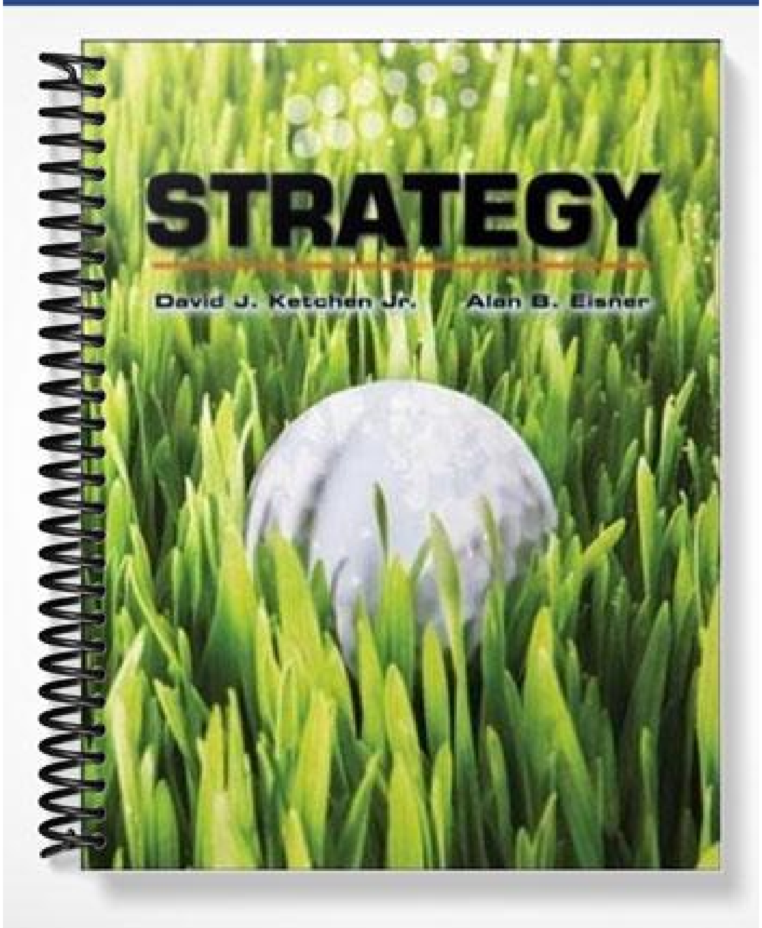
SOLUTIONS MANUAL



Chapter 2

The Context of Strategic Management

Summary/Objectives

This chapter highlights two major contextual factors facing executives responsible for the strategic management process. These two major contextual factors are globalization and business ethics. How firms can create value and achieve competitive advantage ethically in a global marketplace, is the overarching issue explored in this chapter. The chapter is divided into four major sections.

1. The first section of this chapter discusses the rise of globalization and addresses the factors that determine a nation's competitiveness in a particular industry. Using Porter's framework, four dimensions – factor conditions, demand characteristics, related and supporting industries, and firm strategy, structure and rivalry – are discussed as shaping the competitive process in the international arena.

2. The second section provides a discussion of the benefits and risks associated with international expansion efforts. Benefits and potential pitfalls are highlighted. Offshoring and outsourcing are discussed.

3. The third section focuses on corporate governance and stakeholder management. Corporate governance refers to owners' efforts to ensure that managers act appropriate in their role as strategic managers. Successful firms, however, go beyond an overriding focus on satisfying owners. These firms recognize the inherent conflicts among stakeholders' interests and work to develop mutual benefit and interdependence among them – a symbiosis.

4. The final section discusses the importance of managers' acting in a socially responsible manner with an emphasis on issues related to environmental sustainability.

Lecture/Discussion Outline

The introductory case in the chapter addresses Wal-Mart's $900 million loss in South Korea. The primary cause was its failure to adapt to local market conditions. For example, Wal-Mart tried to use a membership approach (similar to Sam's Clubs) and did not offer the types of products that attract South Koreans to hypermarkets—food and beverages. Their western model did not work in South Korea and Wal-Mart eventually sold all of its 16 stores to a local retailer.

? ***Discussion Question 1:*** *What are some examples of firms that have had major successes in international markets? Why were they successful?*

Discussion Question 2: *What are some examples of firms that have experienced failure when attempting to enter international markets? What were the underlying causes of their failures?*

I. Globalization & Factors Affecting a Nation's Competitiveness

We start first by providing a brief summary of some key issues in the global economy. We emphasize the increase in global trade and point out that it is estimated that by the year 2015 that there will be more trade between nations than within nations.

The "Extra Example" below addresses some of the implications for global trade after the September 11, 2001 terrorist attacks and the ongoing "war on terror." (Although some of these types of issues were raised in earlier chapters, it might be interesting to ask students what they think some of these implications are in a global context.)

Extra Example: Implications Of September 11th for Global Trade

The events of September 11 certainly do not create an environment that fosters global commerce, especially since economies were slowing well before these tragic events. HSBC Holdings forecasts that global trade, after surging 12.6 percent in 2000, will expand a mere 0.9 percent in 2001 and just 2 percent in 2002. That should translate into weaker growth.

A major reason is that higher risk means higher costs. Just as insurance costs for Central London offices leaped fourfold after the Irish Republican Army bombings in the early 1990s, rates are likely to leap for companies with properties anywhere terrorism is a threat. Liability insurance for staff will also rise. "These costs will have to be passed on through product prices and will force companies to rethink where they should be doing business," says J. S. Rosenbloom at the Wharton Business School. "The impact will be felt throughout the world."

If disruptions at border crossings become a fact of life, companies will have to stockpile more spare parts, which hikes costs further. Hundreds of U. S. companies with manufacturing or assembly operations in Mexico, from major Detroit automakers to data-processing companies, are rethinking their logistics.

Source: Engardio, P. 2001. What's at stake. *Business Week*, October 22: 36.

We also point out that there have been extremes in the effect of global capitalism on nations' economies around the world and their poverty levels. These extremes are pointed out with examples of success (Hong Kong, Taiwan, South Korea) and failure (many countries in Central America).

