Profts and principles: Four perspectives

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Abstract

This article clarifies the relationship between profits and principles by distinguishing four alternative perspectives: the win-win perspective in which ethical behaviour generates the highest profits; a licence-to-operate perspective in which a minimum ethical performance is required to receive legitimation from the society; an acceptable profits perspective, in which an acceptable profitability is required to assure the financial continuity; and an integrated perspective. These four perspectives are illustrated by statements from Shell reports and from interviews with managers of a large European retail company.

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1 Introduction

Business ethics is a trendy topic. Many companies are concerned about values like integrity and develop ethical codes to foster responsible behaviour of their employees, because they find that social responsibility pays off (Van Luijck, 2000). However, ethical behaviour is not always rewarded by a competitive advantage over companies that are not ethical. Neither is unethical behaviour always punished. The purpose of this article is to clarify the (long-run) relationship between profits and principles.

As a starting point for our investigation of the relationship between profits and principles, we take the Shell report of 1998 *Profits and Principles - does there have to be a choice?* In this report Shell views its role in the challenge of the 21ste century: how to attain a sustainable economic development?[1] Three aspects of sustainability are distinguished: economic, environmental and social sustainability. Companies are more and more judged on criteria related to this so-called 'triple bottom line'. The title of the Shell report of 1999 refers to these three dimensions: profit, planet and people. Following the title of the 1998 Shell report (Profits and principles: does there have to be a choice?), we take the environmental and social dimension together under the heading 'principles' and investigate the balance between profits and principles[2].

Shell is an interesting case indeed. First, Shell is a very large transnational company. Shell operates in 129 countries and investments are allocated to all parts of the world.[3] This means that Shell is confronted with all kinds of ethical questions related to the social-economic and cultural differences between various countries.[4] Second, the core business of Shell is energy. The current expectation is that the estimated stocks of gas will be depleted in 100 years. For oil this is expected to happen within 80 years. As an energy company, Shell has an important responsibility with respect to the future supply of energy. Third, Shell fascinates because of its recent conflicts with the public opinion about its operations in Nigeria and with the Brent Spar.

In Nigeria, Shell operated in an area occupied by the Ogoni people. They subsist from farming and fishing, but due to leaky pipes their land in no longer suitable and the water is

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[1] The Shell Report 1998, page 46.

[2] Or, as Daviss (1999) defines, the balance between cash flow and conscience.

[3] Shell, 1999, People, planet and profits. An act of commitment, The Shell Report 1999, page 7.

[4] For example, if Shell employees all over world are paid an equal salary, employees in developing countries will live on a 'Island of wealth'. If, on the other hand, the salary is adjusted downwards to take account of the local circumstances, the company can be accused of using double standards and exploitation of people living in poor countries. Another dilemma concerns human rights. Oil is sometimes found in countries where the human rights situation is particularly bad. Is it ethical to operate in such a country? For a contractual approach to these questions, see chapter 8 in Donaldson and Dunfee (1999)

polluted. However, the Nigerian government does not compensate for this. In the nineties, Ken Saro-Wiwa succeeds in drawing international attention to this issue. Shell takes measures to clean up the environment and compensate for damages, but the pipelines are regularly damaged by the local population to obtain more compensation. Ken Saro-Wiwa is arrested and sentenced to death in 1995. Although Shell publicly requests for amnesty just before the execution, Saro-Wiwa and eight companions are executed. The international public is furious and criticizes Shell.

Another provoking affair is the Brent Spar case. The Brent Spar is a oil storage and tank installation. After years of research and consultation with the government of the UK, Shell decides to dump this installation in the Atlantic Ocean. Greenpeace protests because it believes that sinking the Brent Spar would produce an environmental disaster (later research falsified this expectation). It successfully mobilizes the public opinion in Northwest Europe and damages the reputation of Shell. Forced by consumer boycotts during this crisis, Shell changes its plans in 1997 and decides to dismantle the Brent Spar in a Norwegian fjord.

In both cases, Shell did not succeed to convince the public of the moral legitimacy of its strategy. From since, there has been a remarkable change in the Shell strategy. From a rather closed and arrogant organisation, it developed into an open organisation willing to a dialogue with NGO's like Pax Christi (Gruiters, 2000). When we compare Shell with other companies, it seems that Shell is in the frontline of business ethics. For example, in the KPMG report *Sustainability Management* (1999) nine of the eleven quotations refer to Shell. As one of the frontrunners in business ethics, one would expect that Shell has a clear idea of the relationship between profits and principles in its report *Profits and Principles - does there have to be a choice?* However, careful reading of the report shows various statements on the relationship between profits and ethics which reflect rather different positions. Shell seems to be unaware of these differences.

