of 1986, when authorities were able to localise the tampering to within 10 days of the victims' deaths.

Signalling and communications

There was nothing Johnson & Johnson could have done to signal more convincingly its firm conformance with the ethical principles of the Credo than its handling of the 1982 Tylenol poisonings – a security crisis. At that time, Tylenol was the undisputed leader in the painkiller field, accounting for a 37% market share. Had Tylenol been an independent corporation, profits would have placed it in the top half of the Fortune 500.

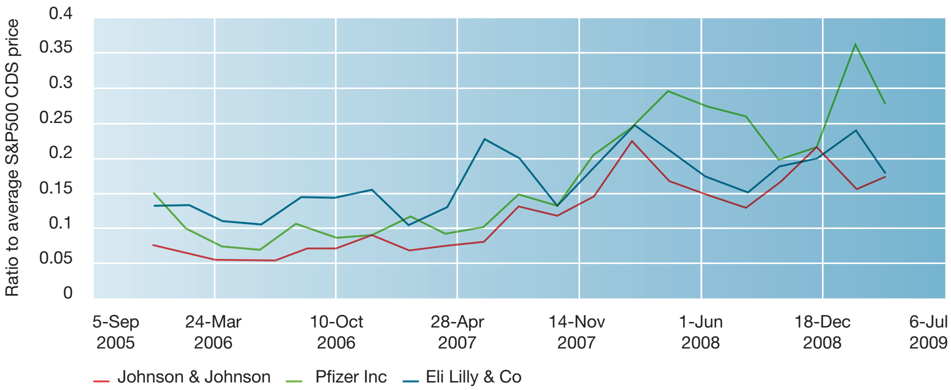
The story, whose recounting has done more to link the words corporate ethics with the company, is: during the autumn of 1982, a malevolent person or persons replaced Tylenol Extra-Strength capsules with cyanide-laced capsules, resealed the packages and deposited them on the shelves of at least a half-dozen pharmacies and food stores in the Chicago area. By the end of the crisis, seven people had purchased the tainted capsules, ingested them and died.

Having learned about the developing crisis from a Chicago reporter's phone call, Johnson & Johnson Chairman James Burke charged a seven-member strategy team with two goals: protecting people and saving the product. The company's first actions were to alert consumers nationwide immediately through the media not to consume any Tylenol product. After two more contaminated bottles of Tylenol were found, Burke ordered a national withdrawal of every capsule.

The crisis generated unprecedented news coverage. More than 100,000 separate news stories ran in US newspapers and there were hundreds of hours of national and local television coverage. The company's post-crisis study revealed that more than 90% of the US population had heard of the Chicago deaths within the first week of the crisis. Two news article clipping services found more than 125,000 clips on the Tylenol story. One of the services claimed that the story received the widest US news coverage since President John F Kennedy's assassination.

Extensive coverage enabled the company to communicate to its stakeholders what it was doing to mitigate

Chart 6. **Firms with superior reputations tend to face lower credit costs. Shown are the Company and two peers, and their respective costs of credit as measured by the ratio of their credit default swap (CDS) price relative to the average CDS price of the S&P500**



Data source: Deutsche Bank

the disaster and restore its reputation – actions proving that the Credo was a core company-wide ethical standard.

When the dust had settled, the central message that stakeholders received was that the company was moral, revered its customers and was itself a victim of a wanton act of terrorism. Its reputation was secured for the next quarter-century.

Intangible asset financial metrics

We report on various measures of the company's reputation today demonstrating the ongoing effects of its 27-year legacy. These indicators include the closely held impressions of stakeholders elicited by surveys whose results have been published as the *Harris Interactive RQ2008* (published February 2009), *2009 Fortune 50 Most Admired* list or the *2009 Forbes 153 Most Reputable* (Chart 2); the public media impression as expressed by the *Financial Times Newssift Sentiment Metric* (Chart 3); a compilation of forward-looking stakeholder decision markets captured by the Steel City Re Corporate Reputation Index; and the financial consequences of the above as measured by return on equity (Charts 4-5) and cost of credit as measured by the price of credit default swaps (CDS) for the company relative to the average price for CDS swaps for the S&P500 (Chart 6).

The data affirm that companies with superior reputations tend to outperform their peers. By various measures this past year, the company's reputation topped the charts. Its return on equity was superior relative to the median of its peers (outperformed by 9%), and to the S&P500. Its cost of credit was much lower than the median S&P500 company, and both lower and less volatile than that for several of its peers.

Executive lesson points

No other case in recent history illustrates the power of moral constitution, business processes that embody the values of that constitution and a communications campaign to inform stakeholders and work in concert to restore and secure a company's reputation.

Johnson & Johnson's Credo is a substantive document that is embraced by its leadership. The business processes arising embody the spirit of conformance with the practices that increase, protect and can restore reputation value in this industry. Few companies, fortunately, are afforded such a mediagenic opportunity to signal conformance in such a substantive manner. As time passes, Johnson & Johnson will need to find creative new ways to foster conformance within its ever-larger organisation and to signal conformance to its stakeholders.

This case also teaches that a company can experience reputation resilience after an extraordinarily adverse event, provided that stakeholders view the company as a victim rather than a culpable party. The culture and systems that Johnson & Johnson manages under its Credo are essential elements in shaping stakeholders' perceptions.

Finally, this case affirms that superior IA management of the business processes that create and sustain a reputation increases enterprise value in ways that myriad financial metrics report. **iam**

In issue 40: Zales pursues innovation at the expense of quality

Nir Kossovsky is Chief Executive of Steel City Re
nkossovsky@steelcityre.com

This series is based on the forthcoming book, *Mission:Intangible®*, sponsored by the Intangible Asset Finance Society. Visit the Society and its blog, Mission:Intangible at www.iafinance.org