Teaching Tip: *It is useful to help students get a basic understanding of why some countries — and their citizens — enjoy the fruits of global capitalism while others continue to be mired in poverty. Ask them what some of the factors are that explain such differences. Some of the factors would include government policy, local entrepreneurs, investment in modern technology, economic factors, a legal system that protects property rights, strong educational system, etc. It is helpful to point out that some countries such as Japan have succeeded even though they do not have a high level of natural resources.*

STRATEGY SPOTLIGHT 2.1 provides an interesting perspective on international trade – marketing to the "bottom of the pyramid." Collectively, this market of 5 billion people represents $14 trillion in purchasing power

The next section discusses "Porter's diamond" and sets forth a useful context for explaining competitiveness at the national level. (This provides a framework to address how firms can create competitive advantages in the balance of the chapter.)

After conducting a four-year study, Michael Porter concluded that there are four broad attributes of nations that individually, and as a system, constitute what is termed "the diamond of national advantage." These attributes collectively determine the playing field that each nation establishes for its industries. These factors are:

- Factor Conditions;
- Demand Conditions;
- Related and Supporting Industries;
- Firm Strategy, Structure, and Rivalry.

The balance of this section will briefly address each of these factors and then provide an integrative example — the Indian software industry.

Discussion Question 3: *How do these factors — individually or jointly — affect industries in countries with which you are familiar?*

A. Factor Conditions

Factors of production include labor, capital, and natural resources (e.g., land and minerals) as well as factors that can be created. The latter are more relevant to developed nations that are seeking competitive advantage over firms in other countries. These include a skilled human resource pool as well as the supporting infrastructure of a country, e.g., communication and transportation systems as well as a stable banking system.

We give the example of Japan's expertise in JIT Systems — in part necessary because of Japan's expensive land costs.

The "Extra Example" below addresses Mexico's efforts to improve its factor conditions by investing in undergraduate and advanced training in engineering.

Extra Example: Mexico's Surprising Lead in Undergraduate Engineering Degree Programs

Mexico has long had a reputation as the provider of cheap, low-skilled labor. But the country realized it needed to enhance the image of its workforce to compete more effectively. To do so, it focused on engineering. Over the last decade, Mexican policy makers have increased enrollments in four-year engineering degree programs and created a network of technical institutes that confer two-year degrees and provide advanced training. The result may come as a surprise to U.S. college students: in 2006, 451,000 Mexican students were enrolled in four-year engineering programs compared to just 370,000 undergraduate engineering students in the U.S.

Mexico's efforts are not confined to degree programs. The country has formed alliances with major manufacturers such as General Electric, General Motors and Honeywell to create research centers employing hundreds of engineers. The students benefit as well because these and other multinational companies also donate high-tech equipment, software, and materials that are used to develop course content that fits their training needs. "In the past five years, Mexican engineers have become increasingly qualified and gained valuable experience," says Alfredo Juarez, a director at the country's top engineering school, the National Polytechnic Institute in Mexico City. "We constantly have major multinationals here trying to recruit dozens of engineers at a time."

Source: Smith, G. 2006. Look who's pumping out engineers. *BusinessWeek*, May 22: 42-43

Demand Conditions

Demand conditions refer to the demands that consumers place on an industry for goods and services. Consumers who demand highly specific, sophisticated products and services force firms to be more innovative to meet such demand. Such consumer pressure presents challenges to a country's industries to also make it more competitive in international markets.

We provide the example of Denmark's world-class position in water pollution control equipment. This is, in part, due to the nation's environmental awareness and demands for environmentally safe products.

Related and Supporting Industries

Related and supporting industries enable firms to more effectively manage inputs. For example, countries with a strong supplier base benefit by adding efficiency in downstream activities. That is because a competitive supplier base helps a firm obtain inputs using cost-effective, timely methods it contributes to reducing manufacturing costs.

We provide the example of the Italian shoe manufacturing industry and the Swiss pharmaceutical industry.

Firm Strategy, Structure, and Rivalry

Firms develop strategies and structures to compete with other firms in the same country that are trying to capture the same customer market. Rivalry is particularly intense in nations with strong consumer demand conditions, strong supplier bases, and high new entrant potential from related industries. Such rivalry provides a strong impetus for firms to innovate and find new sources of competitive advantage.

The example that we provide is the personal computer industry in the United States with such players as Dell, Compaq, and Hewlett-Packard.

STRATEGY SPOTLIGHT 2.2 and EXHIBIT 2.1 provide the integrative example of the Indian software industry. (This should be a rather interesting example to students because many of them may think that most of the software development is in the developed countries in North America, Europe, and Asia).

The "Extra Example" below details some recent figures on India's economy and related demographics:

Extra Example: India: Some Demographics and Economic Figures

Below are some figures that reflect the growth and the dynamic nature of India's economy:

- 1.1 billion people
- Median Age: 24
- Number of engineers who graduate in India each Year: 290,000 (compared to only 100,000 in North America)
- Combined sales at info-tech and service firms in India in 2004: $28 billion
- Increase in info-tech and services revenue since 2000: 130 percent
- Number of cell phone subscribers in India: 55 million
- Number of Internet users in India: 33 million

Source: Brown, E. 2005. India rising. *Forbes*, September 5:137-146.

? ***Discussion Question 4:*** *What do you feel are some of the pros/cons of foreign entry into India at this time?*

Concluding Comment

Porter's conclusions were based on case histories from more than 100 industries. A common theme did emerge: Firms that succeeded in global markets had first succeeded in intense competition in home markets. Thus, successful global firms often result from relentless, continuing improvement, innovation, and change.

We will now turn to the level of the individual firm. In the next section, we'll discuss a company's motivations and risks associated with international expansion.

II. International Expansion: A Company's Motivations and Risks

A. Motivations for International Expansion

There are many motivations for a firm to pursue expansion into global markets. The most obvious one is to increase the size of potential markets. EXHIBIT 2.2 (PPT 2-17) lists the population of the United States compared to other major markets. (Note that the population of the United States is roughly only one-fourth of that of India and one-fifth of that of China.)

