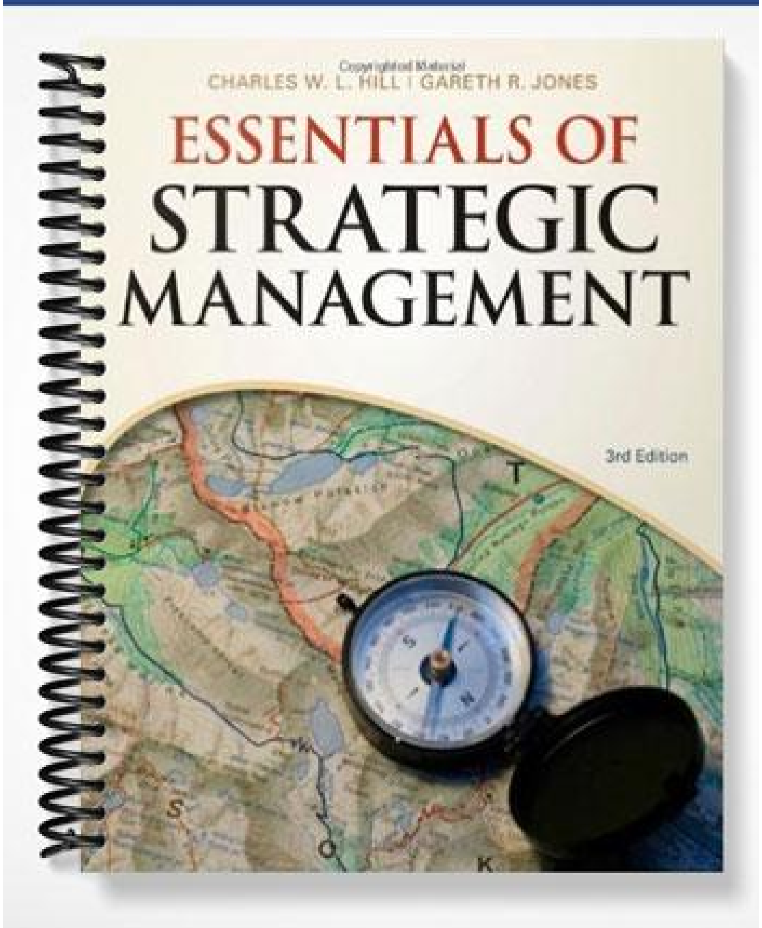
SOLUTIONS MANUAL



CHAPTER 2

Stakeholders, the Mission, Governance, and Business Ethics

SYNOPSIS OF CHAPTER

This chapter introduces the concept of stakeholders and the importance of their support to the success and survival of a company. The stakeholders are the individuals or groups with an interest, claim, or stake in the company. The mission statement is viewed as an important statement of the organization's view of the claims of stakeholders. The purpose of the mission statement is to establish the guiding principles for strategic decision making.

The chapter goes on to examine the issue of corporate governance. Corporate governance is defined as the mechanisms that exist to ensure that managers pursue strategies that are in the interests of the shareholders, an important stakeholder group. The chapter concludes with a discussion of the ethical implications of strategic decisions.

TEACHING OBJECTIVES

1. Explain why managers need to take stakeholder claims into account.
2. Discuss the components of a corporate mission statement.
3. Explain the role played by corporate governance mechanisms in the management of a company.
4. Review the causes of poor business ethics.
5. Discuss how managers can ensure that the strategic decisions they make are consistent with good ethical principles.

LECTURE OUTLINE

I. Overview
   A. This chapter examines the issues and factors that impact strategic management of the firm.
   B. Stakeholders have expectations of the strategic management of the firm
   C. The mission statement establishes guiding principles for strategic decision making.
   D. Corporate governance and business ethics are two tools that can be used to ensure that managers act in the best interests of stakeholders.

