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Corporate Social Responsibility: *Path to Profits or Track to Losses?*

An honors thesis presented to the
Department of the School of Business,
University at Albany, State University of New York
in partial fulfillment of the requirements
for graduation from The Honors College.

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ABSTRACT

Growing concerns for the general welfare of society as well as the environment have become a pertinent aspect of many cultures throughout the world. Corporations have begun to realize that their customers expect them to act in socially responsible ways. This investigation is aimed at discovering if socially responsible behavior has a positive correlation to firm financial performance. A socially responsible firm will be compared to a less socially responsible firm in order to determine if a correlation exists. Profitability ratios will be analyzed between the two firms in order to see which company is experiencing more financial success. It was discovered that socially responsible firms can achieve financial results that are on par with firms that are not as socially responsible.

I. Introduction

Recently many corporations have gone to great lengths to make sure that their companies are being viewed as socially responsible by the public eye. Growing concerns about the environment, employee treatment, and community have become important issues faced by corporations. It appears that the culture around the globe has been changing. People are beginning to judge corporations for their actions. This paper will investigate whether or not a company's social responsibility affects its financial performance.

In the current business world it is very difficult to find a large company that does not consider itself as socially responsible. A quick visit to almost any corporation's website will yield a gold mine of information on how that company has acted socially responsible. It is not uncommon for companies to publish glossy reports describing how they have been socially responsible in the last year. Every day we are bombarded with advertisements stating how a product or service is good for the environment or how a company cares for the public. Do these corporations really care about the wellbeing of the world? With the recent scandals of Enron and

others, it appears that the big corporations are only in it to make as much money as possible without having any regard for the wellbeing of others around them. Corporate greed has plagued the public's perception of corporations. Perhaps, corporate responsibility strategies have become ever more popular recently to turn these negative perceptions behind.

A discussion of corporate social responsibility is enhanced by preceding it with a definition of terminology. There are many definitions and a few will be listed here. Simply put, corporate social responsibility is the way in which a company manages its business processes to produce an overall positive impact on society (Baker, 2004). This definition is very vague and can pretty much be applied to every company out there. As long as a company is not trying to intentionally hurt or deceive the public it is fulfilling this definition. If someone is willing to buy a product or service from a company there must be at least some sort of positive impact on that customer. Perhaps, this next definition will clear a few things up. Corporate social responsibility is an initiative to take responsibility for the company's effects on the environment and its impact on the social welfare of the world. This goes beyond simply following regulations and requires that a company acts in a way that is above what is expected of them (Investopedia). In other words, it is when a corporation acts in a way to best serve its customers while treating its employees fairly, not destroying the environment, and having a genuine desire to make the world a better place. The wellbeing of society should be the goal of corporations not greed.

This investigation focuses on whether corporate social responsibility has a positive or negative influence on firm financial performance. Do the rewards of acting socially responsible outweigh the costs associated with these practices? The fact that more and more corporations are trying to create an image of being a good corporate citizen may in fact mean that social responsibility is good for business. It would be naïve to say that corporations are sharpening up

their corporate image because they solely care for the wellbeing of the world. It would also be naïve to say that no corporation actually cares about the wellbeing of the world. This issue is beyond the scope of this paper. Whatever the motive, it is evident that corporate social responsibility has grown in popularity with companies across the planet and it is uncommon to see a company that does not boast about its contributions to making the world a better place.

II. Literature Review

Conventional economic arguments suggest that top management teams should make decisions that maximize the wealth of their firm's stockholders. To satisfy this objective managers strive to increase the value of the company's future cash flows. Since, socially responsible activities are generally cash intensive, traditional logic assumes that these practices should be avoided (Mackey and Mackey, 2007). However this view only holds stockholders as the major stakeholders in the company. This narrow focus leaves out the other important stakeholders of a firm. A company's employees, vendors, distributors, customers, and the society at large are also very important when it comes to a firm's success and therefore should not be ignored. It is argued that businesses' have a duty to society that goes beyond simply maximizing the wealth of equity holders even if it decreases the present value of a firms future cash flows. However, many forms of corporate social responsibility may not actually decrease the present value of future cash flows. In fact some responsible behavior might actually improve the firm's future cash flows and thus be consistent with wealth-maximizing interest of stockholders (Mackey, *et al.*, 2007).

Multiple decades of research on corporate social performance and corporate financial performance have shown that corporate well-doing has a positive effect on a company's profitability (Van der Laan, Van Ees, and Van Witteloostuijn, 2007). As advances in the

measurement of corporate social responsibility transpire it is becoming more and more obvious that there is a neutral to positive relationship between corporate social responsibility and firm performance. Furthering this, a recent comprehensive review of 95 empirical studies, showed that corporate social responsibility had a positive relationship on performance when corporate social performance was an independent variable (Goll and Rasheed, 2004).