? ***Discussion Question 5:*** *What are the implications of EXHIBIT 2.2 for international trade?*

Many multinationals are intensifying their efforts to market their products and services to countries such as India and China as the ranks of their middle class have accelerated over the past decade. We also address some opportunities presented by China's emerging middle class.

Potential benefits of international expansion include (with examples we discuss):

- attain economies of scale (Boeing's commercial aircraft; Microsoft)
- reducing the costs of research and development as well as operating cost (McDonald's)
- extend the life cycle of a product (soft drink producers PepsiCo and Coca-Cola; personal computer manufacturers such as Dell and Compaq.)
- optimize the location of every activity in its value chain (Microsoft)

The last item — optimize the location of every activity in its value chain — can yield three strategic advantages:

1. Performance Enhancement

We provide the example of Microsoft's decision to locate a corporate research facility in Cambridge, U.K. in order to draw upon superb technical and professional talent.

The "Extra Example" below discusses how General Electric (GE) was able to tap talent in many countries to develop its wind-energy business:

Extra Example: GE Builds a Global Team of Researchers in Germany, China, India, and the U.S.

Under Jeff Immelt's leadership, GE has built two more research centers — one in Shanghai, China, and the other in Munich, Germany (its other research centers are in the United States and India). "We did it," says Immelt, "to access the best brains everywhere in the world."

The multiple research centers have really paid off for GE's wind energy business, which it bought from Enron in 2002. GE has quadrupled the unit's revenues to $2 billion in 2005.

The expertise of all four centers has helped GE develop the huge 92 ton turbines.

* Chinese researchers design the microprocessors that control the pitch of the blade.

* Mechanical engineers from India (Bangalore) devise mathematical models to maximize the efficiency of materials in the turbine.

* Power-systems experts in the United States (Niskayuna, New York) — which has researchers from 55 countries — do the design work.

* And, technicians in Munich have created a "smart" turbine that can calculate wind speeds and signal sensors in other turbines to pitch their blades to produce maximum electricity.

Source: Sellers, P. 2005. Blowing in the wind. *Fortune*, July 25: 63.

2. Cost Reduction

We discuss Nike's decision to source the manufacture of athletic shoes from Asian countries such as China, Vietnam, and Indonesia; and the decision of many multinational companies to set up production facilities just south of the U.S./Mexico border (maquiladoras).

STRATEGY SPOTLIGHT 2.3 addresses a highly emotional topic on international management – the use of child labor. It discusses alternate approaches taken by two firms based on their individual situations.

3. Risk Reduction

Here, we address the risks associated with erratic swings of exchange ratios of the U.S. dollar and other currencies (such as the Japanese yen). Firms can cope with such risks by spreading high-cost elements of their manufacturing operations across a few carefully chosen locations around the world. Such decisions can help lower the overall risk profile of a firm with regard to currency, economic, and political risk.

The "Extra Example" below discusses New Balance. It provides a counterexample to Nike and other athletic shoe manufacturers that have outsourced manufacturing activities offshore.

Extra Example: New Balance Defies Conventional Wisdom

Many United States manufacturers have outsourced manufacturing operations due to the allure of low labor costs in other countries. New Balance, however, has kept much of its labor in its Norridgewock, Maine location. The athletic shoe manufacturer takes a different approach to labor costs — encourage existing labor to work cooperatively and efficiently and apply available technology to keep overall labor costs low.

Twenty-five percent of New Balance's shoes are produced in the United States. By "incessantly boosting worker productivity, we're able to keep jobs in America," says Herb Spivak, Executive Vice President of Operations. The firm also has plants in China, so managers at U. S. plants are well aware of labor cost differentials. With an average wage of $10 per hour for New Balance U. S. workers, efficiency, teamwork, and technology must compete with Chinese counterparts earning only 20 to 30 cents an hour. Although the Chinese manufacturers are slightly under the $4 to $4.50 cost of an average pair of New Balance shoes made in the U. S., the U. S. plants stay competitive once tariffs are factored in.

In addition, New Balance uses advanced technology to keep its manufacturing costs down. Workers scan the edges of material with advanced optical technology while stitching seams together. The company also has intensive training for its U. S. workers. They have recently changed from a piece work compensation system to the hourly rate, encouraging workers to concentrate on training and skill upgrades that lead to future productivity gains. This certainly hasn't hurt revenues — total sales have grown from $221 million in 1992 to $1.5 billion in 2004.

Claims Chairman and CEO Jim Davis, "While we do make some shoes overseas, we also operate five USA factories, remaining committed to our domestic workforce who has remained dedicated to us through the years."

Sources: Coplan, J. H. 2001. New Balance stays a step ahead. *U. S. News and World Report*, July 2: 34; Anonymous. 2000 New Balance enhances its fastest growing segment. *New Balance Press Release*, March 23: np.; and Company Records.

Teaching Tip: *The example of New Balance provides you with an opportunity to point out that when it comes to attaining competitive advantage through low labor costs, it is important to take into account the overall costs of labor, NOT just labor costs. Also, make the point that it is important to view the entire value chain and the integration of activities in the value chain — not just one activity such as "operations.*

Discussion Question 6: *What are some other examples of firms that help to illustrate the benefits from international expansion?*

The "Extra Example" below discusses the growing interest by many large automobile manufacturers to invest in China's dramatically expanding domestic market.

Extra Example: Increasing Car Ownership in China Is Spurring Foreign Investment

After nearly a quarter century of economic liberalization, car ownership is coming within reach of millions of ordinary Chinese. With rising incomes, decreasing car prices, and more roadways being built, China's 1.3 billion people are eager to trade in their bicycles for something that is more comfortable and faster. In 2002, passenger car sales topped the one million mark for the first time. And, in the first six months of 2003, China's new car sales have surged 85 percent over the same period in 2002.