II. Stakeholders
   A. **Stakeholders** are individuals or groups with an interest, or stake, in a firm. **Internal stakeholders** include stockholders and employees at all levels. **External stakeholders** are all other groups, and typically include customers, suppliers, creditors, governments at all levels, unions, local communities, and the general public.

See Figure 2.1: Stakeholders and the Enterprise

B. Stakeholders are in a reciprocal relationship with the firm, providing the organization with resources and expecting some benefit in return.
   1. Each stakeholder group has a unique relationship with the firm.
      a) Stockholders provide funds and expect returns.
      b) Creditors provide funds and expect repayment and interest.
      c) Employees provide labor, skills, and ideas, and expect income, job satisfaction and security, and good working conditions.
      d) Customers provide sales revenues and expect products that provide value for money.
      e) Suppliers provide inputs and expect revenues and dependable buyers.
      f) Governments provide regulation and expect companies to adhere to the rules.
      g) Unions provide productive employees and expect income and other benefits for their members.
      h) Local communities provide local infrastructure and expect companies to behave as responsible citizens.
      i) The general public provides national infrastructure and expects the company to improve their quality of life.
   2. Companies that neglect to satisfy the needs of one or more important stakeholder groups will find that the stakeholders withdraw their support, damaging the firm.
C. A company cannot fully satisfy all of its stakeholders at the same time. To understand stakeholder needs and to develop effective strategies for satisfying those needs, companies use stakeholder impact analysis.
   1. To begin a stakeholder impact analysis, a company must first identify stakeholder groups, along with their interests and concerns.
   2. Next, a company must identify the claims that each stakeholder group is likely to make on the organization.
   3. Then, a company must decide the relative importance of each stakeholder group from the company's perspective.
   4. This process will result in an identification of some critical strategic challenges.
   5. Based on this process, most firms identify the three most important stakeholder groups as customers, employees, and stockholders.

III. The Mission Statement
A. A **corporate mission** or **vision** is a formal statement of what the company is trying to achieve over a medium- to long-term time frame. The mission states why an organization exists and what it should be doing. A customer-oriented definition claims that a mission statement should describe the customer, their needs, and the method the firm will use to satisfy those needs.

See Figure 2.2: Defining the Business

B. The **values** of a company state how managers and employees should conduct themselves, how they should do business, and what kind of organization they should build to help a company achieve its mission. Values are the foundation of a company's **organizational culture**. Values include respect for the organization's diverse stakeholders.
C. A **goal** is a desired future state or an objective to be achieved. Corporate goals are a more specific statement of the ideas articulated in the corporate mission. Well-constructed goals are precise and measurable, address crucial issues, are challenging but realistic, and have a specified time horizon for completion.
D. A major goal of business is to provide high returns to shareholders, either through dividends or through an appreciation in the value of the shares. High profitability will enable the firm to pay high dividends as well as create an appreciation in share value. Thus, high

profitability provides the best return to shareholders. However, managers must be aware that the profitability should be sustainable, and they should not sacrifice long-term profits for short-run profits.

Teaching Note: Ethical Dilemma

This dilemma illustrates the economic and moral conflicts that arise between different stakeholders of an enterprise. External forces and changes over time created this conflict and management must act. If in theory management is obligated to act as agent for the stockholders then it is obligated to maximize profits. However, in practice, if operations move overseas, are the consequences acceptable to them ethically and morally and, more broadly, are they acceptable to society? Would customers be willing to pay a premium price for furniture Made in America? Could the company increase the price of its furniture through a focused differentiation strategy? What quality factors would have to exist? If the plant is closed, what could be done to limit the negative impact of job loss and hardship for employees in the local community?

IV. Corporate Governance and Strategy - The Agency Problem

A. **Agency theory** looks at the problems that can arise in a business relationship when one person delegates decision-making authority to another. It offers a way to understand why managers do not always act in the best interests of stakeholders.

B. An **agency relationship** occurs whenever one person delegates decision-making authority to another. The **principal** is the person delegating authority, and the **agent** is the person to whom the authority is delegated.

