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Is There a Correlation Between a Company's Ethical Practices and Financial Performance?

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ABSTRACT

This paper examines thirty-nine different companies within and across various sectors to determine if a correlation exists between a company's ethical business practices and financial success. To create such a comparison, a unique model of business ethics was created; one that was both quantifiable and took into account various aspects of the company. As a relatively new field, business ethics has traditionally been examined qualitatively and largely neglected. By examining business ethics directly with success, this project not only aims to raise awareness of business ethics but also determine whether companies have an incentive to follow through with ethical practices. After thorough research, nine factors comprised the ethics score, while five factors were totaled to obtain the success portion of the score; each score was worth 100 points. The calculations and graphing were done in Python using Google Colab. The results indicated that no correlation existed between a company's ethical conduct and success, with companies in the Media sector scoring the highest on the ethical scale. These results point out the need for stricter policies on business ethics and more ethical training within companies.

Introduction

The idea of business ethics has always seemed questionable, even bringing rise to the quip: "business ethics… isn't that an oxymoron?" (Is business ethics an oxymoron? 2011). The sentiment is understandable, witnessing scandals from companies such as Enron, or more recently, Theranos. With 62 percent of the adult population located in economically developed areas believing businesses are corrupt, it is clear that the field still remains relatively unknown and largely disregarded (Porter, 2012). The book *Business Ethics* defines business ethics as "the conduct by which companies and their agents abide by the law and respect the rights of their stakeholders, particularly their customers, clients, employees, and the surrounding community and environment" (Byars & Stanberry, 2019). Currently, laws such as the Sarbanes Oxley and Equal Employment Opportunity Act and organizations like the Occupational Safety and Health Administration and Environmental Protection Agency govern proper conduct in American corporations. However, no metric has been created that defines business ethics as a whole, with an empirical approach rarely being taken. It, therefore, comes as no surprise that "many students are prepared…to compromise their ethical principles in conflict of interest situations…where achieving success seems to require it" (W. Cragg, 1997). It seems that ethics is being perceived as a hindrance to success in our capitalistic economy, rather than an advantage. Yet, According to a report published by Forbes, " Today's shoppers are looking for ethical, eco-friendly brands that put people and the planet ahead of profits" (Council, 2019). Furthermore, the "Why Diversity Matters" study conducted by McKinsey and Company reveals companies with ethnic and racial diversity outperform lacking companies by around 35 percent (Hunt et al., 2021). Thus, this paper aims to determine whether a correlation between a company's ethics and success exists, using quantifiable and standardized metrics to create objective comparisons. A variety of companies are chosen and based on the collected data, ethics and success scores are then calculated and compared.

Literature Review

After thorough research, it was apparent no common metric concerning business ethics had been created. A study conducted at the Hankamer Business School at Baylor University compares ethical attitudes between small businesses and large corporations with surveys. The ethics score they defined consisted of personal factors, such as Locus of Control and Cognitive Development, as well as situational factors like Environmental Forces and Institutional Factors (Longenecker, Moore, Petty, Palich & McKinney, 2006). Another study published in the Journal of Business Ethics titled, “Business Ethics Index: Measuring Consumer Sentiments Toward Business Ethical Practices” surveys consumers on their perceptions of business ethics with ratings such as “Always Ethical” and “Somewhat Ethical” Factor analysis is used to determine a relative score based on the consumer’s experiences with the business and what they have seen in the media (Tsalikis & Seaton, 2006). Both studies use consumer opinion as a basis for their data and observe qualitative metrics. A paper published in the Journal of Business Ethics, titled, “A Model of Business Ethics” created a qualitative model for business ethics based on the expectations, perceptions, and evaluation of the business, each with different factors. For instance, some factors described include lawful behavior, being environmentally friendly, socially responsible management, and leadership. This study utilizes various factors outlined in “A Model of Business Ethics” when creating the ethics scoring calculator by obtaining quantifiable metrics of the factors (Svensson & Wood, 2008).