Socially responsible strategies have been used in order to differentiate products, enable a firm to avoid government imposed fines and to reduce a firm's exposure to risk. Studies have shown that 1 in 5 consumers are willing to pay more for products that are socially or environmentally responsible (Cheah, Chan, and Cheing, 2007). Research has also suggested that 88% consumers in the United States are more likely to buy products from a company that is socially responsible over one that is not. Studies have also shown that negative corporate responsibility associations by the general public can have negative effects on overall product evaluation, while positive associations can enhance a consumer's product assessment (Maignan, 2001).

Other studies have investigated when a firm is likely to engage in corporate social responsibility. When companies experience a munificent environment they are more likely to be engaged in socially responsible behavior (Goll and Rasheed, 2004). When times are prosperous and profits exist a firm has the ability to spend its resources in other ways instead of just on its core products. Thus when times are non-munificent firms don't have this ability and thus only focus their resources on the production of core products. From this it can be inferred that in order for a company to direct its attention to socially responsible actions it must first be profitable. This perhaps complicates the study of corporate social responsibility on profits because firms that are experiencing good financial performance are the ones capable of being socially

responsible. Goll and Rasheed's study concludes that much of the early disagreement on corporate social responsibility and firm performance was caused due to this factor (Goll, *et al.*, 2004). However, with the new measurement techniques discussed above analyst may have gotten past this barrier.

The changing general environment also must be taken into consideration when discussing corporate social responsibility. The public's attitude towards corporate accountability is mounting. Society now expects business to act in a socially responsible way. Companies must act responsibly if they expect to profit in the long run. Social goals have become a great concern with the public and a firm must show that it supports these goals in order to achieve a favorable public image (Bronn and Vidaver-Cohen, 2009). Socially responsible behavior can be used to build up brand awareness and value. Governmental restrictions with regard to social conduct are on the rise and customers are beginning to demand sustainable products. Investors are even jumping on board with the movement and are no longer just valuing firm performance but are also judging the corporation's social actions as well. Research shows that there is a positive correlation between a firm's social reputation and stock market returns (Beurden and Gossling, 2008). Research has even shown that investors are willing to pay a premium of over 20% for the shares of companies that are socially responsible (Cheah, Chan, and Cheing, 2007). If society is pushing for more social responsibility, corporations can be expected to be held accountable for their social performance. Thus, if a company wants to be successful it better make sure it is acting socially responsible. Other studies investigate the role of the competitive environment. In the service industry customers have a more direct relationship with the firm. Thus there is a stronger relationship between the customer and the service provider. Consequently a service provider's attitude on social responsibility can have direct consequences on the relationship

between the two parties. A study investigating Spanish telephone service concluded that corporate social responsibility had a significant influence on the consumers' valuation on the service provided (Garcia de los Salmones, Crespo, and Rodriguez del Bosque, 2005).

Taking this all into consideration it appears that corporate social responsibility is becoming an important aspect of positive firm performance. Consumers are beginning to demand information on the social actions of companies. The greater the extent of information from internal and external sources available to consumers regarding social actions the greater the positive impact on consumers (Adam and Shavit, 2008). Thus it is advantageous for firms to let the public know about their socially responsible actions in order for them to have a positive influence on performance.

III. Research Questions and Hypotheses

The overriding questions of this research is related to whether customers will strongly support firms that are socially responsible and whether these firms will be able to operate competitively and profitability. To answer these questions the research focused on three dimensions of profit and compared these to two highly competitive firms in the drug manufacturing industry. One firm has demonstrated a significant disposition toward social responsibility (Johnson & Johnson) and the other appears less sensitive to social issues (Covidien).

Q1 Are socially responsible activities correlated with Return on Sales (ROS)? This may indicate that firms that are socially responsible have the opportunity to maximize their profits by attracting higher prices for the goods and services.

Q2 Do socially responsible firms provide greater returns on shareholder equity? Return on Equity (ROE) is a measure how effective a firm has been in maximizing its profits to benefit of its investors.

Q3 Will return on assets in a socially responsible firm exceed those of competitive firms? This is a measure of a firm's effectiveness in utilizing its assets to maximize its profitability.

H-1 Corporate social responsibility will be positively associated with ROS.

H-2 Socially responsible actions are positively correlated with ROE.