In order to clarify the (long-run) relationship between profits and principles, we develop an economic framework that distinguishes between four different perspectives on the relationship between profits and principles. First, a win-win perspective which assumes a positive relationship between principles and profits. This win-win perspective implies that no choice between profits and principles is required. Second, if there is a tension between profits and principles, firms that strive at profit maximisation will need a minimum value of principles that is required by the society for obtaining a licence to operate. This is the licence-to-operate perspective. Third, in the acceptable profit perspective companies want to maximize principles but are restricted by the restriction that the profitability must reach an acceptable level that is required by the capital market to assure the financial continuity. Fourth, in an integrated perspective the company attaches an intrinsic value to both profits and principles and selects an optimal balance. Each of these perspectives is illustrated by statements from the Shell Report 'Profits and Principles' of 1998. We compare these statements with statements of managers of a large European retail company (which, for privacy reasons, I will abbreviate with ERC) that I have interviewed during 2000. Like Shell, ERC introduced several ethical procedures in the second half of the nineties after complaints of violation of human rights in 1995. Compared to other companies in the sector where it operates, the ethical standards of ERC are currently relatively high. We analyse which situation was most relevant for Shell and ERC in 1998. The last section summarizes the main results.

2 The win-win perspective

The first perspective is that there is no tension between profits and principles. Rather, profits and principles reinforce each other. As Velasquez (1998) argues: ethical behaviour is the best long-term business strategy for a company. Firms who do not meet the ethical norms and expectations of the society have a higher probability of losing their reputation with a negative impact on market shares and profitability (McIntosh et al, 1998). This positive relationship between profits and principles is also indicated by empirical research. For small and medium Dutch firms, Wirtz (1999) find that entrepreneurs perceive a positive relationship between the ethical standard of the employee relations and the productivity. For US corporations, Waddock and Graves (1997) find that corporate social performance (measured by a weighted index including employee relations, community relations, performance with respect to the environment, product characteristics and other attributes) is positively associated with future financial performance.[5] This also impacts the stock market. Financial institutions or private persons will not invest their money in companies with actual or potential social and environmental liabilities, because they want to avoid the risk of owning a company that suddenly owes huge fines or faces drastic consumer boycotts (Daviss, 1999).[6] This changes the very nature of business and creates win-win situations.

Let us call this the win-win perspective. In a win-win situation the business strategy is straight forward. Just be sure that you attain the highest ethical standing, then you will be the most successful firm. Mathematically, we define the win-win perspective in Box 1 as the maximization of a goal function U subject to a restriction in which profits (π) depend positively on the level of principles (p). That means: the derivative of the function f (describing the relationship between profits and principles), $\partial\pi/\partial p$, is positive. For the specification of the goal function there are three possibilities: both profits and principles are positively valued $U(\pi,p)$, only profits are considered $U(\pi)$ or only principles $U(p)$. In a win-win perspective the exact specification of the goal function is not really important for analysing the behaviour of the firm. If principles have a positive impact on profits, it does not matter which goals enter the goal function, because maximizing profits implies maximizing principles and vice versa. It only

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5 There are, however, several other studies that find a neutral or negative relationship between profits and principles. See McWilliams and Siegel (2001).

6 Hence, also the stock prices will be negatively affected if the reputation is damaged by unethical behaviour becoming known. For an empirical research confirming this effect, see Rao and Hamilton (1996).

considers the positive relationship between profits and principles in the restriction under which the goal function is maximized.

Examples of statements in Shell reports and statements from ERC managers that reflect a win-win perspective are given in Box 1. The first statement of Shell reflects the general idea that principles and profits are not necessarily competing goals. The second and third statement give some concrete examples of this general statement. Climate-friendly technologies and innovative products like Shell Pura can be profitable if consumers are prepared to pay for higher ecological standards. This kind of product differentiation can generate extra rents. The third statement underlines that the prevention of corruption not only fosters fair prices, but also increases the efficiency and profitability of the company because it raises the transparency of the organisation.