This study differentiates itself by not only creating an algorithm to derive the ethical score of a company but also taking the metric to determine if a relationship exists between the ethics and success of a company. The paper takes into account business ethics throughout multiple sectors of the business to obtain a comprehensive score. Furthermore, the success of the company is defined by various factors, rather than just profits, in order to mitigate aspects, such as company life span, from manipulating the results.

Methods

Choosing Companies to Analyze

To create accurate comparisons with the ethics score derived from companies, a variety of companies were chosen from different sectors. A total of thirty-nine public mid-cap and large-cap companies were chosen from eight different sectors. Any company with any missing data was immediately eliminated from the study to ensure that the scores were based on the same data for each company.

Table 1. Companies Chosen for the Study in Various Sectors

Technology	**Media**	**FoodService**	**Banking**
Apple	New York Times	Starbucks	Wells Fargo
Amazon	News Corp	Chipotle	Bank of America
Microsoft	Fox	McDonald’s	Goldman Sachs
Zoom	Netflix	Yum!	JP Morgan

Cisco	Disney	Wendy's	Capital One
Consumer Goods	**Hospitality**	**Apparel**	**Beauty**
Procter & Gamble	Hyatt	Nike	L'Oreal
Johnson & Johnson	Hilton	Macy	Estee Lauder
Costco	Marriott	Ralph Lauren	Revlon
Walmart	Wyndham	Under Armor	Ulta Beauty
Target	Intercontinental Hotel Groups	Guess	

Ethics Analysis Criteria

When choosing ethical criteria for companies, it was crucial that each factor was measurable and enough data was available for all companies chosen. A total of nine different metrics were chosen, overall reflecting lawful behavior, financial transparency, company culture, and societal impact.

Data for the following criteria was sourced from Class Action. It is often stated that the first step to being ethical is being lawful, prompting the following two factors to be considered in the ethics score.

Lawsuits: Lawsuits are any civil action taken against a company. This metric was quantified by taking the number of class action and mass tort lawsuits the company was involved in.

Settlements: Settlements are the resolution of a legal case taken outside court action. The metric was quantified by taking the number of settlements the company was involved in.

Data for the following criteria was sourced from Comparably. A company's culture and environment play an important role in ethics. In their book Managing Business Ethics, Authors Lina K. Trevino and Katherine A. Nelson describe, "From an ethical systems perspective, creating and sustaining a strong ethical culture is fundamental to creating an organization that supports people making good ethical decisions and behaving ethically every day" (Treviño & Nelson, 2018). Taking that into consideration, 5 factors representing a company's ethical culture were included in the score.

CEO Score: The CEO score at Comparably scores a company's CEO on a scale from 0 to 100. The CEO serves as a representative for the business and therefore must model the ethical standards they set for the company.

Manager Score: The Manager Score at Comparably ranks the Management of a Company on a scale of 0 to 100. Managers are also a form of leadership in business. As written in the book *Business Ethics*, "managers should be ethical leaders who serve as role models and mentors for all employees" (Byars & Stanberry, 2019).

Diversity Score: The Diversity Score is a measure of how ethnically and racially diverse the company is. The scores are ranked from 0 to 100. A company with high diversity displays its adherence to the Equal Employment Opportunity Act.

Gender Score: The Gender Score is a measure of gender inclusivity at the company. The scores are ranked from 0 to 100. A company with high gender inclusivity displays its adherence to the Equal Employment Opportunity Act.

Employee Net Promoter Score (eNPS): The eNPS is a measurement of how likely an employee would recommend working at the company. It is an indication of positive company culture and proper employee treatment. To calculate the eNPS, employees are asked how likely they would recommend the company on a scale from one to ten. Employees who rank the company a nine or ten are considered promoters, while employees who provide a ranking between one and six are considered detractors. The employee net promoter score is the percentage of detractors subtracted from the percentage of promoters (What is net promoter?).