C. The **agency problem** is that principals and agents may have different goals, and therefore, that agents may act in ways that are not in the best interests of their principals.

1. Agents may do this because of **information asymmetry**—that is, because the agent almost always has more information about the resources they are managing than does the principal.
2. Thus, it is difficult for the principals to measure the agent's performance or to hold them accountable for their performance.
3. To some extent, it's impossible for a principal to know for sure whether the agent is acting in the principal's best interests, and so the principal must trust the agent.
4. The principals also make efforts to monitor agents, evaluate their performance, and, if necessary, take corrective actions.

D. The agency problem exists in corporations, as stockholders (the principals) are the company's owners, but they delegate decision-making power to the company's managers (the agents).

1. Managers, like other people, desire status, power, job security, and income. They can use their decision-making authority and control over corporate funds to satisfy those desires at the expense of stockholders. This is called **on-the-job consumption**.
2. Boards of directors typically make executive pay decisions in order to control expenses. However, CEOs can use their influence with the board to get pay increases. The historically high level of CEO pay in the U.S. can be attributed to this cause.
    a) CEO pay is rapidly increasing and is at the highest level it has ever been.
    b) CEO pay is rising more rapidly than workers' pay. In 1980, the average CEO earned forty-two times what the average worker did; by 1990, CEO pay was 400 times greater.
    c) CEO compensation is increasing, including stock options or other forms of indirect payment. For most CEOs, stock options are a far bigger part of their total compensation than is their base salary.

d) CEO compensation doesn't seem to be linked to corporate profitability; many CEOs of companies that posted an overall financial loss received large increases in pay for that same period.

3. To increase power, status, and income, a CEO might engage in empire building—that is, buying many new businesses to increase the size of the firm through diversification.
   a) Empire building, which is diversifying without an appropriate reason for doing so, reduces profitability, because funds are now used to pay the debt incurred to finance growth.

See Figure 2.3: The Tradeoff Between Profitability and Revenue Growth Rates

   b) Too much growth too quickly also leads organizations to pay too much for acquisition targets, further depressing profits.

E. The agency problem also exists in the relationship between higher-level managers and their lower-level subordinates. For example, a subordinate may withhold information to increase his pay or job security or get more than his unit's fair share of organizational resources.

Strategy in Action: The Agency Problem at Tyco

The case describes the situation at Tyco under the leadership of Dennis Kozlowski. The company grew from $3.1 billion in revenues in 1992 to $38 billion in 2001. Most of this was due to the acquisition of a number of unrelated businesses. Tyco financed the acquisitions by taking on significant debt. Critics claimed that Tyco was unable to service its debt commitments and some questioned Tyco's accounting. In 2002 Dennis Kozlowski was forced out and was subsequently charged with tax evasion by federal authorities. Kozlowski was also charged with using Tyco as his personal treasury, using company funds to pay for a lavish birthday party for his wife and for furnishing his apartment. In 2005, Kozlowski was found guilty of twenty-three counts of grand larceny, conspiracy, securities fraud, and falsifying business records. Kozlowski was found guilty of looting $90 million from Tyco.

Teaching Note:

The Dennis Kozlowski story illustrates many of the aspects of agency problems. As CEO, he was able to use company funds for his own personal enrichment. He was also able to hide the true performance of the company through a series of acquisitions. Having a board of directors to monitor the CEO did not help in this case, because the board either approved his expenses, or was misled by Dennis Kozlowski on these issues. The board did not act as a diligent monitor working on behalf of the stockholders and other stakeholders.

V. Governance Mechanisms

A. **Governance mechanisms** are put in place by principals to align agents' incentives with their own, and to monitor and control agents.