Box 1 The win-win perspective

goal $\max U(\pi, p)$ *with* $\partial U/\partial \pi > 0$ *and/or* $\partial U/\partial p > 0$

restriction $\pi = f(p)$ *with* $\partial \pi/\partial p > 0$

U *goal function*
π *profits*
p *principles*
f *function describing a positive relationship between profits and principles*

Examples in Shell reports:

We believe fundamentally that there does not have to be a choice between profits and principles in a responsibly run enterprise. (Shell Report 1998, page 3, 48)

New fast-forward advances in climate-friendly technologies could bring commercial succes as well as climate benefits. (Cor Herkstöter, Reflections on Kyoto, 1998, page 3)

We believe that cutting corruption is essential and leads to greater equality, a happier workplace, more efficient economies, rapidly increasing investment flows and the spread of prosperity. (Shell Report 1998, page 20)

Examples from interviews with ERC managers

If you squeeze too much, the supplier will reduce the quality

Since the closure of one division has been announced, this division is doing extremely well. The explanation for this remarkable effect is that the managers of this division have received full autonomy in the way how they finish the business of this division.

In some cases these environmental innovations actually safe money

The first ERC statement shows that ERC buyers are aware that fair prices raise the quality of the merchandise. Generally, the ERC buyer is unknown with the exact cost structure of the supplier. If a ERC buyer squeezes too much, the supplier might reduce the quality. Although he will not cut the wages of his employees (for example, because of binding minimum wages), he might ask them to work harder. Hence, the more you squeeze, the lower the quality. An experienced buyer can judge the impact of squeezing on the quality of the product. The second statement shows that good labour relations and respect for the autonomy of employees can raise the productivity. The third statement relates to ecological actions for improving the environmental situation (required to certify for the ISO14001 norm), like a test of all ERC properties on asbestos, a reduction in the number of cash-notes and an improved way of separating different types of rubbish in the stores. Particularly successful was the increase in the percentage of recycled braces used for clothes in the stores which actually saved cost.

The win-win situation is, of course, the most ideal situation. The task of the manager is to turn as many problems into win-win situations as possible. Then there is no tension between 'ought' and 'is'. Business ethics boils down to choosing an effective business strategy. The critical question is of course: does the win-win perspective capture all situations? Are win-win strategies sufficient to realise sustainability in the long run? Is Shell too optimistic if it views the relationship between profits and principles as a win-win situation? Are the risks involved well taken into account? Or is this optimistic view motivated by the wish to avoid costly adjustments in the production and investments patterns, which would be necessary to prevent an environmental and energy crisis in the future?

In this respect, the future scenario's of Shell are telling. For example, in the Shell report *Klimaatverandering: Hoe denkt Shell erover en wat doet Shell eraan?* Shell develops two energy scenario's about the future. In the first scenario the share of energy in world production falls by 1 percent per year. Moreover, after 2025 Shell expects a substantial increase in the share of renewable energy sources, up to 50% in 2050, because innovation will reduce the costs of these alternative sources whereas the increase in oil and gas prices will further stimulate this substitution process. The second scenario assumes a more drastic reduction in the consumption of energy, partly because of the information and communication technology. In both scenario's the expulsion of CO2 reaches a maximum between 2020-2030. This seems encouraging in two aspects. First, it seems that we will gain control on the expulsion of CO2. Second, it is remarkable that both scenario's come to the same conclusion. This suggests limited risks involved. However, other scenario studies like, for example, the Central Planning Bureau (1992) show a much larger bandwidth. This indicates that Shell might be too optimistic. Is Shell's expectation to raise the share of renewables in 2050 to 50% realistic or is it rather to be interpreted as a *stretched target*?

Another reason why the win-win perspective is insufficient to describe the whole reality is that the optimal strategy implied in such a situation is reached when both profits and principles are infinite. This can easily be seen from the mathematical formulation of the win-win perspective. This suggests no scarcity and an abundance of free lunches. This is not realistic. For example, a full guarantee of work safety by making the probability on business accidents negligible can only be attained at a very high cost, which will not pay itself back. This suggests that the strategic decision problem of the firm can not be fully described by a win-win perspective. Although dynamic external changes may temporarily create new win-win situations, the steady state will generally not be characterized by this perspective.

3 Licence-to-operate perspective

Sometimes doing what is ethical will prove costly to a company. Ethical behaviour is not always rewarded by a competitive advantage over companies that are not ethical. Much depends on how consumers react and whether they are prepared to pay a higher price for products that are produced in a responsible way. Neither is unethical behaviour always punished. On the contrary, unethical behaviour sometimes pays off and the good guy sometimes loses.