Data for the following criteria was sourced from Guru Focus. Financial statements have always been considered a source of manipulation from companies; a study conducted by professors at Emory revealed that approximately 20 percent of public companies lie about their earnings (Boesler, 2012). The ethics score takes into consideration proper financial conduct with the following criteria.

Beneish M-Score: The Beneish M-Score is a mathematical model that determines the possibility of financial fraud in a company that manipulates its earnings. A company with a score less than negative 1.78 is unlikely to be a manipulator, while a company with a score greater than negative 1.78 is likely (Kenton, 2022).

Only recently has the focus on the environment come into consideration for consumers, and therefore businesses. However, corporations using tactics such as greenwashing — using marketing efforts to make a company seem more environmentally friendly than it really is — have come into focus as well. Properly mitigating societal risks, including environmental ones, was also decided as a criterion. Data for the following criteria was sourced from Sustainalytics.

Environmental Social Governance (ESG) Score: The ESG score is “a measure of a company's exposure to long-term environmental, social, and governance risks that are often overlooked during traditional financial analyses.” The ESG score from Sustainalytics is derived from public data, with a low score being considered a ‘Negligible Risk’ and a high score of 40 or above categorized as ‘Severe’. The scores are calculated by first determining a company’s total exposure to the risk, steps they are taking to manage the risks, and the amount of risk that simply cannot be managed (Lev, 2022).

Other Considered Metrics:

- Privacy/Customer Confidentiality: this metric could not be quantified properly so was not included
- Social Media Presence: Could not properly define ethical behavior on social media
- Tax avoidance: A metric accurately representing tax avoidance could not be determined

Success Analysis Criteria

The traditional view of a ‘successful’ company is typically determined by its profitability. However, this can easily be influenced by other factors, such as the age of the company. To gain a more comprehensive view of success, this paper weighs five different criteria to examine the success of a company.

Data for the following criteria is sourced from Macro Trends from the first quarter of 2022.

<u>Basic Earnings Per Share (EPS)</u>: The Basics Earnings per Share shows how much of a company’s income has been allotted to a share of market stock. The Basic EPS is calculated by subtracting preferred dividends by net income and dividing the result by the weighted average of common shares outstanding during the period. The higher the EPS, the better off the company (Ganti, 2021).

EPS = (Net income - preferred dividends) ÷ weighted average of common shares

<u>Market Capitalization (Market Cap):</u> Market Capitalization represents the total value of the shares of the company held by stockholders. It is calculated by multiplying the number of shares outstanding with the share price. Company sizes are divided by their Market Capitalization into “large-cap” “mid-cap” and “small-cap” companies (Fernando, 2022).

Market Capitalization = Current Market Price per share × Total Number of Outstanding Shares.

Data for the following criteria is sourced from Comparably.

<u>Net Promoter Score:</u> Similar to the Employee Net Promoter Score, the Net Promoter Score is an important tool for managing customer experience and serves as a trusted indication of future business growth. The Net Promoter Score is derived from the question: "On a scale from one to ten, how would you recommend the company to a friend?" Customers who give a score of nine and up are known as promoters, while those who give a score between one to six are known as detractors. The net promoter score is calculated by subtracting the percentage of detractors from the percentage of promoters (What is net promoter?).

Data for the following criteria is sourced from Guru Focus.

<u>Piotroski F-Score:</u> The Piotroski F-score determines a firm's financial position with a score from zero to nine. A score of zero indicates poor financial health and a score of nine indicates strong financial health. Each point of the F-score corresponds with a standard, and a point is added to a company's score each time it is met (Chen, 2022).

Data for the following Criteria is sourced from Yahoo Finance.