B. There are four main types of governance mechanisms.

1. U.S. and U.K. firms tend to rely heavily upon corporate boards of directors, elected by stockholders, to represent the interests of the stockholders.
   a) Boards of directors are charged with several responsibilities.
      (1) Boards of directors are legally responsible for the firm's actions and act to oversee the actions of the firm's CEO and top managers.
      (2) The board makes decisions about hiring, firing, and compensating top corporate executives.

(3) The board ensures that the audited financial statement, which is the primary reporting tool from managers to stockholders, presents a true picture of the organization's health.

b) Boards of directors are typically composed of a mix of corporate insiders and outsiders.

(1) Inside directors are senior employees of the firm and are charged with bringing information about the company to the board. However, they are employees and their interests tend to be aligned with management.

(2) Outside directors are not full-time corporate employees, and they are charged with bringing objectivity to the board. Full-time professional directors hold positions on several boards and do a good job because their professional reputations are at stake.

c) Many boards perform admirably, but some, such as that of Enron, do not.

(1) One criticism of boards of directors is that insiders often dominate them and therefore can manipulate perceptions.

(2) Another criticism of boards is that many are dominated by the CEO, particularly when the CEO is also chairman of the board. When this occurs, the CEO may choose both the inside and the outside directors, who may feel loyalty to the CEO or allow the CEO to control the agenda.

d) In recent years, boards of directors have been playing a more active role in corporate governance.

(1) One reason for the enhanced oversight is the lawsuits that stockholders have filed against board members. In some cases, board members must pay damages out of their own pocket.

(2) Another rationale for active boards of directors is the increasing number of institutional investors, such as the managers of large pension funds, that are putting their own employees on the boards of firms whose stock they own.

(3) Other trends in increased vigilance include boards calling for CEO removal and an increase in outsiders serving as chairmen.

2. Another governance mechanism is stock-based compensation for principals. If agents are working under a pay-for-performance system, then it will be in their best interests to increase profitability.

a) The most common pay-for-performance system grants stock options to managers, which gives them the right to buy shares at a predetermined price (called the strike price) at some point in the future. Typically, the strike price is the trading price at the time the option was granted.

b) However, when CEOs exercise their options several years later, their compensation increases dramatically. Some claim that stock options are too generous, especially when the strike price is set deliberately low.

c) Another criticism of stock options is that issuing more shares of stock dilutes the equity of the existing stockholders. Some critics would like options to be shown on financial statements as an expense, but at this time, companies are not required to do so, although some do so voluntarily.

3. A third governance mechanism is the use of independently audited financial statements.

a) Publicly traded companies are required to file with the Securities and Exchange Commission periodic statements that comply with Generally Accepted Accounting Principles (GAAP).

b) To ensure that the statements are consistent, detailed, and accurate, companies must employ independent auditors to evaluate each statement.

c) However, although most companies file accurate statements and most auditors do a careful job reviewing that information, a minority of companies have abused the system, in some cases aided by their auditors.

4. The fourth governance mechanism is the takeover constraint.
   a) Stockholders can always sell their shares if they are dissatisfied with the management team.
   b) If sufficient numbers of shareholders sell their shares, the share price may fall sufficiently for the company to become an attractive acquisition target.
   c) This is the takeover constraint, which limits the extent to which mangers can pursue strategies and take actions that put their own interests above those of the stockholders.

VI. Ethics and Strategy

A. Ethics is another important consideration as managers make and implement strategic decisions. Ethics are the principles of right or wrong that govern the conduct of an individual, profession, or organization. **Business ethics** are the accepted principles of right or wrong governing the conduct of businesspeople. **Ethical dilemmas** are situations where there is no agreement over what are the accepted principles of right and wrong, or when none of the alternatives seems ethically acceptable.

B. In our society, many accepted principles of right and wrong are codified into law.

C. The goal of managers should be to pursue strategies that maximize the long-run profitability and profit growth of the enterprise, thereby boosting returns to stockholders. Managers should do this within the bounds of the law and also with ethical standards.