If principles have a negative impact on profitability, there are again three possible specifications of the goal function of the company: both profits and principles are positively valued $U(\pi,p)$, only profits are considered $U(\pi)$ or only principles $U(p)$. Let us first consider the case that the firm only attaches an intrinsic value to profits, in accordance with the standard neoclassical model of the firm. In the neoclassical theory, the shareholder is the only legitimate stakeholder (Friedman, 1970). Friedman argues that the sole responsibility of business corporations is to increase profits because of various reasons. First, a corporation is an 'artificial person'. Hence, it cannot have moral responsibilities. Second, accepting social responsibilities means not having profit as the only goal and this would imply that political mechanisms will interfere with economic mechanisms. Third, Friedman endorses Adam Smith's 'invisible hand' argument that the common good is best served by people pursuing their own self-interest. Fourth, managers are agents of the shareholders and, as such, they must only do what is in the interest of these shareholders, which means making as much money as possible. Friedman's last argument is that the costs involved with taking social responsibility implies a tax on shareholders because of lower dividends, or alternatively on customers because of higher prices or workers because of lower wages.

If profits are negatively related to principles and profit is the only goal of the firm, the optimal situation is reached where profits are at a maximum value and principles at a minimum value. This minimum value cannot be freely chosen by the firm. Because of the countervailing power of consumers, NGOs and the media, the company will have to take some minimum social responsibility in order to get a licence to operate. Let us call this the licence-to-operate perspective. In this perspective the company maximizes profits under the condition that the level of principles is sufficient to receive a licence to operate from the society. In some cases, this licence takes the form of a real licence. For example, Shell needs a licence from the Dutch government for its gas operations in the Dutch Waddenzee. In order to receive this licence, Shell must convince the politicians that its operations will not harm the unique environment of the Waddenzee. More general, the licence stands for the acceptance of Shell's operations by all stakeholders who can effectively impact the profitability of Shell. Also non-governmental organisations and the public at large have to be convinced of the moral legitimacy of Shell's operations. For example, in the Brent Spar case, Shell was forced to chose for the more expensive option of dismantling the Brent Spar in a Norwegian fjord instead of sinking it into the Atlantic Ocean, because of the public anger and the resulting consumer boycott.

Box 2 The licence-to-operate perspective

goal $\max U(\pi)$ with $\partial U/\partial \pi > 0$

restrictions (1) $\pi = g(p)$ with $\partial \pi/\partial p < 0$
(2) $p \geq p_{,-}$

U	*goal function*
π	*profits*
p	*principles*
g	*function describing a negative relationship between profits and principles*
$p_{,-}$	*minimum required level of principles*

<u>Examples in Shell reports</u>

To continue, it is essential to have endorsement from society - what some call a 'licence to operate'. (Shell Report 1998, page 18)

Business realises that its success depends on the approval of a broad range of people, including those outside the organisation. (Shell Report 1998, page 29)

<u>Example from interviews with ERC managers</u>

We defined a code of conduct for suppliers and set up an audit organisation in order to upheld our reputation

Mathematically, the licence-to-operate perspective can be modelled by the maximization of profits subject to two restrictions (see Box 2). The first restriction specifies the negative relationship between profits and principles. The second restriction requires that the level of principles is at least as large as some minimum level of principles, required to obtain the licence to operate. Box 2 gives two statements in the Shell reports that illustrate this perspective. These statements show that Shell has learned from past experiences in Nigeria and with the Brent Spar that its choice set is limited by external restrictions.

Furthermore, we added one example from the interviews with ERC managers. The background of this example was the discovery of the violation of human rights by an Asian supplier of ERC. The increased competition between retailers in this sector has triggered a high concern for low cost strategies. As a result, the location of suppliers moves from relative high wage countries to relative low wage countries in the third world. However, the labour conditions in these relative poor countries are bad. In the Western countries there is considerable public concern about the conditions under which goods are produced in the developing countries. Sourcing is now a subject of vigorous debate between companies, unions, NGOs and governments. This has raised the relevance of applying sourcing ethics and was one of the reasons for ERC (although not the only one, see below) to introduce a code of conduct for suppliers and to set up an audit organisation.

The advantage of this perspective is that the role division is clear. Firms have to take responsibility for sustainability from an economic point of view, the other parties are responsible for setting minimum standards of principles that secure social and ecological sustainability. If these other parties are successful in setting a high standard of minimally required principles, principles will really matter and unconditionally be applied. Indeed, one of the main functions of NGOs and the media is that they transform the relative small power of individual persons into a strong interest party at a relatively low cost of a small contribution. However, it remains uncertain that this countervailing power is strong enough. If these external parties fail somehow, the company will reduce its level of principles and restrict its social and ecological efforts to the level where profits are maximized.

