CHAPTER 2: STAKEHOLDERS, MANAGERS, AND ETHICS

LEARNING OBJECTIVES

1. Identify the various stakeholder groups and their interests or claims on an organization.
2. Understand the choices and problems inherent in distributing the value an organization creates.
3. Appreciate who has authority and responsibility at the top of an organization, and distinguish between different levels of management.
4. Describe the agency problem that exists in all authority relationships and the various mechanisms, such as the board of directors and stock options, which can be used to help control illegal and unethical managerial behavior.
5. Discuss the vital role that ethics plays in constraining managers and employees to pursue the goals that lead to long-run organizational effectiveness.

CHAPTER SUMMARY

Organizations are embedded in a complex social context that is driven by the needs and desires of its stakeholders. Organizations exist because of their ability to create value and acceptable outcomes for stakeholders. The two main groups of stakeholders are inside stakeholders and outside stakeholders. Effective organizations satisfy, at least minimally, the interests of all stakeholder groups. The problems that an organization faces as it tries to win stakeholders' approval include choosing which stakeholder goals to satisfy, deciding how to allocate organizational rewards to different stakeholder groups, and balancing short- and long-term goals. Shareholders delegate authority to managers to use organizational resources effectively. The CEO, COO, and top-management team have ultimate responsibility for the use of those resources effectively.

The agency problem and moral hazard arise when shareholders delegate authority to managers, and governance mechanisms must be created to align the interests of shareholders and managers to ensure managers behave in the interests of all stakeholders. Ethics are the moral values, beliefs, and rules that establish the right or appropriate ways in which one person or stakeholder group should interact and deal with another. Organizational ethics are a product of societal, professional, and individual ethics. The board of directors and top managers can create an ethical organization by designing an ethical structure and control system, creating an ethical culture, and supporting the interests of stakeholder groups.

CHAPTER OUTLINE

2.1 Organizational Stakeholders

Organizations exist because of their ability to create value and acceptable outcomes for various groups of stakeholders, people who have an interest, claim, or stake in an organization, in what it does, and in how well it performs. In general, stakeholders are motivated to participate in an organization if they receive inducements that exceed the value of the contributions they are required to make. Inducements include rewards such as money, power, and organizational status.

Contributions include the skills, knowledge, and expertise that organizations require of their members during task performance. The two main groups of organizational stakeholders are inside stakeholders and outside stakeholders. (Refer to Table 2.1)

Inside Stakeholders

Inside stakeholders are people who are closest to an organization and have the strongest or most direct claim on organizational resources: shareholders, managers, and the workforce.
- **Shareholders** are the owners of the organization, and, as such, their claim on organizational resources is often considered superior to the claims of other inside stakeholders.
- **Managers** are the employees responsible for coordinating organizational resources and ensuring that an organization's goals are met successfully.
- An organization's **workforce** consists of all non-managerial employees.

Organizational Insight 2.1: Unethical Managers at a Peanut Company

The fall of Parnell and his business shows the devastating consequences of ethical lapses on the part of senior management. The need for managers to run their organizations ethically is vital as the public relies on the basic integrity, ethics, and honesty of food industry managers to make food that is safe to eat.

Question: What led to the closedown of PCA's operations?

Answer: In 2009, a major nationwide outbreak of salmonella poisoning was traced by the Food and Drug Administration (FDA) to the peanut butter produced by the Blakely plant of PCA. PCA's contaminated peanut butter had caused over 600 illnesses, nine deaths, and the largest ever food recall in the country. This led to its closure.

Question: Why did Parnell fail to give due attention to food safety regulations at his plants?

Answer: Parnell was worried about maximizing his profits, especially when prices of peanut products had started to fall. He used contaminated peanuts and avoided salmonella tests to reduce his operating costs.

Outside Stakeholders

Outside stakeholders are people who do not own the organization and are not employed by it, but they do have some claim on or interest in it.