D. Ethical issues arise due to a conflict between the goals of the enterprise or the goals of the individual managers and the rights of important stakeholders.
   1. Proponents of this view would argue that it is the enlightened self-interest of managers to behave in an ethical manner that recognizes and respects the rights of all stakeholders.
   2. Others argue that managers should behave ethically because it is the right thing to do.

E. Unethical behavior arises when managers put their own goals or the goals of their organization above the rights of other stakeholder groups. Common examples include:
   1. **Self dealing,** when managers misappropriate corporate monies for their own purposes.
   2. **Information manipulation,** when managers use their control over corporate data to enhance their own financial situation or the competitive position of the firm.
   3. **Anti-competitive behavior** covers the range of actions aimed at harming actual or potential competitors, often through the use of monopoly power.
   4. **Opportunistic exploitation** occurs when managers seek to unilaterally rewrite the terms of a contract in ways that are more favorable to their own firm.
   5. **Substandard working conditions** arise when managers underinvest in working conditions or pay employees less than market rates.
   6. **Environmental degradation** occurs when the firm takes actions that directly or indirectly result in pollution or other forms of environmental harm.
   7. **Corruption** occurs when managers pay bribes to gain access to lucrative business contracts.

Running Case: Working conditions at Walmart

The running case looks at the changes in working conditions at Walmart from the days when the founder Sam Walton was in charge, to the current. The case describes Sam Walton's values, based on respect, pay for performance, opportunities for advancement, and trusting them by decentralization. aspects of the code. It contrasts this with more recent times, when Walmart has been in the news for a succession of law suits claiming that Walmart pressures hourly employees to work off the clock, systematically discriminates against women, and knowing uses contractors who hire undocumented immigrant workers to clean its stores, paying them below minimum wage.

F. The roots of unethical behavior include: faulty personal ethics, a focus on the business dimension of a decision to the exclusion of other considerations, an organizational culture that deemphasizes business ethics, an environment that pressures managers with unrealistic performance goals, and leadership or the lack thereof.

G. Here are things that a business and its managers can do to make sure ethical issues are considered in a business decision.

1. Hire and promote people with a well-grounded sense of personal ethics.
2. Build an organizational culture that places a high value on ethical behavior.
3. Make sure that leaders articulate ethical behavior and enact it.
4. Put decision-making processes in place that require people to consider the ethical dimension of business decisions.
    a) "Does my decision fall within the accepted values or standards that typically apply in the organizational environment?"
    b) "Am I willing to see the decision communicated to all stakeholders affected by it—for example, by having it reported in newspapers or on television?"
    c) "Would the people with whom I have a significant personal relationship, such as family members, friends, or even managers in other organizations, approve of the decision?"
5. Appoint an ethics officer to make sure that employees are trained to be ethically aware, that ethical considerations enter the decision process, and that the ethical code is followed.
6. Put strong governance in place.
7. Act with moral courage.

ANSWERS TO DISCUSSION QUESTIONS

1. How prevalent was the agency problem in corporate America during the late 1990s?

    There have been a number of high-profile lawsuits that resulted from executive misconduct in the last several years. Investors have lost confidence in corporate honesty and in auditors' ability to rein in corporate excesses, and this has been reflected in their defection from the stock market. The agency problem is facilitated by information asymmetry, and the popular decentralized decision-making and empowerment programs of the 1990s made it easier for workers to hide their actions from their superiors. In addition, as the audit industry becomes more competitive and less profitable, auditors are increasingly reluctant to be tough and risk losing a customer. It's impossible to know the true extent of the problem from outside, but even highly respected firms such as GE have come under close scrutiny in this new era of investor paranoia.

2. Who benefited the most from the late-1990s boom in initial public offerings of Internet companies: investors (stockholders) in those companies, managers, or investment bankers?