<u>Stock Market Performance:</u> To take into account the recent fluctuations of the stock market, the stock market performance section was scored in comparison to the Standards and Poor 500. The company's growth from the beginning of the year to the current date was compared to the S&P 500's performance in that time period. The calculations were performed on Google Colab using the Pandas library from Python, with all the data downloaded in a CSV file. Both the ethics and success scores were scaled so they would be worth 100 points each.

Ethics Score Calculation

Lawsuit Score (10 points): A score of 0 was assigned to companies with over 100 lawsuits while a score of 10 was assigned to companies with 0, as only outliers had lawsuits above 100. The rest of the companies were given a score out of ten in proportion to where the number of company lawsuits fell between 0 to 100.

Settlement Score (10 points): A score of 0 was assigned to companies with over 10 settlements while a score of 10 was assigned to companies with 0. A maximum of ten was chosen as no company's lawsuits exceeded ten and the score was proportional to the number of points added. The rest of the companies were given a score out of ten in proportion to where the number of company settlements fell between 0 to 10.

The following factors were scored based on what numeric score received a poor letter grade on comparably.

CEO Score (10 points): Zero points were added to companies with a CEO score of less than 60, while 10 points were added to companies with a score of 100. The rest of the companies were given a score out of ten in proportion to where the number of company settlements fell between 60 to 100.

Manager Score (10 points): Zero points were added to companies with a Manager score of less than 50, while 10 points were added to companies with a score of 100. The rest of the companies were given a score out of ten in proportion to where the number of company settlements fell between 50 to 100.

Diversity Score (10 points): Zero points were added to companies with a Diversity score of less than 50, while 10 points were added to companies with a score of 100. The rest of the companies were given a score out of ten in proportion to where the number of company settlements fell between 50 to 100.

Gender Score (10 points): Zero points were added to companies with a Diversity score of less than 40, while 10 points were added to companies with a score of 100. The rest of the companies were given a score out of ten in proportion to where the number of company settlements fell between 40 to 100.

Employee Net Promoter Score (10 points): An eNPS of -10 is considered to be average, while an eNPS of 40 is considered excellent. Thus, a company with an eNPS less than -10 received zero points, while a company with an eNPS of 40 or higher received ten points. Companies with scores between -10 and 40 received a score out of ten proportional to where their eNPS fell in that range.

Beneish M- Score (10 points): The Beneish M-Score was scored simply: companies with scores of greater than -1.78 and therefore likely to be manipulating their financial statements were given a score of zero, while any company with a score less than -1.78 was given ten points.

ESG Score (30 points): With the ESG score already comprising three factors (environmental, social, and governance risks) more weightage was given to the particular component of the scoring guideline. A company with an ESG score greater than 40 was given a score of 0. Companies with scores between 0 and 40 received a score out of ten proportional to where their ESG score fell in that range.

With the total of the points currency adding up to 120, the total scores were then multiplied by the constant 10/12 so the scores would be out of 100.

Success Score Calculation

Basic Earnings Per Share (10 points): A score of 0 was assigned to companies with an EPS less than 0 while a score of 10 was assigned to companies with an EPS greater than 2, as only extreme outliers had an EPS greater than 2 or less than 0. The rest of the companies were given a score out of ten in proportion to where the company's EPS fell between 0 to 2.

Market Capitalization (10 points): A score of 10 was assigned to companies with a market capitalization greater than or equal to 500 billion, as only extreme outliers were above 500 billion. The rest of the companies were given a score out of ten in proportion to where the company's market capitalization fell between 0 to 500.

Net Promoter Score (10 points): Any Net Promoter Score above 0 is considered decent while 30 is considered excellent. Thus, zero points were added to companies with an NPS less than 0, while 10 points were added to companies with a score greater than or equal to 30. The rest of the companies were given a score out of ten in proportion to where the number of company settlements fell between 0 to 30.

Piotroski F-Score (10 points): The Piotroski F-Score the company received was multiplied by the constant 10/9 to scale it up to ten points. The result of the calculation was the Piotroski F-Score's contribution to the success score.