H-3 Socially responsible firms will earn a greater return on assets (ROA) than competitive firms.

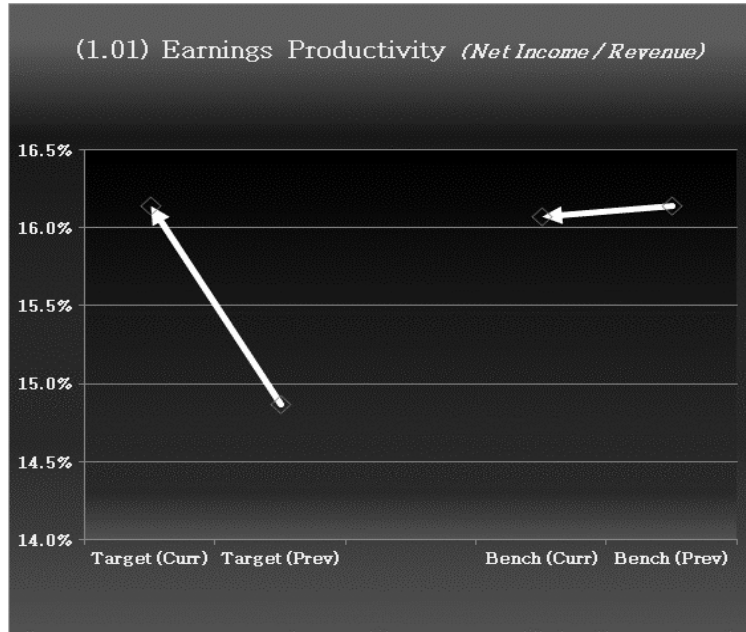
IV. Methodology

This research study will compare a target company that considers itself to be exceptionally socially responsible against a benchmark company that does not put as much effort into being a good corporate citizen. The target company of this study will be Johnson & Johnson and the benchmark will be Covidien Plc. The two companies are both in the drug manufacturing industry and are part of the healthcare sector. Companies were chosen from the same industry to avoid disparities that exist between varying industries. Each company's financials will be entered into a sophisticated software program called the Performance Scorecard, which will analyze and compare the financial performance of each firm. Financial data from fiscal years 2011 and 2012 will be used when comparing the two companies.

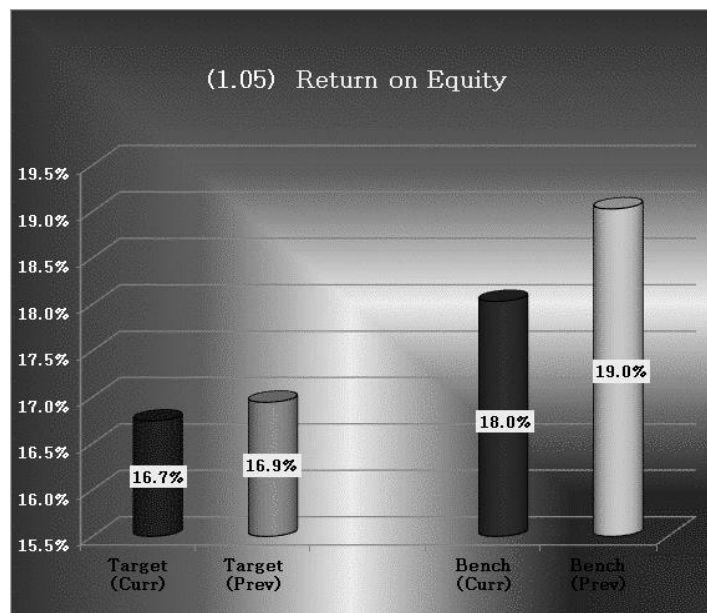
V. Results

Hypothesis 1 was not supported by the data. In 2011 Johnson & Johnson had a ROS of 14.9% while Covidien had a ROS of 16.1%. In this year the responsible company's ROS was

1.2% lower. In 2012 the ROS for Johnson & Johnson improved to 16.1% while Covidien stayed consistent with its returns at 16.1%.



Hypothesis 2 was not supported by this research. During the last two years Johnson & Johnson’s Return on Equity decreased from 16.9% to 16.7% while the benchmark’s ROE decreased from 19% to 18%. Johnson & Johnson’s socially responsible actions did not maximize profits to benefit the investors to the extent the benchmark company did.



Hypothesis 3 that ROA would be greater for a socially responsible firm was not supported by the evidence. Instead the data shows that Johnson & Johnson's ROA is comparable to that of the benchmark's during the investigation period. In 2011 the socially responsible company's ROA was 8.5% while the benchmark's ROA was 9.2%. In 2012 the tables turned and Johnson & Johnson's ROA improved to 8.9% while the benchmark's decreased to 8.6%. The average ROA for the two years was 8.7% for the socially responsible firm and 8.9% for the benchmark.