4 Acceptable profit perspective

In the licence-to-operate perspective, we assume that firms only strive for maximum profits. Another situation arises if the goal function of the company only depends on principles. Indeed, some companies like ASN bank are well known for their high ethical standards and are intrinsically motivated to pursue these (Scott and Rothman, 1994). At a negative relationship between profits and principles, the firm will seek a combination of a maximum level of principles and a minimum level of profits. In that case, a firm will tend to be restricted by the constraint that the firm must be sustainable in a financial sense. This is illustrated, for example, by the case of Consumer Unity. Founder Gibbons funded a local youth group in Washington D.C. and promised each of the children who joined that if they stayed drug-free Consumer United would pay their way through college. Such largesse drew attention of insurance industry regulators. They were not convinced that Gibbons was prudent enough with policy-holders' money and sought a court order declaring Consumers United insolvent. In 1993, the company was shut down (Daviss, 1999).

Firms that strive at maximum principles, will therefore be restricted by the condition that the profitability is equal to a minimum acceptable level of profits that is necessary to guarantee the continuity of the firm. The real goal of the firm, however, is the contribution of the firm to the interest of its stakeholders and the society at large. An acceptable profitability is just a necessary condition to realise these goals. It generates the freedom to act in a responsible way. Let us call this the acceptable profit perspective.

Box 3 The acceptable profit perspective

goal max $U(p)$ with $\partial U/\partial p > 0$

restrictions (1) $\pi = g(p)$ with $\partial\pi/\partial p < 0$
(2) $\pi \geq$ _,-

U	*goal function*
π	*profits*
p	*principles*
g	*function describing a negative relationship between profits and principles*
_,-	*minimum required level of profits*

<u>Examples in Shell reports</u>

Profits are essential to sustain a private business: without profits to re-invest, a business ceases to exists and contributes nothing. They enable us to fulfil our social and environmental obligations. (Shell Report 1998, page 9).

Profits give us the confidence to take a long-term view, and the capacity to avoid the temptation of short-term wins, which could undermine our commitment to sustainable development. (Shell Report 1998, page18)

Without profits, no private company can sustain principles (Shell Report 1998, page 19) Acceptable is used intentionally, rather than ‘maximum’. This is because it reflects our responsibility to make profits while taking full account of social and environmental considerations. (Shell Report 1998, page10)

<u>Examples from interviews with ERC managers</u>

The highest priority is to realise the turnaround within two years. I feel that ERC cannot meet the high standards of the past.

The corporate giving program of ERC aims at good citizenship by providing financial assistance to local project. Because of the uncertain situation, the budget for corporate giving is currently limited and fixed on an annual basis.

Mathematically, the acceptable profit perspective can be defined as the maximisation of the level of principles subject to two restrictions (see Box 3). The first restriction is the negative relationship between profits and principles. The second restriction is that profitability must be at least as high the minimum acceptable profitability required to assure the continuity of the company. Examples of Shell statements reflecting this view are presented in Box 3.

Furthermore, Box 3 gives two examples from the interviews with ERC managers. Increasing competition and a stagnating market were putting financial returns of ERC under considerable pressure. In some European countries, ERC made huge losses. Responding to this required a far-reaching change in the corporate strategy. Because of the current economic problems, ERC recently stopped its efforts to maintain its ISO14001 certification in some countries. The management system is officially still in place, but without certificate. The reason for putting accreditation on hold was mainly due to the internal pressure caused by an increased workload. This forced the management to reconsider its priorities. As the internal and external audits required for ISO certification were putting too much additional pressure on the ERC staff, the actions have been reduced to a minimum. In some other countries ERC still continues its ISO14001 efforts. Another example is that the funds of the corporate giving program of ERC have temporarily been limited and fixed on an annual basis.

A crucial question is: How high is the minimum acceptable profitability? Shell states that dividends should grow at least as fast as inflation (Shell Report, 1998, page 10). This seems to be a modest and not very realistic target. A more realistic target is the profitability of the competitors or the business at large. Indeed, if Shell wants to attract the financial capital required to finance its investment plans, it cannot afford to stay behind its competitors. Otherwise, the value of its stocks will start to decline and the probability of successful issues will fall. Another crucial question is, then: Does the minimum acceptable profitability leave some room for realizing principles? If competitors take a strong shareholder view, how much freedom is left to integrate social and ecological goals in the business strategy? This is illustrated in the ERC case that halted its efforts for ISO14001 certification due to the tough market circumstances.

The advantage of the acceptable profit perspective is that social and ecological sustainability is more guaranteed than in the licence to operate perspective. Even if the countervailing power of the society is lacking, companies will consider the social and ecological effects of their operations because they attach intrinsic values to principles. On the other hand, if the acceptable profit restriction is not effective in assuring the economic continuity of the firm, this perspective will not guarantee economic sustainability.