Stock Market Performance (10 points): A company with growth trailing the S&P 500 by 10% was given a score of zero, while a company with growth exceeding the S&P 500 by 10% was given a score of ten. The rest of the companies were given a score out of ten in proportion to where the performance of the company fell between -10% to 10%.

Determining the Correlation

After both the success scores and ethics scores were calculated for each company, a graph was plotted using Matplotlib and Numpy libraries. The ethics scores were on the X-axis, while the success scores were plotted on the Y-axis. The Scipy library was used to determine the line of best fit as well as the Pearson Correlation Coefficient.

Results

Table 2. Company Ethics Scores (Maximum Possible Score is 100)

Technology	**Media**	**FoodService**	**Banking**

Apple: 47	New York Times: 73	Starbucks: 58	Wells Fargo: 38
Amazon: 49	News Corp: 55	Chipotle: 61	Bank of America: 42
Microsoft: 69	Fox: 58	McDonald's: 49	Goldman Sachs: 55
Zoom: 65	Netflix: 71	Yum!: 62	JP Morgan: 42
Cisco: 68	Disney: 62	Wendy's: 47	Capital One: 53
Average: 59.6	*Average: 63.8*	*Average: 55.4*	*Average: 46*
Consumer Goods	**Hospitality**	**Apparel**	**Beauty**
Procter & Gamble: 54	Hyatt: 60	Nike: 49	L'Oreal: 61
Johnson & Johnson: 58	Hilton: 63	Macy: 52	Estee Lauder: 63
Costco: 68	Marriott: 58	Ralph Lauren: 57	Revlon: 41
Walmart: 41	Wyndham: 51	Under Armor: 53	Ulta Beauty: 51
Target: 54	Intercontinental Hotel Groups: 55	Guess: 46	*Average: 54*
Average: 55	*Average: 57.4*	*Average: 51.4*	

Table 3. Company Success Scores (Maximum Possible Score is 100)

Technology	**Media**	**FoodService**	**Banking**
Apple: 76	New York Times: 36	Starbucks: 47	Wells Fargo: 43
Amazon: 51	News Corp: 25	Chipotle: 65	Bank of America: 28
Microsoft: 62	Fox: 53	McDonald's: 76	Goldman Sachs: 56
Zoom: 38	Netflix: 58	Yum!: 58	JP Morgan: 70
Cisco: 50	Disney: 47	Wendy's: 20	Capital One: 20
Average: 55.4	*Average: 43.8*	*Average: 53.2*	*Average: 43.4*
Consumer Goods	**Hospitality**	**Apparel**	**Beauty**
Procter & Gamble: 75	Hyatt: 56	Nike: 51	L'Oreal: 38
Johnson & Johnson: 97	Hilton: 52	Macy: 41	Estee Lauder: 54

Costco: 57	Marriott: 70	Ralph Lauren: 53	Revlon: 30
Walmart: 58	Wyndham: 6	Under Armor: 35	Ulta Beauty: 63
Target: 51	Intercontinental Hotel Groups: 54	Guess: 43	*Average: 46.25*
Average:67.6	*Average: 47.6*	*Average: 44.6*	

Study Insights

- Highest Ethical Average: Media
- Lowest Ethical Average: Banking
- Most Successful Industry: Consumer Goods
- Least Successful Industry: Banking

The success and ethics scores could have been calculated differently to yield different results. This is reflected by these results, which are not necessarily true; banking is not the least successful industry.

Analyzing The Correlation

Figure 3 indicates there is no apparent linear relationship between the ethics of a company and its corresponding financial success. The Pearson Correlation Coefficient for the graph was 0.16736, confirming the results shown in the graph.

Figure 1. Graph of Company Ethics Score and Success Scores with Line of Best Fit

Correlation vs Causation

When analyzing these results, it is important to understand the difference between correlation and causation. Correlation refers to the appearance of a relationship between two variables while causation refers to one variable influencing the other. Correlation does not imply causation.