VI. Discussion

It appears that socially responsible companies do not necessarily have a greater Return on Sales than a company that is not branded as being corporately responsible. Socially responsible activities can be very expensive and since they are not directly associated with creating profits it is not surprising that a responsible firm may have a lower earnings productivity ratio. Even if consumers give more patronage to a company that is being a good corporate citizen the extra

revenue may still not be enough to offset the heavy costs associated with responsible practices. When the two company's gross margins are compared the socially responsible company had a better ratio. The gross margin of Johnson & Johnson decreased slightly from 68.7% to 67.8% between 2011 and 2012 while the benchmark's ratio increased from 56.8% to 57.5% during the same period. This data shows that the socially responsible firm is better at controlling its cost per goods sold. Therefore it should have extra money to spend on social initiatives before its ROS ratio reaches the same level as the benchmark. In 2011 the responsible firm had a ROS that was 1.2% less than the benchmarks. Since, the gross margin ratio discussed above is much higher for the responsible firm it is surprising that the ROS for that respective firm would be lower. In 2012 the socially responsible firm improved its ROS to 16.1% which was equivalent to that of the benchmark. In this year the firm was able to participate in a wide variety of socially responsible activity and still have the ability to have an ROS that was on par with a company that does not commit as much money to socially responsible behavior. The fact that the responsible firm was able to increase its ratio by 1.2% in one year is impressive and could be attributed to the firm's social responsibility. An increase of this size in one year is notable and could be a sign that responsible behavior has positive effects on ROS. If this trend continues the socially responsible company could find itself having a greater return on sales than the benchmark. Due to this it could be possible that socially responsible behavior could have the capability of having a positive correlation to ROS.

If the ROS has the capability of at least being equivalent between a socially responsible company and non-socially responsible firm it would not be detrimental to practice corporate social responsibility. In 2011 Johnson & Johnson the socially responsible company was faced with numerous recalls and these unexpected costs could be why the ROS is lower in that year. If

this is the reason that the ROS is lower, then acting socially responsible would not be the cause of the lower ROS. Instead it would be the recalls that lowered the ROS in that year.

Unfortunately, the results of this examination cannot prove that there is a positive correlation between acting socially responsible and Return on Sales.

The results of this investigation showed that socially responsible companies do not have a greater Return on Equity than ordinary companies. In 2011 and 2012 the socially responsible company had a ROE that was 1.3% and 1.1% lower during the respective years. The amount of revenue that got generated for each dollar of equity by the responsible firm was faintly lower than that of the benchmark. From this data it can be inferred that when a company acts socially responsible its return on equity can be lower than that of a firm that just focuses on its business processes.

The responsible firm may have experienced a lower ROE in both years because instead of focusing on using its equity to maximize profits it was partaking in activities that would have a benefit on society as a whole. The target firm Johnson & Johnson emphasizes in its credo statement that its main obligations are to doctors, nurses, patients, customers, employees, vendors, and the community. The interests of stockholders don't come into play until after these stakeholders have been served first. This statement alone helps explain why the ROE may be lower for this company. The company is not solely concerned with the Return on Equity it provides for its stockholders. Fortunately the firm does not completely disregard its stockholders and states in its credo that its shareholders will earn a fair return. Since, the ROE is roughly 1% lower for Johnson & Johnson it is safe to say that its equity holders are in fact earning a fair return. Due to the fact that socially responsible activity is costly and does not have a direct affect on the bottom line it is not surprising that the ROE could be lower for a socially responsible firm.

Investor dollars are not fully directed towards generating profits, instead a portion is budgeted to go towards the betterment of society.

Although the ROE was not positively correlated to socially responsible activity does not mean that socially responsible behaviors should be abandoned. If a firm can act in a manner that greatly benefits society it should continue to act that way. If the ROE only decreases 1% for a firm that takes part in countless social initiatives the benefit to society will be much greater than a slightly higher ROE would have on stockholders.

That data suggests that it is possible for a socially responsible firm to have a Return on Assets that is consistent with a firm that does not take part in many socially responsible activities. This is not shocking because the sole purpose of assets is to be an investment that is used to generate profits. A company generally uses assets in their daily business processes. A socially responsible company would not find it beneficial to manage its assets in a way that wouldn't maximize profits. It also does not make sense to have assets that are sitting idle and not generating profits.