    All of these benefited to some extent, but in different ways. Stockholders who bought at the time of the initial public offering (IPO) and sold when the stock was high profited tremendously. Unfortunately, however, the average investor who bought some time after the IPO when the stock value was already high, and didn't sell until the price had fallen substantially, made little money, or even experienced losses. Managers, to the extent that they were stockholders, experienced the same risk-return relationship. Many managers were among those who invested early, and therefore had a greater chance of profits if they sold before the drastic decline. Investment bankers made money primarily on fees for the IPOs, which are quite steep. Fees are less risky than are stock investments, and therefore the bankers had a greater chance of profiting from their participation in the IPOs.

3. How might a company configure its strategy-making processes to reduce the probability that managers will pursue their own self-interest at the expense of stockholders?

   In order to reduce the agency problem, firms must exercise appropriate and adequate control and monitoring. In order to control the actions of top executives, the board of directors should be involved in strategy-making at high levels, and should be charged with ensuring that the strategies chosen are in the long-term interests of the firm. The board should also be given responsibility for overseeing the actions of top managers to ensure that they are in fact implementing the chosen strategy. The board should be composed of mostly outside members representing any large stockholder groups.

   Another governance mechanism is to use strategic controls to ensure that lower-level managers act in agreement with the wishes of top managers. This process requires top managers to establish standards, create a system for periodic measurement, compare actual performance to the standards, and evaluate results. In order to implement this system, there must be some centralization; highly decentralized organizations do not provide adequate opportunities for oversight, and the resulting information asymmetry can lead to the agency problem.

4. Under what conditions is it ethically defensible to outsource production to producers in the developing world who have much lower labor costs when such actions also involve laying off long term employees in the firm's home country?

   It is the responsibility of the managers to maximize profitability for the shareholders. If the choice is between moving production to the developing world for lower labor costs versus continuing to employ long-term employees in the firm's home country, then the former is the appropriate action to take so that the firm can continue to be competitive. Managers should not endanger the survival of the firm to maintain employment practices. However, this should only be done if it is legal and the foreign employees are paid at a normal rate for their home country and otherwise treated equitably.

SMALL-GROUP EXERCISE: EVALUATING STAKEHOLDER CLAIMS

Students are asked to break into small groups and identify the stakeholders of their school. They are asked to describe the claims the stakeholders put on the organization, to show how the school is responding to their claims, and to make suggestions for improving the school's strategy with regards to various stakeholder groups. Students also should prioritize the claims of various stakeholder groups on the institution and decide which claims should take precedence.

Teaching Note:

Students are likely to see the needs of students as most important, but you should also point out the contributions that are made by groups such as faculty, staff, benefactors, funding agencies, the local community, and corporate sponsors. One way to graphically illustrate for students the importance of a variety of stakeholder groups is to show them how the school's expenses are paid: what proportion comes from tuition, from alumni, from government agencies, and so on. You can also ask them to consider what would happen if they lost support from one of these groups—for instance, if professors went on strike or the federal government quit offering student loans.

EXPLORING THE WEB: VISITING MERCK

Students are asked to visit Merck's website (at http://www.merck.com, select "About Merck" and then "Mission Statement") to view the firm's mission statement. They should examine the mission statement for a statement of basic goals, guidelines for managerial action, and recognition of stakeholder claims. They are then asked to discuss the firm's stated interest in and success at balancing the stockholders' need for profitability against society's need for beneficial and affordable medicines. They are also asked to evaluate Merck's decision to remove Vioxx from the market after research showed that the drug increased the risk of heart attack in patients who took it. In the General Task, they are asked to find an example of a firm in which there was overt conflict between principals and agents about the future strategic direction of the firm.