Comparing the Ethics Score with Specific Success Factors

To further analyze ethic's relationship with success, graphs of the ethical score of the company and specific factors of the success scores were created as shown in Figure 4. All of the graphs created showed there was no apparent relationship between a company's ethics and any component of success.

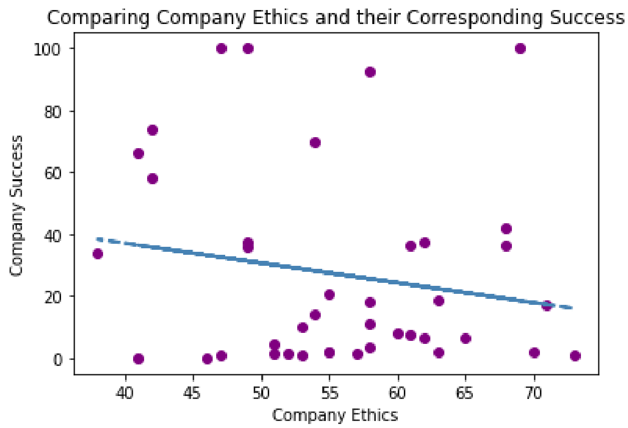

Figure 2. Graph of Company Ethics Score and Market Cap Score (Scaled to 100) with Line of Best Fit

Discussion

The lack of correlation between a company's ethical conduct and financial success could stem from various factors. For instance, some components of the ethics or success score could be worth more than others. Furthermore, certain ethical factors that had to be omitted due to their inability to be quantified could have also influenced the results. There were also many inconsistencies found when researching data. Any wrong information obtained could have influenced the study as well. Other confounding variables, such as the age of the company and the recent downturn of the market as a whole during the time the study was conducted could have played a part in the obtained data.

Comparing the Ethical Scores

To determine the validity of the ethical score created for the companies, the results found were compared with a similar scoring guide. The Ethical Consumer creates ethical scores for companies out of 15 based on the factors of animals, environment, people, politics, and sustainability and uses a more qualitative approach. The data for the companies from the Ethical Consumer is from 2019. Although the data availability was limited, the comparisons found show how similar and different the scores are.

Table 4. Comparing the Ethical Scores

Company	Yielded Score	Ethical Consumer Score
Apple	47%	46%
Amazon	49%	0%

Future Considerations

Today's consumers are already pushing for a better ethical purchasing experience and the results obtained from this study demonstrate it is pertinent that future studies be done to refine ethical scoring and bring more awareness to this issue. Additionally, more thorough research into a company's ethical policies must be done so studies reflect accurate information and ensure strategies such as greenwashing are not used to create misinformation and manipulate public opinion. In order to change the mindset of future business leaders into understanding the value of ethics, a more direct relationship must be made apparent between ethics and success. To create such an incentive, policies similar to the carbon tax should be implemented and ethical scores, such as ESG scores, should be made public. Websites displaying the most ethical companies, such as B Corporations, and The Ethical Consumer, and awards for company ethics should be given more publicity.

Limitations

The biggest limitation faced by the study was the access to company data. Many potential companies had to be cut from the study as not all the data points for the company could be found and verified. Moreover, certain ethical factors had to be omitted as well, since they could not be quantified.

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Conclusion

Although no correlation could be found between the ethical and success scores derived, the results obtained point to further research needing to be done to verify these findings. The next steps include quantifying more ethical factors and formalizing a definition of business ethics to hold them accountable. To test the reliability of the results, the study could be repeated at other times throughout the year to see if the results were affected by current circumstances. Also, more companies could be added and different data sets used for each factor. Ultimately, the end goal of this study is to provide a standardized answer to the questions, "What does it mean to be ethical?" and "Is it worth it?" With the field of business ethics becoming more prominent in modern society and consumers eager to purchase from reputable brands, it is clear that a better – more ethical way— of doing business will come into focus.

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