During the two year period the socially responsible company had a higher ROA in one year and a lower ROA in another year. Since the average ROA was 8.7% for the socially responsible and 8.9% for the benchmark it is safe to say that the Return on Assets were at compatible levels for the two firms. Both firms had managed their assets effectively to generate consistent levels of profits using their assets. It would not make sense for socially responsible activities to get in the way of effectively managing a firm's assets. However Johnson & Johnson has made a commitment to helping the victims of natural disasters by donating medical supplies. The latest natural disaster that the company donated to was Hurricane Sandy. Since the firm donated supplies that it produced using its assets makes it is impressive that the company would

have an ROA that is consistent with the benchmark. When the company donates supplies it does not generate a profit from using the assets it owns. Thus it is possible for a firm to act socially responsible and not see its ROA decrease.

Although a company's ROA depends heavily on the effective management of a firm's assets and less on socially responsible behavior it is still possible to have consistent returns when acting socially responsible as opposed to not. Johnson & Johnson donates a share of the products it produces and still has the ability to have similar returns to the benchmark. Although the results of this investigation do not support the hypothesis that responsible companies will have a higher ROA it is possible for them to have a ROA that is consistent with that of less socially responsible company.

VII. Summary

In recent years it has become the norm for companies to boast about how they have been trying to be good corporate citizens. Top management teams from various firms have been making socially responsible behavior part of their strategy for success. The culture of the general environment has been changing and people are beginning to value socially responsible actions. Managers have started to show a legitimate concern for social initiatives whether it be personal or profit driven.

Research has begun to show that companies that act socially responsible have been seeing positive financial results connected to their behavior. If that is the case it will prove beneficial for firms to act in this manner. Unfortunately the results of this investigation do not positively correlate socially responsible behavior with firm performance.

Hypothesis 1, 2, and 3 were not supported by the data. Social responsibility did not appear to positively affect Return on Sales or Return on Equity nor provide greater Returns on

Assets. In fact the firm that acted socially responsible had a lower Return on Equity than the benchmark. The costs associated with acting responsibly are greater than the cost of doing nothing at all. Instead of maximizing the ROE, socially responsible behavior decreased the value of the ROE. Investments that could have been used to generate larger profits were shifted to contribute to the social well-being of the planet. In this instance stockholder's interests are slightly reduced to benefit society.

The investigation into the Return on Sales metric yielded more promising results for corporate social responsibility. Although the responsible firm had a lower ROS in 2011, the ROS grew to a level in 2012 that was consistent with the benchmark company. If socially responsible behavior can yield similar performance results to those of a company that does not act socially responsible at all, it would not hurt a firm to take part in socially responsible behavior. Since the ROS is equivalent for the two firms in 2012 it is possible that the public's perspective on socially responsible companies can allow responsible firms to charge higher prices as well as sell a higher quantity than the competition. Higher sales volume combined with higher prices can offset the heavy costs associated with behaving socially responsible. Thus it would be beneficial to society if firms could improve social conditions without sacrificing profitability.

The final metric of this investigation showed that a company that is socially responsible could achieve consistent Returns on Assets as a company that does not go out of its way to support public causes. This proves that even if a firm diverts some of its attention from generating profits toward the social well-being of the world that it still can be efficient at using the assets it owns to maximize its profits. Unfortunately greater Returns on Assets did not occur to socially responsible actions.

The combination of the results from this examination currently cannot be associated with a positive correlation between firm performance and corporate social responsibility. Two of the three categories produced results that were consistent with that of the benchmark while one of the categories had a negative correlation to firm performance. Although a vast array of recent research has suggested a positive correlation on performance and corporate responsibility this research has not supported that assumption.

VIII. Limitations & Recommendations for future research

The scope of this research paper is not flawless and has a few limitations. The fact that this sample consists of two companies for a period that is only two years makes it hard to make definitive conclusions. Future research on this matter should include a larger sample size and include firms from a wide variety of industries. A larger sample size will help negate the chances of making inappropriate assumptions. Since many factors affect a firm's profitability it would be beneficial to have a larger sample size to make sure that improper conclusions are not made. Unpredicted events like lawsuits, natural disasters, and product obsolescence can all affect financial results. If these events are not accounted for appropriately they can skew the results. An increased sample size combined with a longer period of analysis could help reduce the chances of having other factors interfering with the results. Some firms that are acting socially responsible may have subpar financial performance to begin with and it would be unsafe to make strong assumptions with such a small sample size over two years. In the future we hope to increase the sample size and time period in order to get a better understanding of the affect of social responsibility on firm financial performance.

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