- **Customers** are the largest outside stakeholder group. The money paid for a product is a customer's contribution to the organization. Unless they get value, customers withdraw monetary support, and the company loses a stakeholder.
- **Suppliers** contribute to the organization by providing reliable raw materials and component parts that allow the organization to reduce uncertainty in its technical or

production operations and thus reduce production costs. Suppliers have a direct effect on the organization's efficiency and an indirect effect on its ability to attract customers.

- The **government** wants companies to compete fairly and comply with laws pertaining to employee pay, safety, discrimination, and other issues. The government contributes to organizations by standardizing rules.
- **Trade unions** directly impact a company's productivity and effectiveness, but union demands can conflict with shareholder demands.
- **Local communities** have a stake in the performance of organizations because employment, housing, and the general economic well-being of a community are strongly affected by the success or failure of local businesses.
- **The general public** is happy when organizations compete effectively against overseas rivals as the present and future wealth of a nation is closely related to the success of its business organizations and economic institutions.

Organizational Insight 2.2: BP Has Problems Protecting Its Stakeholders

In 2005, the United States witnessed one of its largest ever explosions at the British Petroleum plant situated 40 miles from Houston. Despite the aftermath of the incident, the company was found to breach the security restrictions placed upon it a second time in a row and was fined. This prompted the company to take remedial measures. However, in 2010, an accident on its oil drilling unit killed a few employees and brought about a full-fledged oil spill.

Question: What was the cause of the 2005 British Petroleum explosion?

Answer: Investigations revealed that the 2005 explosion occurred because BP had relaxed safety procedures at its Texas City refinery to reduce operating costs. The U.S. Occupational Health and Safety Association (OSHA) decided the 2005 explosion was caused by defective pressure relief systems and by poor safety management programs.

Question: After the 2007 accident, what measures did British Petroleum take?

Answer: After the 2007 accident, BP's board of directors decided to move quickly. They fired the CEO and many other top managers and appointed a new CEO, who was instructed to make global refinery safety a key organizational priority. The board also decided to make a substantial portion of the future stock bonuses for the CEO and other top managers dependent on BP's future safety record. Additionally, the board committed over $5 billion to improving safety across the company's global operations.

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2.2 Organizational Effectiveness: Satisfying Stakeholders' Goals and Interests

Organizations are coalitions of stakeholders who bargain to balance inducements with contributions. An organization must minimally satisfy the interests of all stakeholders who often have conflicting goals. To win stakeholder approval, the organization faces the problems of competing goals, allocating resources, and balancing short- and long-term goals.

Competing Goals

An organization's choice of goals has political and social implications. One view is that shareholders own the company, thus managers should maximize shareholder wealth. Yet ownership and control are separated because managers control the company and can pursue personal interest. They may focus on short-term profits instead of long-term growth or avoid risk taking because they control their own salaries.

Allocating Rewards

Another major problem that an organization has to face is how to allocate the profits it earns as a result of being effective among the various stakeholder groups. Reward allocation is important because it motivates stakeholders, yet it is difficult to determine the distribution of excess rewards.

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2.3 Top Managers and Organizational Authority

Authority is the power to hold people accountable for what they do. Shareholders are the legal owners of the corporation, and they are represented by a board of directors, who act as trustees. The board has the legal authority to hire, fire, and discipline top management. However, the responsibility of using organizational resources to create value is delegated to managers. (Refer to Figure 2.1)

There are two kinds of directors: inside directors and outside directors. Inside directors are directors who hold offices in a company's formal hierarchy; they are full-time employees of the corporation. Outside directors are not employees of the company; many are professional directors who hold positions on the board of many companies, or they are executives of other companies who sit on other companies' boards.

The Chief Executive Officer

The CEO is the person ultimately responsible for setting organizational strategy and policy. The CEO is at the top of the hierarchy and can influence organizational effectiveness and the decision-making process in the following five ways:

1. The CEO is responsible for setting an organization's goals and designing its structure.

2. The CEO chooses key executives to fill top-level positions in the hierarchy.

3. The CEO determines top management's rewards and incentives.

4. The CEO controls the allocation of scarce resources among an organization's functions and divisions.

5. The CEO's actions and reputation influence inside and outside stakeholders' opinions of the organization and impact the organization's ability to attract resources from its environment.

