INSEAD The Business School for the World®

KNOWLEDGE

How Operations Can Stop Labour Violations Before They Happen

Three business characteristics can serve as leading indicators of possible human-rights abuses in the making.

For decades, policymakers and corporate CSR departments have undertaken sustained, sincere efforts to clamp down on labour abuses such as slavery, perilous working conditions and wage theft. Sadly, the results so far appear limited, if **recent studies** are any indication. Far from disappearing, **modern-day slavery** may be spreading in developed economies, with the United Kingdom reporting **a 50 percent increase in cases** year-on-year for 2019.

The cost and challenges of end-to-end supply chain oversight are almost certainly a source of strain for government agencies and internal auditors alike. Beyond that, we believe that there is a key voice missing from the well-intentioned chorus crying out against labour malpractice. Viewing such abuses as either ethical aberrations or crimes to be punished neglects the reality that they are also business decisions that, though indefensible, may be driven by how the firm in question operates. Decades of research in supply chain management can help us identify which firms may be likely to violate labour laws, based on their operational characteristics.

Our recent **working paper** (co-authored by Wei Kiat Lim of National University of Singapore and Hsiao-Hui Lee of National Chengchi University) confirms that operational characteristics of firms indeed influence labour malpractice. Further, it explores how business executives might use operational levers to prevent labour abuses before they happen.

Understanding labour malpractice

Our study drew from the Thomson Reuters ESG (environmental, social and governance) database to gather details on labour controversies involving 2,151 publicly listed companies, covering the years 2008-2018. We also looked at quarterly and annual financial reports for the same companies, as well as comprehensive lists of their direct suppliers and customers.

For each company, we considered a host of variables, including firm size, liquidity, labour controversies affecting supply-chain partners and judicial efficacy (a proxy for the integrity of the rule of law in the company's home territory). Controlling for all of the above, we weighed the impact of three business characteristics not obviously connected to labour malpractice: sales volatility, inventory turnover and accounting conservatism.

To measure volatility, we tracked how predictable a firm's sales were from quarter to quarter based on reported earnings. Firms exposed to higher volatility, we reasoned, were more likely to take on temporary employees to meet unforeseen upswings in demand. Compared to full-time staff, it is far easier to get away with abusing the rights of this less-protected class of employees. For unethical managers or those driven to desperation by stiff financial pressures, the temptation may be too great.

Similarly, satisfying erratic demand can become more challenging as a firm's inventory turnover increases. (For the purpose of our study, we calculated inventory turnover as the ratio of cost of goods sold to the average inventory held by the firm.) While high turnover is associated with greater return on investment (and is therefore ideal from a pure-profit point of view), holding less inventory renders firms more vulnerable to costly shortages if demand suddenly spikes. In the race to ramp up productivity, managers may resort to hiring contingent employees, raising the same temptation as in the volatility case above, or commit abuses in an attempt to wrest more value out of the existing employee base.

Finally, accounting conservatism – or the firm's propensity to include projected earnings (i.e. accruals) in annual reports – is a useful proxy for how firms trade-off short-term benefits against possible long-term negative outcomes. Companies that are willing to declare earnings that have not yet materialised despite the clear risks of doing so would be more prone to cut corners – both moral and monetary – in other areas as well, such as their treatment of labour. However, firms that are more conservative in their accounting practices usually exercise caution in all areas of business.

The results of our study strongly supported all three of our hypotheses. Firms with higher sales volatility and inventory turnover were involved in more labour controversies, as were firms with less conservative accounting practices.

What can be done

If your firm presents one or more of the three red flags above, there are tangible steps you can take to counter the potential to commit abuse.

For example, it is well-established in the operational literature that transparent information-sharing across supply chains cuts down on excessive sales volatility. The pertinence of this rule increases the further out toward the periphery one goes in the supply chain because the ability to anticipate demand fluctuations declines as the distance between partners widens.

Most supply chain managers won't need much convincing when it comes to the need to control volatility. Regulating inventory turnover, however, entails some tough trade-offs between profit-seeking and risk management. There is no ideal number of inventory turns; it all depends on the needs of each business and how much of a stable inventory buffer it can afford to maintain. The first step for managers is knowing that the higher their turnover, the greater their need for human-rights audits in all relevant areas of the supply chain.

Moreover, **research suggests** that firms whose accounting books betray an unhealthy appetite for risk – and the implied recklessness regarding labour malpractice – can be nudged toward a more conservative outlook using a cognitive quirk known as recency bias. This means that events to which we have been exposed most recently strike us as most probable. Therefore, frequent and widespread sharing of cautionary tales about companies that were penalised (e.g. through heavy fines, or a steep decline in share price) for their involvement in labour scandals may induce and prolong risk-aversion. It may also help to communicate that the penalties for labour malpractice are increasing in both magnitude and number – for example, the rise of ESG investing may inflate the cost of capital for firms accused of labour mismanagement.

To be clear, we are not at all suggesting that the above recommendations should replace what is currently being done to combat labour malpractice. Quite the contrary: A multi-perspective approach involving enforcement agencies, civil society groups and corporate compliance remains absolutely essential. As a complement to current solutions, the operational point of view can highlight the business conditions that generate impetus to commit abuses – thus making it a crucial, if neglected, piece of the puzzle.

Sameer Hasija *is a Professor of Technology and Operations Management at INSEAD.*

Niyazi Taneri *is an Assistant Professor of Operations & Analytics at NUS Business School, National University of Singapore.*