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EXECUTIVE DIGEST

Business ethics, strategic decision making, and firm performance

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Nothing is more difficult, and therefore more precious, than to be able to decide. — Napoleon Bonaparte

Whenever you see a successful business, someone once made a courageous decision. — Peter Drucker

1. The importance of strategic decision making

One of the most commonly utilized frameworks within Strategic Management is the SWOT (Strengths, Weaknesses, Opportunities, and Threats) analysis model. This framework entails identifying a firm's strengths and weaknesses, and the opportunities and threats that are present in the external environment. It helps managers design an effective strategy, using the firm's strengths to exploit opportunities and minimize exposure to threats (Ketchen, Snow, & Street, 2004; Priem, 2001). Using this framework requires managers to identify, acquire, and assimilate information from multiple sources (both external and internal, many of them stakeholders) and integrate those data into the strategic decision-making process.

A well-developed internal decision-making capability is generally considered critical to the effectiveness of a firm's strategic decisions (Elbanna & Child, 2007). A large body of evidence exists supporting the view that higher quality decisions result from incorporating a broad range of information into the decision-making process (Dalton, Daily, Ellstrand, & Johnson, 1998; Miller, Burke, & Glick, 1998). For firms operating in complex competitive environments, the most effective decision processes are those that draw upon a diversity of frames of reference to identify important factors such as customer needs, availability of new market opportunities, operational best practices, competitive interactions, and critical resources. Thus, the importance of knowledge diversity and the key role that knowledge-based resources play in creating and sustaining competitive advantage are widely recognized (Anand, Glick, & Manz, 2002; Hambrick, 2007). One of the vital challenges for a top management team (TMT) is to effectively incorporate reliable, accurate information into the firm's strategic decision-making process (Certo, Lester, Daily, & Dalton, 2006; Finkelsteik & Hambrick, 1996; McFadyen & Cannella, 2004).

Executives involved in making strategic decisions are concerned with how the resulting actions will affect firm performance. Typically, the common goal

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of strategic leaders is to develop and sustain a competitive advantage (i.e., one which cannot be easily duplicated by competitors). Developing such a competitive advantage becomes increasingly difficult in complex business environments, however, as myriad stakeholders strive to influence decisions made inside the firm. The growing challenge facing strategic leaders is how to reconcile conflicting expectations among these stakeholder groups, while at the same time maintaining acceptable levels of firm performance (Windsor, 2006).

The aforementioned quotes by Napoleon Bonaparte and Peter Drucker suggest the rarity and value of high-quality decision making. Effective strategic decisions by top executives serve as the cornerstone of successful strategic management practices, especially in turbulent and unpredictable environments. Corporate scandals that have taken place over the past several years have led to increased scrutiny of firms' actions and the processes by which strategic decisions are reached. Various stakeholder groups attempt to sway decisions regarding how firm resources are allocated (inside the firm versus outside the firm) and how decisions are made by top executives. Yet, an important issue is what influence, if any, making ethical decisions has on firm performance (Schuler & Cording, 2006).

In this article, we review some recent attempts to develop conceptual and empirical linkages between business ethics and firm performance. We also briefly critique attempts to conceptualize business ethics as a performance-related issue for strategic leaders. Finally, we conclude by offering a few thoughts about how future research in this area could be improved, and highlight some unresolved issues for executives.

2. Linking strategic management and ethics

Broadly defined, business ethics relate to a set of standards by which the actions taken by a firm and its authorized representatives are determined, by the firm's stakeholders, to be morally appropriate (Heath, 2006; Jones, Felps, & Bigley, 2007). At a minimum, organizations are compelled to comply with legal constraints and regulations. Often, executives view the question of legality as the minimum standard of conduct guiding their assessment of "ethical behavior." As an increasing number of stakeholder groups exert influence on targeted firms, however, the expectations of firms' ethical behavior often greatly exceed legal requirements. Firms are being forced to engage in a more detailed assessment of actions and consequences for which no detailed rules exist. Thus, executives must utilize their subjective judgment and discretion in determining which types of action are appropriate (i.e., "ethical").