The Top-Management Team

The president is the person who has a position directly below the CEO and generally is called the chief operating officer (COO). In most companies, the president takes responsibility for managing the organization's internal operations, and the CEO takes responsibility for managing the organization's relationship with external stakeholders and for formulating a long-range business plan.

At the next level of top management are the executive vice presidents. People with this title have responsibility for overseeing and managing a company's most significant line and staff responsibilities. A **line role** is held by managers who have direct responsibility for the production of goods and services. A **staff role** is held by managers who are in charge of a specific organizational function such as sales or R&D.

The CEO, COO, and the executive vice presidents are at the top of an organization's chain of command. Collectively, managers in these positions form a company's top-management team, the group of managers who report to the CEO and COO and help the CEO set the company's strategy and its long-term goals and objectives. All the members of the top-management team are corporate managers, whose responsibility is to set strategy for the corporation as a whole.

Other Managers

Other corporate managers include senior vice presidents and vice presidents. Vice presidents report to senior vice presidents, who report to executive vice presidents.

Companies may also have general managers or **divisional managers**. These managers are present only in companies that are organized into separate business divisions. These managers are divisional management and not corporate management and they determine policies for the divisions they run instead of objectives for the organization as a whole. Divisional managers generally report to a member of the top-management team.

Managers at the next level are called **functional managers**; these managers are in charge of a certain function, like marketing or finance. Functional managers are responsible for developing capabilities in their area that lead to core competences.

2.4 An Agency Theory Perspective

Agency theory is useful for understanding the relationships between various levels of management. A relationship exists when one party (the principle) delegates decision-making authority or control to another (the agent). The **agency problem** is a problem in determining managerial accountability that arises when delegating authority to managers.

The Moral Hazard Problem

Two conditions lead to the existence of a **moral hazard**: (1) a principal finds it very difficult to evaluate how well the agent has performed because the agent possesses an information advantage, and (2) the agent has an incentive to pursue goals and objectives that are different from the principal's. Self-dealing is the term used to describe the conduct of corporate managers who take advantage of their position in an organization to act in their own interests rather than in the interests of other stakeholders, such as taking advantage of opportunities to misappropriate corporate resources—including secret information.

Solving the Agency Problem

Governance mechanisms are forms of control that align the interests of principal and agent so both parties have the incentive to work together to maximize organizational effectiveness.

Stock-based compensation schemes are monetary rewards in the form of stocks or stock options that are linked to the company's performance.

Promotion tournaments and career paths: One way of linking rewards to performance over the long term is by developing organizational career paths that allow managers to rise to the top of the organization.

2.5 Top Managers and Organizational Ethics

Ethics are the inner guiding moral principles, values, and beliefs that people use to analyze or interpret a situation and then decide what is the "right" or appropriate way to behave. Following ethical principles when faced with **ethical dilemmas** or situations when one must decide whether or not they should act in a way that benefits someone else, even if it harms others and isn't in their own interest are a major part of corporate governance today. The essential problem in

dealing with ethical issues, and thus solving moral dilemmas, is that no absolute or indisputable rules or principles can be developed to decide if an action is ethical or unethical.

Ethics and the Law

The society as a whole, using the political and legal processes, creates, passes, and enforces laws that specify what people and organizations can and cannot do along with sanctions and punishments for the same. However, neither laws nor ethics are fixed principles and since no absolute or unvarying standards exist to determine how we should behave, people are caught up in moral dilemmas and have to learn to make ethical choices.

Ethics and Organizational Stakeholders

Ethics guide managers in their decisions about what to do in various situations. Ethics also help managers decide how best to respond to the interests of various organizational stakeholders. Philosophers have debated for centuries about the specific criteria that should be used to determine whether decisions are ethical or unethical. The three models that have been suggested by them are the utilitarian, moral rights, and justice models. (Refer to Table 2.2)

Sources of Organizational Ethics

The three principal sources of ethical values that influence organizational ethics are societal, group or professional, and individual. These three sources of ethics collectively influence the ethics that develop inside an organization, or organizational ethics, which may be defined as the rules or standards used by an organization and its members in their dealings with other stakeholders groups. Each organization has a set of ethics; some of these are unique to an organization and are an important aspect of its culture.