Foreign manufacturers are racing to China to lay claim to a stake in the rapidly growing market. Volkswagen, China's biggest foreign automaker, has promised to invest $6.8 billion over the next five years to increase capacity. General Motors, which has spent $1.5 billion to build a state-of-the-art factory in Shanghai, also has aggressive plans. Japanese giants Toyota, Nissan, and Honda have all established joint ventures with Chinese partners. Clearly, the boom has just begun: Only one in 100 Chinese owns a car, compared with one in two Americans. However, in the richest Chinese cities — Shanghai, Beijing, Guangzhou — incomes are approaching $4,000, the level at which private-car consumption shifts into high gear.

Source: Chandler, C. 2003. China goes car crazy. *Fortune*. September 1: 120-130.

B. Potential Risks of International Expansion

There are also many potential risks associated with international expansion. To help companies assess such risks, rating systems have been developed. EXHIBIT 2.3 (PPT 2-21) depicts a sample of country risk ratings published by The World Bank, from the 178 countries that Euromoney evaluates. In EXHIBIT 2.3, note that the lower the score, the higher the country's expected level of risk.

Next, we address the four main types of risk: political, economic, currency, and management.

1. Political and Economic Risk

As indicated in EXHIBIT 2.3, countries vary significantly in their level of political risk. Such risk can lead to such problems as the destruction of property, nonpayment of goods and services, and the appropriation of a firm's assets in a country.

We also address the enforcement of laws associated with the protection of property rights and discuss how Microsoft has lost billions of dollars in potential revenue through the piracy of its software products in many countries such as China.

STRATEGY SPOTLIGHT 2.4 addresses a key threat to global trade – piracy. Ask:

? ***Discussion Question 7:*** *What actions should developed nations take to combat piracy?*

The "Extra Example" below is a brief excerpt from an essay on the role that U. S. politics can have on long-haul trucking across its borders. (The example serves to illustrate that political risk can also be rather subtle.)

Extra Example: Changing U.S. Politics on Mexican Long-Haul Trucking

The U. S. has stringent standards for long-haul trucking. Under NAFTA, Mexico — despite its weaker standards — may send trucks across the Rio Grande. During the Clinton Administration, U. S. policy ignored NAFTA and restricted Mexican trucks to a narrow border zone. President Bush wants to give the trucks free access to North America. Liberal lawmakers are pressing for border inspections so that Mexican trucks, just like Mexican lettuce, will meet U. S. safety standards. The Bush Administration says that violates free trade.

Source: Kuttner, R. 2001. A global market isn't as easy as it looks. *Business Week*, September 3: 26.

? ***Discussion Question 8:*** *Ask the class where they stand on this issue. Has their position changed since September 11th? What are the implications of either (or both) positions? Clearly, restrictions impose constraints on the move toward a "frictionless economy," but there are security tradeoffs.*

2. Currency Risks

Currency fluctuations can pose substantial risks. A company with operations in several countries must constantly monitor the exchange rate between its own currency and that of the host country. We provide a hypothetical example of negative implications for an American company with overseas operations.

3. Management Risks

Management risks may be considered the challenges and risks that managers face when they must respond to the inevitable differences that they encounter in foreign markets. These take a variety of forms: culture, language, income levels, customer preferences, distribution systems, and so on.

We show how cultures vary across four international locations – Ecuador, France, Hong Kong, and Singapore – and discuss implications for the conduct of business across national boundaries. We also provide here the problems that Coca-Cola had with the Greeks when they "insulted" the Acropolis.

The "Extra Example" below addresses some additional protocol issues that multinational firms doing business in Hong Kong must be aware of in order to be successful. Note how they vary from customs in the United States.

Extra Example: Protocol Issues in Hong Kong

Gestures:

- Members of the same sex may hold hands to signify friendship, but members of the opposite sex may not.
- Although women may cross their legs, men should keep their feet on the floor. Place your hands in your lap while sitting.
- The Chinese may communicate in closer proximity than is common in the United States.
- Do not pat people on the shoulder or initiate any physical contact. It is not appreciated.
- “Come here” is signified by turning the palm face down and waving the fingers.

Gifts:

- Gift giving is an intricate and important custom in Hong Kong. The best-intentioned businessperson can offend counterparts by giving

1. Clocks (they connote death)
2. Books (they represent a “Curse to Lose” for gamblers)
3. Blankets (they stifle the recipient’s prosperity)
4. Unwrapped gifts (this is rude)
5. Gifts wrapped in blue (the color of mourning)
6. Green hats (they suggest that you are a cuckold or your sister is a prostitute)

Source: Morrison, T., Conaway, W. & Borden, G. 2000. *Kiss, Bow, or Shake Hands.* Diane Publishing Company: 159.

Teaching Tip: *Cross-cultural examples are typically very interesting to students. Although we provide examples in this section as well as in the “Extra Example” above, it is always useful to ask students what examples they can come up with — both from their business courses as well as from personal experience. It also provides an opportunity to get some insights from the international students in the class.*

C. Global Dispersion of Value Chains: Outsourcing and Offshoring

This section addresses two of the emerging trends in international business — outsourcing and offshoring. *Outsourcing* occurs when a firm decides to utilize other firms to perform value-creating activities that were previously performed in-house. *Offshoring* takes place when a firm decides to shift an activity that they were previously performing in a domestic location to a foreign location.

It is important to point out that the movement of jobs offshore in the manufacturing sector was repeated by the service sector as well in the mid-1990s. However, the trend that began with low-level programmers and data entry work to countries such as India has grown many-fold to include a wide variety of white collar and professional activities ranging from call centers to R&D. To survive, companies have to locate each stage of the value chain in places where factor conditions are most conducive.

The "Extra Example" bellow addresses a "global delivery" approach which is indicative of the extent to which outsourcing and offshoring have become part of global commerce.

🕮 **Extra Example:** Outsourcing's global delivery model

The use of offshore providers of information technology, human resource management, and other services is central to today's global expansion. In fact, many service providers are pursuing a global delivery model that permits them to fulfill their outsourcing obligations from offices around the world. For example, BT (formerly British Telecom), the UK telecom giant, recently outsourced its human resources operation to Accenture. To fulfill this task, Accenture is using offices in India, the Czech Republic, and the U.S as well as the U.K. Dutch bank ABN Amro outsourced its IT operations to five companies. One of them is Tata Consultancy which uses employees in Mumbai, Bangalore, Budapest and Luxembourg to do the work. In another deal, Tata signed a joint agreement with Microsoft and a branch of the Chinese government to create a software joint venture to supply IT outsourcing services. Nearly half of the 5,000 employees Tata will need for the job will be employee in Latin America – Brazil, Uruguay, and Chile.