Finally, we note that public corporations are more likely to be bound to the profit restriction than closely held companies like family owned companies. As family companies are not directly subject to the market forces on the capital market, their minimum required profitability will generally be lower than that of public corporations. Hence, there is more freedom for family owned firms to live up with their principles. This illustrates that there are several ethical aspects of turning a family company into a public corporation. Of course, a complicating factor is that principles are less well defined and measured than profits, especially if a company holds a lot of different principles. A family company therefore also runs a higher risk of moral hazard, not being disciplined by the market.

5 The integrated perspective

Both the licence-to-operate perspective and the acceptable profit perspective are extreme in their specification of the goal function of companies. In the licence-to-operate perspective, firms only strive at maximum profits, in the acceptable profit perspective principles is the only goal of the firm. A more realistic option is that a company attaches an intrinsic value to both profits and principles. In that case, an optimal balance must be found between profits and principles. Let us call this the integrated perspective.

Mathematically, the business problem can now be defined as the maximization of a goal function in which both profits and principles are positively valued, subject to a restriction in

Box 4 The integrated perspective

goal max $U(\pi, p)$ with $\partial U/\partial \pi > 0$ and $\partial U/\partial p > 0$

restriction $\pi = g(p)$ with $\partial \pi/\partial p < 0$

U	*goal function*
π	*profits*
p	*principles*
g	*function describing a negative relationship between profits and principles*

Examples in Shell reports:

Sustainable development is about balance and integration. Integrating the economic, social and environmental aspects of everything we do. (Shell Report 1999, page 1)

Our primary responsibility has to be economic - wealth generation, meeting customer needs, providing an acceptable return to investors, and contributing to overall economic development. But there is also an inseparable responsibility to ensure that our business are run in a way that is ethically acceptable to the rest of the world and in line with our own values. (Shell Report 1998, page 3)

Example from interviews with ERC managers

We set up an audit organisation for four reasons:

- The company attaches an intrinsic value to ethical sourcing (the intrinsic value function);
- To be able to answer questions of customers and organisations (the dialogue function);
- A company should know under which conditions its merchandise is produced in order to improve these conditions (the management function);
- To upheld a good reputation, although this should not be the basic reason (the reputation function)

which profits depend negatively on the level of principles (see Box 4). Some examples of statements in Shell reports reflecting this view are presented in Box 4. Also the ERC example shows that the setting up of its audit organisation was partly motivated by external pressure and commercial reasons and partly by an intrinsic interest in moral standards.

The integrated perspective is the most balanced perspective. On the one hand, social and ecological sustainability is more guaranteed than in the case of the licence-to-operate perspective. On the other hand, since the property rights of shareholders are more directly considered, economic sustainability will be more secured than in the acceptable profit perspective.

6 An encompassing framework

Figure 1 presents an encompassing framework for the four perspectives on the relationship between profits and principles. The vertical axes reflects the profit level, the horizontal axes the level of principles. The curve connecting the points A-B-C-D reflects the restriction on the choice of the company. Let us call this the profit-principle restriction curve, or more shortly, the PPR curve.

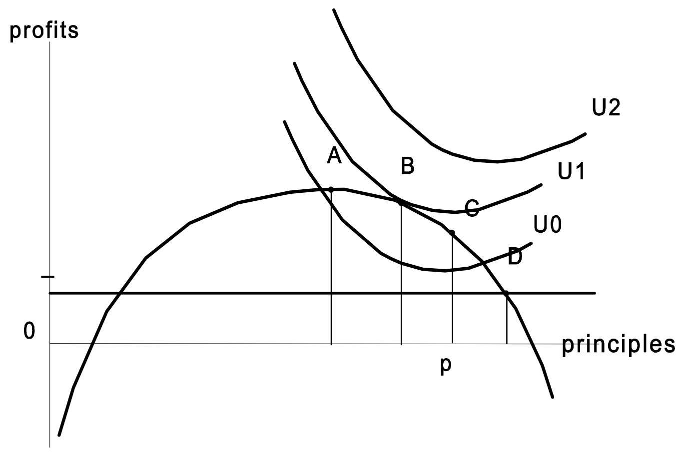

Figure 1 An encompassing framework

The PPR curve as depicted in Figure 1 is based on two assumptions. First, it is assumed that raising the ethical standard of the company improves its profitability if its ethical standards are relatively low. A company without any principles has a high probability of getting a bad reputation and, in the long run, will have no future. Indeed, some empirical studies (like Posnikoff (1997) and Waddock and Graves (1997)) suggest that (long-term) profitability is positively related to the ethical standard. Ethical aspects of firm behaviour for which this win-win relationship with profits hold are, for example, integrity of employees and the prevention of corruption and bribery. Companies that are able to successfully realise these working patterns, for example by developing ethical codes, reduce the transaction costs and raise the transparency of their organisation which allows a more efficient allocation of production factors within the company.