Societal ethics are codified in a society's legal system, in its customs and practices, and in the unwritten norms and values that people use to interact with each other.

Professional ethics are the moral rules and values that a group of people use to control the way they perform a task or use resources. Usually people internalize the rules and values of their profession, just as they do those of society, and they follow these principles automatically in deciding how to behave.

Individual ethics are the personal and moral standards used by individuals to structure their interactions with other people. Personal ethics are also the result of a person's upbringing and may stem from family, friends, religious membership, or other significant social institution. Personal ethics influence how a person acts in an organization.

Organizational Insight 2.3: Is it Right to Use Child Labor?

In recent years, the number of U.S. companies that buy their inputs from low-cost foreign suppliers has been growing, and concern about the ethics associated with employing young children in factories has been increasing. Many U.S. retailers who typically buy their clothing

from low-cost foreign suppliers have policies that dictate their foreign suppliers not employ child labor; they also vow to sever ties with any foreign supplier found to be in violation of this standard. However, retailers differ widely in the way they choose to enforce this policy and in places like Guatemala, a very high proportion of the work is still done by children who work long hours and receive little pay.

Question: What is the Economist's stance on the issue of child labor?

Answer: According to the Economist, though child labor is not desirable, citizens of the rich countries need to recognize that in poor countries children are often a family's only breadwinners. Thus, denying children employment would cause whole families to suffer, and one wrong (child labor) might produce a greater wrong (poverty). Instead, the Economist favors regulating the conditions under which children are employed.

Question: What is the plight of child laborers in Guatemala?

Answer: Guatemala is a popular low-cost location for clothing manufacturers that supply the U.S. market. As many as 300,000 children below the age of 14 are working up to sixty hours a week and receiving less than the minimum wage of $2.80 a day.

Organizational Insight 2.4: Always Ask for an Estimate from a Cab Driver

In 2009, the New York City taxi commission discovered one of the largest ever frauds in the taxi industry's history. The taxi drivers were estimated to have cheated customers of over eight million dollars by resorting to a higher meter code. This led to many measures being taken by officials and customers who previously relied completely on drivers' honesty.

Question: What were the measures taken by the New York City taxi commission to ensure that customers are not cheated?

Answer: The commission began introducing digital meters, encouraging customers to be alert, and installed the latest GPS tracking systems that eliminated chances of a similar fraud recurring.

Why Do Ethical Rules Develop?

Ethical laws and rules emerge to control self-interested behavior by individuals and organizations that threatens society's collective interests. Ethical rules reduce transaction costs between people, that is, the costs of monitoring, negotiating, and enforcing agreements with other people. Transaction costs can be enormous when strangers meet to engage in business, and ethics help resolve such complexities. Additionally, behavior that follows accepted ethical rules confers a reputation effect on an individual or an organization that also reduces transaction costs. Lastly, behaving ethically leads to feeling good about one's behavior and enjoying the good conscience that comes with acting within the rules of the game.

Why Does Unethical Behavior Occur?

Personal ethics: Ethics are obtained from such sources as family and friends, places of worship, education, professional training, and organizations of all kinds. From these, people learn to differentiate right from wrong in a society or in a social group and if one has internalized the wrong ethical beliefs, then they may continue to apply it at the workplace as well.

Self-interest: Individuals face ethical issues when they weigh personal interests against the impact of their actions on others. Research suggests that individuals with high stakes are more likely to behave unethically. Companies with financial problems are more likely to commit unethical and illegal acts.

Outside pressure: Many studies have shown that the likelihood of a person's engaging in unethical or criminal behavior is much greater when outside pressure exists for that person to do so. For instance, in some organizations, top managers' desires to increase performance lead them to create reward systems that have the intentional or unintentional effect of making employees act unethically and overcharge consumers.