Recent years have brought heightened scrutiny of the ethics involved in corporate behavior such as taking competitive shortcuts to maintain expected levels of firm performance (Bernard, 2006). Moreover, stakeholders often frame issues such as executive compensation, governance structures, environmental stewardship, community involvement, and employee relations as ethical issues (Heath, 2006; Windsor, 2006). Although stakeholders' ethical expectations have been found to influence the strategic processes within firms (Stevens, Steensma, Harrison, & Cochran, 2005), the influence of ethical decisions on firms is still being debated among researchers (Kassinis & Vafeas, 2006; Pajunen, 2006). Our review of numerous studies on this topic suggests a wide range of different, and sometimes conflicting, results. An analysis of the following research provides the potential for improved conceptual clarity.

A recent study examined the performance and risk profiles of Canadian mutual funds identified as maintaining ethics-related criteria for their portfolio investments, versus peer mutual funds which were not explicitly involved in ethics-related investment decisions. The evidence from this study supports the position that the performance differential between "ethical" mutual funds and their conventional peers is statistically insignificant (Bauer et al., 2007). These results buttress the view that while making ethical decisions may be laudable, such decisions do not necessarily improve the firm's performance.

Another current analysis found a curvilinear (U-shaped) financial performance pattern for mutual funds employing socially driven ethics investment screens. This research discovered an initial decline in financial performance as the number of social screens used by a mutual fund increased. The effect of screens turned positive, however, as the number increased (Barnett & Salomon, 2006). Interestingly, it has been found that the likelihood of a given firm behaving unethically is expected to be higher when the executives rely heavily on personal relationships as a primary source of inputs for making strategic decisions. Relying on personal relationships can limit executives' search for new information, and to suboptimal use of firm resources (Adobor, 2006). These conclusions suggest that firms benefit from having a strategic decision process incorporating a broad range of information and inputs.

A major problem with many such studies is that they define or conceptualize "ethical decisions" differently and use varying philosophical perspectives to evaluate alternative courses of action for the firm (Jones et al., 2007). Additionally, most large organizations often do some, but not all, things "right" as identified by multiple stakeholders. David Vogel (2007) suggests that most people (including executives) are complex beings, and rarely do all things in ways that others would define as "ethical or socially responsible." The author cites examples of Andrew Carnegie and John D. Rockefeller, who were known to be "ruthless" businessmen but were also highly generous philanthropists. If we accept this attribute of individuals, organizations are even more complex, with multiple people making decisions; further, strategic decisions are sometimes made by many large subunits (subsidiaries) operating across multiple countries, where values and "ethics" may vary. Vogel cites BP, which has been considered a leader in concerns regarding global climate change, but which has also recently been criticized for a major leak in its Alaskan oil pipeline due to ineffective and insufficient maintenance. As the scholar concludes, there are few "virtuous firms without sin," and few villains without some positive attributes (Vogel, 2007).

In fact, evidence suggests that most firms have overtly undertaken initiatives to highlight the importance of ethical decision making. Prior research has found that greater than 90% of corporations have made ethics and ethical behavior one of their top concerns; indeed, 73% have multiple written ethics statements (Kelly, 2005; Velthouse & Kandogan, 2007). Whereas many executives have long viewed non-owner stakeholders' efforts to define ethically appropriate behavior as problematic, recent evidence suggests that leaders of some of the world's most successful firms are recognizing enormous potential in economic opportunities that can coincide with ethical demands of stakeholders. For example, Jeffrey Immelt, CEO of General Electric, recently identified environmental stewardship as one of the top priorities facing the current generation of business leaders (Gunther, 2007). Moreover, *Fortune* magazine acknowledged Honda, Tesco, Patagonia, Alcan, S.C. Johnson & Co, PG&E, and Goldman Sachs as among the most proactive firms in embracing opportunities presented by the call for environmental ethics.

Importantly, the culture within the organization is also closely associated with the ability of the firm to effectively balance the ethical demands of multiple stakeholders. Firms that intentionally develop and cultivate a pro-stakeholder culture should be more effective at developing a comprehensive understanding of the demands of constituent stakeholders (Jones et al., 2007). Understanding the relevant ethics-related concerns of stakeholders should also provide these firms with an advantage in recognizing economic opportunities associated with such concerns. The reality remains, however, that the evidence is decidedly mixed regarding the impact of ethical decision making, in terms of performance benefits to firms.