Source: Dolan, K. A. 2006. Offshoring the Offshorers. *Forbes,* April 17: 74-76.

The "Extra Example" below discusses some of the key potential benefits of offshoring: building capabilities and reaping the benefits of increased specialization.

Extra Example: The Rationale for Offshoring

The benefits of offshoring can go far beyond merely short-term savings in operations. It can also encompass the rapid building of capabilities and increased specialization.

Several computer manufacturers have recently begun to compete in a variety of consumer electronics markets. Gateway, in a very short time, has established a leadership in the U. S. plasma TV market. Hewlett-Packard has entered the digital camera market and has recently gained a 6 percent market share among leaders like Nikon and Canon. And, Dell is targeting televisions and smart phones. These firms have one thing in common: they have relied heavily on offshore design suppliers in their core businesses to accelerate their entry into consumer electronics.

Firms should see offshoring as more than a form of wage arbitrage. Rather, look at it as a form of skill arbitrage supplemented by the opportunity to generate savings via lower wages. Even this perspective does not capture the full potential of offshoring. In the longer term, it should become a powerful source of innovation in products and services.

In the near term, innovation will be focused on serving the unique needs of demanding consumers in the high-growth emerging economies of China and India. Over time, however, it will disrupt markets in more developed economies as consumers in these countries begin to realize that they too can get more value at lower cost.

To continue to create value, executives must adopt a much more strategic and dynamic view of offshoring. They must use offshoring (and related outsourcing) decisions to reexamine the most basic question of all: What business are we really in? Firms must be clear about their own areas of expertise before they can leverage the specializations of others.

Source: Hagel, J. III. 2005. Productive friction: How business partnerships can accelerate innovation. *Harvard Business Review*, 83 (2): 82-91.

Many students may be (justifiably!) concerned about the potential of having their job (or future job) "offshored." The "Extra Example" below provides some useful insights on how one may help to inoculate themselves against such a fate.

Extra Example: Inoculating Oneself Against Having Your Job "Offshored"

The safest bet is having a job that absolutely requires your physical presence, such as being a barber, electrician, or a brain surgeon. Failing that, sustainable careers typically are those that involve deep relationships with customers and extensive knowledge of local market conditions. It helps if you have multidisciplinary skills that aren't yet common in many low-cost countries. (Think computer science plus biology, or law and international business.) Bonus points go to those who perform well in person with the boss.

The face-time factor was one of the variables that Alan S. Blinder, a professor at Princeton University, built into the "offshorability index" he published in March, 2007. At the top of Blinder's list of the most likely white collar jobs to be sent overseas are software programmers, data entry clerks, draftsmen, and computer research scientists. Overall in the U. S., Blinder classifies 8.2 million people's current jobs as "highly offshorable" and 20.7 million more as "offshorable." "The message is: If your job can be done by a person in India who is just as smart as you but works for a fraction of the wage, you're in a perilous occupation", he says.

Plenty of jobs have been lost already. Between 2000 and 2006, the American computer programmer work force fell from 530,730 to 396,012, or about 25%, according to the U. S. Bureau of Labor Statistics. *A different BLS measure, however, shows the number of people in computer systems design services is at an all-time high.* So, while some lower-level programming jobs are moving offshore, techies who specialize in advising clients are still in demand.

Source: Hamm, S. 2007. The changing talent game. Business Week, August 20 & 27: 68-71.

III. The Role of Corporate Governance and Stakeholder Management

We discuss three important and related concepts: corporate governance, stakeholder management, and social responsibility. Clearly, these topics (especially corporate governance) have generated quite a bit of controversy in the early 2000's and the topic should lead to some spirited discussion.

Corporate governance addresses the relationship between various participants in determining the overall direction and performance of corporations. It consists of three primary participants—shareholders, management, and the board of directors.

EXHIBIT 2.4 (PPT 2-30) illustrates these three participants.

? ***Discussion Question 9:*** *What are some recent examples of poor corporate governance? (Examples would include Tyco International, WorldCom, Enron, Adelphia, etc.)*

It might be interesting to read the following excerpt from a January 2007 *Business Week* article. The writer speculates that the key issue for boards of directors is the sometimes astronomical level of executive pay. After discussing the article it might be interesting to ask questions such as the following:

? ***Discussion Question 10:*** *How should a CEO's pay be determined? How much is too much—or should there be any limits? (For example, as proposed by one CEO, should it be a multiple of the next highest executive?) Should stockholders have a say in approving CEO pay packages?*

Extra Example: **Executive Compensation – A Hot Topic for Boards of Directors**

The hottest issue for boards this year is shaping up to be executive compensation. For the first time ever, companies are required to disclose a complete tally of everything they have promised to pay their executives, including such until now hidden or difficulty-to-find items as severance, deferred pay, accumulated pension benefits, and perks worth more than $10,000. They will also have to provide an explanation of how and why they've chosen to pay executives as they do. The numbers are likely to be eye-popping. Michael S. Melbinger, a top compensation lawyer in Chicago, thinks that when all the proxies are filed, there could be 50 companies or more with CEO pay packages worth $150 million-plus.

Source: Byrnes, N. & Sasseen, J. 2007. Board of hard knocks. *Business Week*, January 22: 35-39.

B. Governance Mechanisms: Aligning the Interests of Owners and Managers

Three key governance mechanisms are addressed in this section. The first two address the primary means by which the behavior of managers can be monitored: (1) a committed and involved board of directors that acts in the best interests of shareholders, and (2) shareholder activism, wherein the owners of the corporation become actively involved in the governance of the corporation. In addition, a third mechanism of governance is the effective use of managerial incentives, which are intended to align the interests of management with those of the stockholders.