The second crucial assumption is that the marginal profits from raising the ethical standing of the firm decline with the ethical level of the firm. The current concern for social and ecological sustainability indicates that the room for win-win measures is limited for companies. For example, a further reduction in the probability of an environmental accident in the chemical industry becomes progressively costlier if the current safety standards are higher. At a certain point (point A in Figure 1), the marginal return of an investment in safety standards becomes negative. Right of point A, an additional increase in the level of principles will cause a reduction in the profitability. The win-win perspective is therefore restricted to points that lie to the left of point A. Companies operating in a win-win perspective, will end in point A if they go for maximum profits.

There are three reasons why firms may choose a point further at the right than point A. First, the level of principles at point A may be insufficient to receive a licence to operate. Suppose, for example, that p,- denotes the minimum level of principles to attain such a licence. That means, only points at the right of point C belong to the part of the PPR curve that the firm can choose. If profits is the only goal of the firm, as in the licence-to-operate perspective, the firm will choose point C.

Second, if firms only strive at the maximization of principles, they will raise the level of principles to the point where the level of profitability is restricted by requirement that the financial continuity of the firm be assured. In Figure 2 this is reflected by point D.

Third, if the company attaches an intrinsic value both to profits and to principles and is not restricted by the licence-to-operate restriction nor by the acceptable profit restriction, it will also select a point right to point A. The exact position of the integrated perspective depends on the relative weight of profits and principles in the goal function of the company. To illustrate, Figure 1 depicts three so-called iso-utility curves[7] reflecting a low level of utility (U0), an intermediate level (U1) and a high level (U2). U2 is unattainable because it does not intersect with the PPR curve. U0 is attainable but not optimal, because a point in between the two points of intersection generates a higher utility. The highest utility is realized in the point of tangency between the iso-utility curve (U1) and the PPR-curve. In Figure 1, this is reflected by point B. In any other point, the utility will be lower. Note, however, that at a minimally required level of principles p,-, the level of principles in point B is not sufficient to receive a licence to operate. Hence, in this case, the firm will be forced to chose for point C.[8]

[7] An iso-utility curve is a relationship between the goal variables that reflects all points with an equal level of utility. For example, for U1 the iso-utility curve is specified as $U(\pi,p) = U1$.

[8] In that case, the behaviour of the firm is seemingly not distinguishable from that of firms that operate in a licence-to-operate perspective. However, if the restriction is relaxed for one or another reason, such a firm

7 Interpreting Shell's and ERC's position in 1998

In which position did Shell operate in 1998? The statements of Shell in the Report of 1998 indicate that they felt that several perspectives were relevant for them. How is this possible? To answer this question, we must realise that Figure 1 depicts a very specific situation. The optimal choice depends on the position of all curves. For example, if the minimum acceptable profitability lies at the profit level in point A, the firm is left no other choice than maximizing its profits, even if the goal of the firm is to maximize principles. If, moreover, the minimum level of principles matches the level of principles in point A, the firm is also restricted from this point of view. In such a case, both the profit restriction perspective and the licence-to-operate perspective may be relevant.

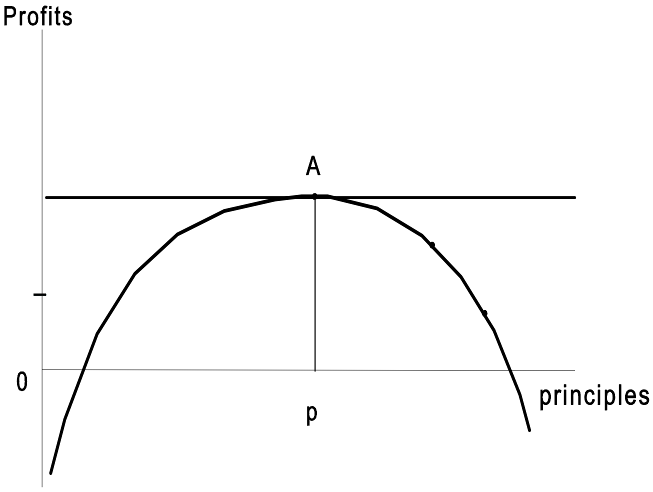

Figure 2 Shell's position in 1998

The Shell report suggest that this was the situation Shell perceived in 1998. Indeed, in 1998 Shell was in a difficult position. The return on average capital employed (ROACE) was 3%, much lower than the level expected in 1997 and also much lower than the ROACE of Exxon, Chevron and Texaco, some important competitors of Shell. Accordingly, the market value of Shell's stocks declined by 24 billion dollars, whereas for BP the market value increased by 24%. At the same time, Shell had committed itself to a more responsible strategy in reaction to the Brent Spar debacle and the ongoing criticism of Shell's operations in Nigeria. The combination

will react in another way than firms that only attach an intrinsic value to profits.