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2.6 Creating an Ethical Organization

Ethical people create an ethical organization. An employee decision is ethical if it falls within acceptable standards in the organization's environment, is communicated to all affected parties, and is approved by those with whom the decision maker has significant personal relationships. An unethical decision hurts stakeholders in a manner that is unacceptable in the organization's environment. Top managers influence a company's ethical culture. As a figurehead, a manager models the company position on ethics and promotes ethical behavior through employee incentives. A manager informs customers and stakeholders about values and allocates resources to social causes.

Organizational Insight 2.5: John Mackey and the Whole Foods Ethical Code

Whole Foods adheres to a strong code of ethics. It has strong ethical stances on how suppliers, customers, and employees should be treated. This benefits all stakeholders, and the value of the company has increased twenty-fold since 1992.

Question: What, according to Mackey, is the reason behind his successful business?

Answer: Mackey believes that the principles he established to manage his company since its beginning—which were founded on the need to behave in an ethical manner toward everybody affected by its business—is responsible for its growth and success.

Question: Why does Mackey claim that each of the supermarkets of his chain is unique?

Answer: Mackey allows for tremendous individual initiative at Whole Foods, which makes the company innovative and creative. In each of the supermarkets of his chain, team members are constantly experimenting with new and better ways to serve customers and improve their well-being.

Designing an Ethical Structure and Control System

Structure and culture can be designed to encourage ethical behavior. Authority relationships and rules can be designed to foster ethical behavior. The mission statement can direct employees toward ethical decisions.

If employees feel helpless to prevent an unethical act or are afraid to discuss ethical concerns, they may confide in an outside person or agency through an act called whistle-blowing, which can be made acceptable in an organization. An organization can take the following actions to make whistle-blowing acceptable:
1. Allow subordinates to discuss ethical concerns with upper-level managers.
2. Create an ethics officer to investigate claims and inform employees about ethics.
3. Create an ethics committee to make formal ethical judgments.

Creating an Ethical Culture

The values, rules, and norms that define an organization's ethical position are part of culture. The behavior of top managers strongly influences organizational culture. An ethical culture is most likely to emerge if top managers are ethical, and an unethical culture can become an ethical one if the top-management team is changed—provided that there is commitment to this cause at all levels.

Supporting the Interests of Stakeholder Groups

Although shareholders want high profits, they don't want increased profits through unethical behavior. Unethical behavior makes a company a riskier investment, hurts a company's reputation, and lowers its stock price. Outside stakeholders, such as the government, can create rules to promote ethical behavior. Outside regulation can help establish societal ethics.

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DISCUSSION QUESTIONS AND ANSWERS

1. Give some examples of how the interests of different stakeholder groups may conflict.

A good way to illustrate this is to have the students imagine that an organization has much more profit at the end of the year than originally forecasted. What would each stakeholder group want

to do with the profits? For example, employees would want a bonus, shareholders would want a dividend, customers would like to see reduced prices, etc. This is a good way to illustrate how different groups will view the same issue.

2. What is the role of the top-management team?

A group of managers who report to the CEO and COO and help the CEO set the company's strategy and its long-term goals and objectives make up the top-management team. All the members of the top-management team are corporate managers, whose responsibility is to set strategy for the corporation as a whole.

3. What is the agency problem? What steps can be taken to solve it?

Agency theory is useful for understanding the relationships between various levels of management. A relationship exists when one party (the principle) delegates decision-making authority or control to another (the agent). The agency problem is a problem in determining managerial accountability that arises when delegating authority to managers. Three steps are suggested for solving the agency problem:
- Using governance mechanisms
- Providing stock-based compensation schemes
- Linking rewards to career growth

4. Why is it important for managers and organizations to behave ethically?

Managers are the agents or employees of shareholders who are responsible for coordination and functioning of an organization. If an organization is known for its unethical behavior, then its employees come to be branded with the same reputation as the organization because they are assumed to have performed according to its code of ethics. Even if the organization's unethical behavior was the product of a few self-seeking individuals, it will affect and harm all employees. Thus employees have the incentive for their firm to behave ethically because their fortunes are tied up with that of the organization.

5. Ask a manager to describe an instance of ethical behavior that she or he observed and an instance of unethical behavior. What caused these behaviors, and what were the outcomes?