1. A Committed and Involved Board of Directors

In effect, the board of directors is the group who provide a balance between a small team of key managers in the firm and a vast group of shareholders. In the United States, the law requires that the board have a strict and fiduciary duty to ensure that the company is run consistent with the long term-interests of the owners (shareholders).

We provide five duties of the board of directors, according to the Business Roundtable. These include such issues as the selecting, evaluation, and replacement (if necessary) of the CEO; review of strategies; financial objectives; providing advice and counsel to top management; etc.

A key element of effective boards is director influence, i.e., that board members are free of all ties to the CEO or the company.

The "Extra Example" below provides more information (which your students may find interesting) on the conflicts of interest on the board at Disney.

Extra Example: Disney's Board of Directors: Not So Independent!

Among some revelations at Disney in 2002… In 2002, Walt Disney paid $232,782 to a private company for use of a plane by Vice-Chairman Roy Disney. The company, Air Shamrock, is owned by the Disney family and a holding company run by director Stanley Gold. Disney also disclosed that in 1997 it had pledged $25 million to build the Walt Disney Concert Hall and has donated $20 million so far. Who was the chairman and CEO of the arts center? "Independent" director Andrea Van de Kamp, who joined the board the year after Disney pledged the cash.

Ira Millstein, Disney's governance advisor, responded by saying that the board should be applauded for making the disclosures, which in most cases were not required. Claims Millstein: "As long as you tell everybody what you're doing, that's good governance." Might Disney shareholders have a different opinion?

Source: Lavelle, L. 2002. Disney: More insiders at the castle. *BusinessWeek*. December 30: 14.

? ***Discussion Question 11:*** *How can such conflicts of interests be avoided by firms?*

Discussion Question 12: *Do you agree with Millstein's perspective in the last paragraph of the "Extra Example"? (This should generate some interesting discussion!)*

The "Extra Example" below discusses a primary reason why boards of directors will need to be more vigilant on the issue of executive pay: new regulations that have just taken effect.

Extra Example

Boards have begun to pay greater attention to how they set the chief executive's pay and to being seen to do it in a way that serves the interests of shareholders. A key reason is the requirement that compensation committees consists entirely of independent directors, introduced as a listing requirement by the New York Stock Exchange in the wake of the corporate scandals at the start of this decade. These committees must now hire compensation consultants, and many are insisting that they do no other work for the firm. Previously, such consultants had other lucrative contracts, which may have affected their judgment.

This new climate surrounding pay has already had an effect. Base salary has stabilized, though it was never the fastest-growing part of pay. Options, which even before the recent backdating scandal were losing their appeal, have been partly replaced by performance-related pay.

"Boards are being tougher with new hires, in particular, as it is hard to get a sitting chief executive to give up pay promised in his contract, at least without compensation," says Russell Miller of Korn Ferry, a recruitment firm. Even being tough on new chief executives is not easy, however. Boards know that the choice of a boss can have a huge impact on a firm's performance. Executive talent is valuable and private equity is on the prowl, offering packages with incentives that a public company will find harder to match amid all the denunciations of fat cats. Those are good reasons to expect pay to continue to grow, in spite of the outrage.

Source: Anonymous. The politics of pay. *The Economist*. March 24: 71-72.

We list some of the excellent governance practices of Intel, the world's largest semiconductor chip manufacturer with $36 billion in revenues. These include: mix of inside and outside directors; board presentations and access to employees; and, formal evaluation of officers.

In EXHIBIT 2.5 (PPT 2-34), we provide some examples of "best practices" for directors regarding pay, strategy, financials, and crisis management.

The "Extra Example" below cautions that having outside directors in *not* a panacea for improving the objectivity of directors. It provides several examples of corporations (Enron, Tyco, Disney, WorldCom) with a large percentage of outside members in which shareholder interests were not protected. And, it discusses two problems faced by shareholders: moral hazard and information asymmetry.

Extra Example: Outside Board Members: No Cure-All

Some of the most egregious cases of malfeasance have occurred in firms with a majority of outside directors. These include:

- Enron (80 percent outside directors),
- Tyco (65 percent),
- Disney (60 percent), and,
- WorldCom (45 percent).

Such boards, like others dominated by outsiders, often act like they are members of the emperor's court, either approving the CEOs' actions or not being terribly interested in what the CEOs do, so long as they are able to hold on to their board status.

Stockholders are faced with two problems. The first is *moral hazard*. Here, the CEO may take advantage of his/her position to pursue self-interests rather than shareholders' interest.

The second is *information asymmetry*. Here, the CEO and top management team may withhold important information from shareholders and the board of directors. What happened at Enron, Tyco, WorldCom, and many other corporations are excellent illustrations of these two problems.

Source: Tosi, H. L., Shen, W. & Gentry, R. J. 2003. Why outsiders on boards can't solve the corporate governance problem. *Organizational Dynamics*, 32 (2): 180-192.

? ***Discussion Question 13:*** *How do you think these reforms will enhance corporate governance? What else is needed?*

2. Shareholder Activism

Although, as a practical matter, individual shareholders hold relatively little influence, they do — acting collectively — have power to bring about shareholder action suits and demand that key issues be brought up for proxy votes at annual board meetings. In addition, shareholder influence has intensified in recent years because of the growing influence of large institutional holders such as retirement (e.g., TIAA-CREF, CalPERS) and mutual funds (e.g., Fidelity, Vanguard). In fact, institutional investors hold about 50 percent of all listed corporate stock in the United States.

3. Managerial Rewards and Incentives

From a corporate governance perspective, one of the most critical roles of the board of directors is to create incentives that align the interests of the CEO and top executives with the interests of the owners of the corporations. After all, shareholders rely on CEOs to adopt policies and strategies that maximize the value of their shares.

There must be an effective combination of three basic policies to create the right financial incentives for CEOs to maximize the value of their companies:

1. Boards can require that the CEOs become substantial owners of company stock.
2. Salaries, bonuses, and stock options can be structured so as to provide rewards for superior performance and penalties for poor performance.
3. Threat of dismissal for poor performance can be a realistic outcome.