of financial pressure from competitors on the one hand and the public opinion on the other hand just reflects a situation in which one feels bound by external restrictions.

For ERC a similar story can be told. In the past, ERC had a relatively high ethical standard. Competitors were generally not as active as ERC in contributing to social and environmental sustainability. For example, ERC was one of the first retailers in its sector that received ISO14001 certification in several European countries. Although the win-win and licence-to-operate perspective certainly also activated ERC, the dominant perspective was therefore the trade-off perspective. The strong competition and the financial losses during the last five years have changed the perspective. As a result, the profit-principle restriction curve has shifted downwards as illustrated in Figure 3. The focus became exclusively on realising a turnaround in the short run In order to cut production costs, several activities were scaled down or stopped. As a result, the ethical standards declined from point A to B. For example, recently ERC halted the accreditation of ISO14001 in most European countries.

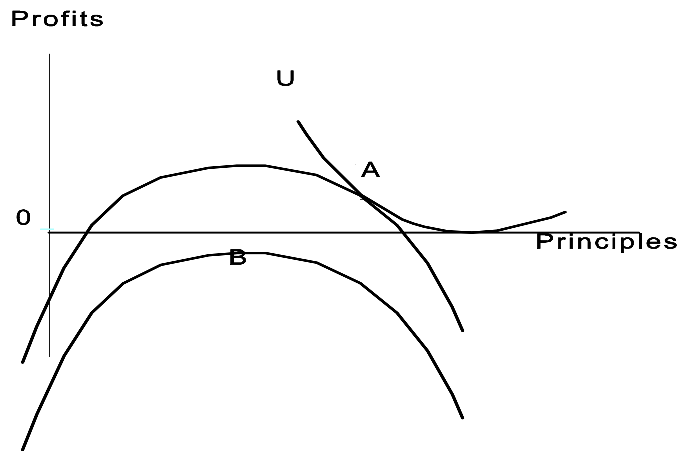

Figure 3 ERC's values in transition

8 Summary

This paper analyses the balance between profits and principles in strategic firm behaviour. For this purpose, we investigate some Shell reports and present some statements from interviews with managers from a large European retail company (ERC) about how they view the relationship between profits and principles. Both companies provide interesting cases. Shell, for example, changed its strategy in order to internalize the effects of the countervailing powers in the society after its clash with German customers and NGOs in the Brent Spar case. Also ERC improved its ethical standards upon discovery of the violation of human rights in the mid nineties. The high market pressure in the late nineties forced it, however, to reduce some aspects of its ethical procedures.

A study of the Shell reports shows, however, that Shell has no clear idea of the relationship between profits and principles. Sections 2-6 clarify this relation by distinguishing between four different perspectives which can all be found in the Shell reports. First, some statements argue that more principles generate higher profits. This win-win perspective implies that no choice between profits and principles is required: maximizing profits implies maximizing principles. The win-win perspective would be the most attractive perspective, provided that the set of measures that are in line with this perspective is sufficient to attain social and environmental sustainability. Other statements show, however, that there can be a tension between profits and principles. In that case, there are three possibilities. If the goal of the firm is profit maximisation, the optimal balance between profits and principles is found where profits are at a maximal value and principles at a minimal value. This minimum value of principles can not be freely chosen, but is set by the society from which the company needs a licence to operate. This is the licence-to-operate perspective. If the goal of the company is to maximize principles, the principles are set at a level where the company is confronted with the restriction that the profitability must reach an acceptable level that is required by the capital market to assure the financial continuity. This is the acceptable profits perspective. Finally, if the company attaches an intrinsic value to both profits and principles, the optimal balance between profits and principles depends on the relative weight of profits and principles in the goal function of the company.

The statements in the report of 1998 indicate that both the licence-to-operate perspective and the acceptable profit perspective were relevant for Shell because of a relatively low return on average capital employed and Shell's commitment to a responsible strategy. For ERC the recent situation can be described as a movement from an integrated perspective to an acceptable profit perspective.

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