Teaching Note:

At the website, students will find information that shows that Merck is pursuing goals related to ethics, excellence in scientific research, diversity, and profitability, but they claim that their most important goal is "preserving and improving human life." The statement shows what actions are expected of managers, and it recognizes the claims of stockholders, employees, customers, and society. This statement also emphasizes that profits should only come as a result of work that benefits humanity. For an interesting classroom discussion, obtain samples of several other mission statements and compare them to that of Merck. Most of them give less emphasis to benefiting society—ask students why they think this is so. A cynical student may note that Merck is under tremendous political pressure to provide life-saving drugs to Third World countries at very low costs, and thus the mission statement may be motivated by public relations to serve as "corporate propaganda." Students may also note that in 2006 Merck has lost several court cases related to the damage caused by Vioxx. Internal Merck documents have shown that researchers there were aware of the heart dangers of Vioxx long before the drug was removed from the market. There are also indications that sales representatives were trained to mislead doctors regarding the dangers of Vioxx.

In the General Task, students should look for companies that have experienced an abrupt, unwelcome change in top leadership, such as a sudden resignation. This is one clue that the relationship between managers and principals has deteriorated, although there are many additional troubled relationships that have not yet reached this conclusion. Recent examples include Skilling's abrupt departure from Enron, Messier's departure from Vivendi, and Waksal's resignation from ImClone.

CLOSING CASE:

Google's Mission, Ethical Principles, and Involvement in China

Google was established with a clear mission in mind: to organize the world's information and make it universally acceptable and useful. Google has developed a search engine that accesses information from all over the web for the user. On the back of its popular search engine, Google has also built a highly profitable advertising business. One of the founding values of the company is captured in the mantra "don't be evil" that Google takes very seriously. This value was seriously challenged when the company expanded to China, and the Chinese authorities began censoring Google's searches – users in China could not access some of the websites that the Chinese government viewed as subversive. In order to increase its presence in China, a country with a huge market potential, Google decided to seek a presence in China while acceding to government censorship. Google's managers claimed that it was better to give Chinese users access to a limited amount of information than none at all.

Teaching Note:

The Google case highlights the importance and difficulty of having strong corporate values to guide the company in the context of internationalization. Strong values that are put into practice help build a culture that supports these values. It also attracts employees that subscribe to these values, and results in reinforcing behavior consistent with these values. When a company goes global, it is likely that some of the values may conflict with the realities of an international context. The company then has to decide a pragmatic solution, based on its true beliefs, without compromising on its values, to maintain the credibility of its operations and culture among its stakeholders.

ANSWERS TO CASE DISCUSSION QUESTIONS

1. How does Google's mission drive strategy at the company?

   Google tries to make sure that its mission is incorporated in its strategy. For instance, it separates out commercial considerations from its rankings in the search results. Its expansion to China itself may be considered a case of helping Chinese residents get more information, and give them a chance to "reduce the influence of evil" in their lives.

2. Is Google's stance toward Internet search in China consistent with its mission?

   The stance is consistent with its mission in as much as is pragmatic in the circumstances. It is easy to disengage entirely, and follow the mission to the letter, but then one deprives the people of China of a fast and easy way to search for information. Disengagement would seem to be more against Google's mission than having a presence in China with some limits.

3. Do you think that Google should have entered China and engaged in self-censorship, given the company's long-standing mantra "Don't be evil"? Is it better to engage in self-censorship than have the government censor for you?

   Google' strategy of engaging in self-censorship was based on pragmatic considerations of providing some service to the consumers in China rather than not serving them at all. It is likely that a large proportion of information would not need to be censored, and the residents of the country would benefit from having access to a fast search engine. So the action can be termed ethical as well, in terms of providing some good to a large number of people rather than depriving them of the entire product by adhering to absolute standards. It is certainly better to engage in self-censorship, rather than have the government censor for you. Via this strategy, Google has a better chance of staying true to its values.

4. If all foreign search engine companies declined to invest directly in China due to concerns over censorship, what do you think the results would be? Who would benefit most from this action? Who would lose the most?

   The result would be that Chinese government would likely have its own "official search engine" for China, which would return only government-approved websites in response to a query. The Chinese government would benefit the most from this action. The people of China may lose most from this action, since they would be deprived of information from other sources, and may become victims of misinformation provided by the Chinese government.