Teaching Tip: *You can spur a lot of debate by asking if the amount of executive pay in recent years has become excessive. Some students will claim that it helps to attract top talent and that, if tied to corporate performance, any level is justified. Others may feel that there should be some realistic limits because, after all, many factors can explain the success (or lack thereof) of a corporation besides the actions of its top executives. Still other students may feel that such huge levels of compensations are simple examples of agency conflicts, i.e., that members of the boards of directors are too closely aligned (not independent) with top executives and do not effectively represent shareholders.*

Zero-Sum or Symbiosis: Two Alternative Perspectives on Stakeholder Management

In this section we recognize, of course, that there are often conflicting demands among an organization's stakeholders. However, managers need to acknowledge the interdependence among stakeholders and strive to achieve symbiosis, that is, the recognition that stakeholders are interdependent upon one another for their success and well being. We briefly review how Outback Steakhouse found that there were positive relationships between employee attitudes, customer satisfaction, and revenue increases.

EXHIBIT 2.6 (PPT 2-37) lists seven key stakeholder groups and the nature of their claims.

? ***Discussion Question 14:*** *What are some other ways that stakeholder demands may conflict? How might they be highly interdependent and positively related to each other?*

The "Extra Example" below addresses the relationship between "enlightened workplaces" and stock valuations. It serves to reinforce the point that there are typically positive relationships between satisfying the needs of multiple stakeholders—employees and owners, in this case.

Extra Example: Enlightened Workplaces and Stock Valuation

In the early 1990s, CalPERS (the organization responsible for the management of the enormous retirement funds for California's state employees) investigated another indicator of intangible value: enlightened workplace practices, for example, offering employees regular training, involving employees in corporate decision making, and linking employees' pay to performance. A 1994 report commissioned by the system concluded that companies that do a poor job of nurturing their human assets often do an equally poor job of protecting the value of their stock. The report went on to recommend that CalPERS consider using workplace practices as another criterion for selecting focus-list companies.

Source: Birchard, B. 1999. Intangible assets + hard numbers = soft finance. *Fast Company*: October: 324.

B. Social Responsibility and Environmental Sustainability: Moving Beyond the Immediate Stakeholders

Managers must consider the needs of the broader community-at-large and act in a socially responsible manner. Social responsibility is the expectation that businesses or individuals will strive to improve the overall welfare of a society.

The following "Extra Example" summarizes some of the central points in the debate as to the value of corporations to devote significant resources to corporate social responsibility:

Extra Example: Stakeholders Versus Shareholders

Although corporate social responsibility may appear to be an "apple-pie virtue," it is quite controversial. Below are some of the chief arguments for and against it:

Proponents will claim that it…

BURNISHES A COMPANY'S REPUTATION. In the wake of corporate scandals, corporate social responsibility builds goodwill—and can pay off when scandals or regulatory scrutiny inevitably arise.

ATTRACTS TALENT. Many young professionals expect their employers to be active in social issues. Membership in Netimpact.org, a network of socially-conscious MBA graduates, jumped from 4,000 in 2002 to 10,000 in 2004.

On the other hand, Detractors will argue that it…

COSTS TOO MUCH. Giving by corporate foundations reached an all-time high of $3.6 billion last year. However, it can come at the expense of other priorities, such as research and development, and is rarely valued by Wall Street.

IS MISGUIDED. Many corporate executives believe, as economist Milton Friedman does, that the role of business is to generate profits for shareholders—not to spend others' money for some perceived social benefit.

Source: Grow, B., Hamm, S. & Lee, Louise. 2005. The debate over doing good. *Business Week*, August 15: 76-78.

Teaching Tip: *You could likely generate some interesting debate by asking students to take alternative positions on this issue. Perhaps, assign one student to the "pro" position and one to the "con" position. Also, give them a chance to rebut the other person's perspective. You could then ask a few others to join the debate by taking their preferred side on this issue. (The debate could become more spirited by raising very "intense" issues such as natural disasters, including Hurricane Katrina in August, 2005.)*

STRATEGY SPOTLIGHT 2.5 discusses how American Express became one of the pioneers in cause-related marketing.

Next, we state that many companies are measuring what they call the "triple bottom line". Such a technique involves an assessment of environmental, social, and financial performance. We state that environmental sustainability is now a value embraced by most successful corporations.

Discussion Question 15: *Do you know of organizations that may have, in effect, used the "triple bottom line" approach to assess environmental, social, and financial performance?*

Discussion Question 16: *How will increases in energy costs affect initiatives such as the "triple bottom line" and environmental sustainability?*

It is important to stress that when considering the "triple bottom line," there are *not* always tradeoffs. At times, firms can attain symbiosis—that is attain increase their effectiveness in attaining multiple bottom lines simultaneously. The "Extra Example" below provides an example of Chiquita, a $3.9 billion fruit giant.

Extra Example: How Chiquita Enhances Its "Triple Bottom Line" Performance

For decades, Chiquita—the $3.9 billion fruit giant—was synonymous with the notion of the rapacious multinational. Farm workers toiled long hours in dangerous conditions, agrochemical runoff contaminated water, and tropical forests were cleared for expansion, according to J. Gary Taylor, coauthor of *Smart Alliance*, a book about Chiquita.

How things have changed! Recently, Chiquita allocated $20 million to overhaul the environmental and employment standards at all of its 127 farms, which employ 30,000 workers in seven Latin American countries. The company now saves $5 million a year on pesticides, while productivity is up 27%. Its CEO has said: "This is the first time I've made an investment decision without having a spreadsheet in front of me, and it's been one of the best." What are some of their actions?

- Chiquita now recycles 100% of the plastic bags and twine used on its farms
- The company cut pesticide use by 26% while providing better protective gear for workers.
- Improved working conditions include Chiquita-built housing and schools for employees: families.
- Buffer zones along far borders help prevent chemical runoff and erosion.

Source: Gilbert, K. 2006. Chiquita cleans up its act. *Forbes*. November 27: 73.