The collective research indicates that the diversity and quality of the inputs used in making strategic decisions appear to be more influential on firm performance than ethics-related concerns. Firms with a culture that embraces stakeholders and their ethical concerns, and incorporates high-quality diverse inputs into the company's strategic decision-making process, are the most likely to recognize economic opportunities emerging from the ethical concerns. The identification of such opportunities can produce growth and enhanced profitability. As a result, ethical decision making can indirectly contribute to improved firm performance.

3. Business ethics: Necessary but insufficient

The processes used by firms to manage resources are critically important in the development of a competitive advantage (Sirmon, Hitt, & Ireland, 2007). Thus, the development of a high-quality decision-making capability within a firm has the potential to serve as the basis for competitive advantage.

However, performance implications for firms utilizing ethical decision-making processes are likely to be indirect. Using an ethical decision-making approach by strategic leaders can satisfy stakeholder expectations, but it is unlikely to produce above-average returns. Although the attitudes held by strategic leaders toward ethical issues almost certainly influence intentional behavior throughout the firm, competitive advantage results from exceptional management of resources. Because ethical expectations tend to be readily observable, the capability to make decisions that satisfy those expectations should be easy to imitate and/or duplicate. Thus, decision making driven by a desire to satisfy the minimum ethical standards of stakeholders should not generate superior returns under normal conditions.

The potential does exist, though, for firms to develop superior capabilities in recognizing emerging economic opportunities associated with ethics-related demands of stakeholders. As products and services may be developed in response to consumers' desires, stakeholders' ethical expectations can, in fact, represent latent signals on emerging economic opportunities. For example, Goldman Sach's multi-million dollar investment in ethanol derived from cellulose, as well as wind- and solar-powered electric facilities, is a direct result of recognizing the profit potential of actively responding to stakeholders' environmental concerns. Honda's development of the most fuel-efficient line of automobiles in the industry has contributed to several consecutive years of revenue growth and above-average returns. Further, Nestlé's investment in infrastructure projects to benefit small farmers in developing market economies has enabled the firm to achieve a competitive advantage in those markets (Porter & Kramer, 2006).

Ethical decision making should be viewed as a necessary but insufficient condition for the development of a competitive advantage. Strategic leaders are encouraged to develop processes which assure that a diversity of reliable knowledge is used in the decision-making process. Doing so can improve the firms' capabilities to recognize emerging opportunities and respond effectively to them. By developing this capability, strategic leaders can increase the propensity of their firm to routinely make high-quality strategic decisions (both ethical and economic).

4. Summary and conclusion

The ongoing effort to develop a conceptually rigorous and empirically supported link between strategic management and business ethics is laudable. One of the most relevant conclusions from this brief review is that the process utilized in making strategic decisions is vitally important for decision effectiveness. Firms that develop a decision-making process based on reliable, diverse knowledge are more likely to make high-quality strategic decisions. Combining this decision-making process with a pro-stakeholder culture can improve opportunity recognition in areas related to stakeholders' ethical concerns. In turn, firms focused on business ethics can enhance their performance. We also believe that knowledge in this area could be enhanced, via future research, by developing answers to the following questions:

- What is the relationship between the variety of ethical demands faced by firms and firms' propensity to make high-quality strategic decisions?
- What effect does developing explicit decision-making guidelines for complying with business ethics demands have on strategic risk taking?
- What role do the characteristics of strategic leaders play in the reconciliation of ethical demands versus economic demands facing the firm?
- Do certain industry groups or partnerships encourage/discourage the development of ethical decision-making capabilities?

Executives are faced with resource limitations, complicated industry environments, intense competition, and dynamic customer demands. Within this context, the effectiveness of executives' decision making is of paramount importance (Elbanna & Child, 2007; Miller & Cardinal, 1994). Through the analysis presented herein, we have attempted to offer some insight regarding the relationship between business ethics and firm performance. Executives are encouraged to embrace a pro-stakeholder culture within their firms. Doing so is likely to enable them to at least minimally satisfy influential stakeholders. More importantly, it can lead to a more thorough understanding of stakeholders' ethical concerns. In turn, this understanding can provide valuable insight as to the potential economic opportunities that can be derived from stakeholders' ethical concerns. Other questions to be answered by each firm include:

- How broadly should executives define organizational "stakeholders"?
- What criteria should firms use when prioritizing inputs from various stakeholders?
- Should ethical and social concerns be incorporated in all strategic decisions?
- Would it be helpful to have, on the TMT, a social concerns advocate who participates in the strategic decision-making process?

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