We close this section with STRATEGY SPOTLIGHT 2.6. It discusses how Adobe Systems benefits financially from its environmental initiatives.

IV. Summary

In this chapter we emphasize that globalization along with social responsibility and business ethics provide an important contemporary context in which the strategic management process takes place.

We first address the factors that determine a nation's competitiveness in a particular industry by introducing Porter's framework. This framework considers four dimensions – factor conditions, demand characteristics, related and supporting industries, and firm strategy, structure and rivalry. Collectively these dimensions shape the competitive process across countries in the international arena. We then discuss the potential benefits and risks associated with a firm's international expansion efforts.

Next, we introduce the concepts of corporate governance and stakeholder management to illustrate the importance of business ethics. Governance refers to the relationship between a firm's owners and executives. Stakeholders are groups such as owners, customers, suppliers, employees, and society at large for whom the firm is important. Successful firms work to develop a mutual benefit and interdependence between stakeholder groups.

Finally, we note that executives must recognize the need to act in a socially responsible manner and address issues related to environmental sustainability in their strategic actions. Globization and business ethics are integral throughout the strategic management process.

Chapter 2: The Context of Strategic Management

A. The United States is widely regarded as the world's leader in the entertainment industry (i.e., movies, music, etc.). Explain the United States' success in this industry by using Porter's Diamond of National Competitiveness.

Teaching suggestions:

(We analyze the Indian software industry in Strategy Spotlight 2.2 and Exhibit 2.1.)

Answers for this question can be quite wide-ranging depending on the students' knowledge relating to this industry. One possible answer is given below:

The position of the United States as the world's leader in the entertainment industry can be understood in terms of the following four broad attributes of the nation that individually, and as a system, constitute "the diamond of national advantage" for this industry.

Factor conditions: The United States has one of the world's most highly skilled manpower and infrastructure in this industry. There are several universities offering high-level programs in film production, music and other forms of entertainment. Hollywood is the world's most regarded place for film production and this has occurred as a result of decades of investments made towards that end. Access to capital for investment is another factor that contributes to competitive success in this industry. Perhaps the most critical is the copyright law that is so stringent. Such copyright protection encourages investments in creating high quality entertainment. A weak copyright protection regime would not leave much incentive for the artists or the producers to invest in creating 'masterpieces.' This is because they would not be able to appropriate the value created if the CDs or the movies created are copied and distributed freely like it happens in some other countries.

Demand conditions: One of the key reasons for the sophistication in the entertainment industry is the existence of very sophisticated consumers who demand high quality entertainment. By the very culture that encourages individualism, people do not hesitate having the best entertainment that they deserve. It would be surprising for many international students that there are courses offered in the US universities on how to be sophisticated movie-goers. This is an example to show the kind of the customers in the United States as far as entertainment is concerned. Such demanding customers put pressure on the industry to deliver high quality products and thus it enhances the industry's world standing.

Related and Supporting Industries are also very well developed. Suppliers are highly sophisticated and thus production costs can be kept low. Components such as CDs, computers, high-quality film, and suppliers of talent are in abundance.

Firm strategy, structure and rivalry: There is intense competition in this industry and there is also a high potential for entry from related industries. Domestic rivalry thus promotes higher levels of innovation for gaining competitive advantages over one another. High domestic rivalry in this industry is certainly an indicator of global competitive success. Also, the creation, organization and management of companies is much easier in the United States whose culture encourages entrepreneurial firms and has favorable bankruptcy laws. Therefore, any group of talented individuals can come together and form a company much more easily in this country than many other countries in the world.

All of these attributes of the United States create its 'national competitive advantage' in the entertainment industry.

B. Analyze your university (or college) from the stakeholder concept. Identify the stakeholders and the nature of their claims on the organization. What are the implications for administrators?

Teaching suggestions:

You might want to begin by asking the students to identify the difference between shareholders and stakeholders in the context of the university.

Discussion should be oriented towards identifying the various stakeholder groups mentioned in the text, such as:

- *__Customers__ : students, alumni, recruiting organizations, organizations using research outputs from the university,
- ***Employees** : teaching staff including faculty, research associates, teaching associates and the non-teaching or administrative staff, operational staff,
- ***Suppliers** : funding organizations and donors, stationery and teaching equipment suppliers, suppliers of utilities, etc.,
- ***Community** : taxpayers and the general public who have expectations from the university and can influence its functioning and funding and, of course, the state would be the owner in the case of a state university.

You might then want to ask whether stakeholder management is Zero sum or symbiotic?

This would be an interesting issue with which to generate discussion. You can play the role of a devil's advocate to enliven the discussion. It can be argued that if faculty and other employees desire higher salaries, this would require that the "customers" have to pay more for their services. Similarly, more funds for research would mean lesser funds for the administrative and support staff. Taxpayers would want to pay less, which means increased tuition burden to the students and so on. This would bring out the competing and conflicting nature of the claims of the various stakeholder groups.

You might want to then highlight the value of stakeholder symbiosis. Stakeholders are dependent upon each other for their success and well-being.

1. Top quality research needs excellent financial and support facilities. And, administrators must recognize that in order to ensure the effective functioning of the university neither the teaching staff nor the support staff should be starved. Further, research can also enhance the ability of the university to generate external funds.

2. Similarly, customers cannot expect to have better quality education unless they are prepared to pay for it. Alternatively, taxpayers need to pay a certain level of taxes in order to maintain the university at a reasonable level of performance.

3. Universities also have the social responsibility of inculcating right attitude, and shaping the integrity and character of the students, so that they become good citizens in all walks of life.

You might then want to ask the students to give examples of other social responsibilities of universities. Some of the social responsibilities that can be discussed are: setting example in terms of waste recycling, promoting environment friendly campus and research lab facilities, being involved with community services, ensuring diversity in the recruiting of students, staff, and faculty, to mention a few.

Conclusion: The expectations of various stakeholder groups are not constant over time and keep changing with changes in technology, globalization and other societal changes. An administrator would have to recognize this dynamic nature of stakeholder management and strive towards achieving mutual benefit through stakeholder symbiosis.