Students' answers will vary. Ensure that the focus is on the long-term outcomes so that students can see the real value of ethical behavior.

6. Search business magazines, such as Fortune or Businessweek, for an example of ethical or unethical behavior, and use the material in the chapter to analyze it.

Students' answers will vary.

ORGANIZATIONAL THEORY IN ACTION

Practicing Organizational Theory: Creating a Code of Ethics

1. Discuss the various kinds of ethical dilemmas that supermarket employees—checkers, pharmacists, stockers, butchers—may encounter in their dealings with stakeholders such as customers or suppliers.

Students' answers will vary. Supermarket employees can engage in a range of unethical behaviors. They can distort figures in the inventories, approve goods beyond their date of expiry, bill unsuspecting consumers for more products than they have bought, and use adulterated goods and sub-standard units of measurements.

2. Identify a specific behavior that the kinds of employees mentioned in item 1 might exhibit, and characterize it as ethical or unethical.

Mr. Parnell's act of using contaminated peanuts and avoiding salmonella tests to reduce his operating costs is a specific example of unethical behavior.

3. Based on this discussion, identify three standards or values that you will incorporate into the supermarket's ethical code to help determine whether a behavior is ethical or unethical.

Students' answers will vary. Quality, honesty, and value for money could be the three standards or values.

The Ethical Dimension #2

Students' answers will vary. Ensure that they understand the difference between ethics and "bad behavior." Students must distinguish between the implications of an ethical dilemma in society as opposed to that in management.

Making the Connection #2

Identify an organization whose managers have been involved in unethical actions toward one or more stakeholder groups or who have pursued their own self-interest at the expense of other stakeholders. What did they do? Who was harmed? What was the outcome of the incident?

Students' answers will vary.

Analyzing the Organization: Design Module #2

This module focuses on having students identify the stakeholders of their chosen organization, analyze its top management structure, and try to understand its ethical stance.

CASE FOR ANALYSIS

How Westland/Hallmark Put Profit above Safety

The Westland/Hallmark Meat Co., based in Chico, California, and owned by its CEO Steven Mendell, was one of the most efficient, sanitary, and state-of-the-art meat packing plants in the United States. The company supplied to numerous consumers like Taco Bell, Burger King, and even the National School Lunch Program, which named it the plant supplier of the year in 2005. However, in 2007, evidence surfaced proving that the company was flaunting government regulations, violating safety procedures, and engaging in animal abuse. This discovery led to the largest ever food recall in the country as many consumers, a large proportion of whom were children, were at risk of consuming contaminated meat. The company faces legal prosecution and risk of a total closure.

In your opinion, why did the managers and employees of the meat packing plant behave in the way they did?

They emphasized high profits over safety regulations, governmental regulations, and the ethics that should govern a food industry.

Outline a series of steps the plant's managers should have taken to prevent this problem from occurring.

Student answers may vary. The plant's managers should have ensured that they complied with the modes by which they slaughter and process meat in order to avoid transgressing any animal abuse laws. They also should have ensured that the hygiene and sanitary conditions of the plant were up to the mark as they were dealing with food products. Lastly, once aware that the conditions of their plants were not satisfactory and could lead to a health hazard, they should have taken an ethical stand by doing the right thing of stopping production on their own, rather than being forced out of business in disgrace.

TEACHING SUGGESTIONS

1. In small groups, have the students identify all of the stakeholders of a well-known organization, such as their local gas station, church, or electric company. Have them make a list of all of the stakeholders, and discuss what their interest or "claim" is in the organization. This helps them to relate management theory to actual practice.

2. A role play exercise can be used to encourage a discussion on ethics. The setting will be a government warehouse. One student will be a warehouse worker who overhears the supervisor, another volunteer, make a deal with a distributor, a third volunteer. The distributor comes to the warehouse, which contains cleaning supplies, and says to the supervisor, "This warehouse has thousands of items. If you bypass procurement procedures, I can sell you brooms at a lower price and give you a 5% commission on the deal." The supervisor states that he or she is tired of paperwork and that will be fine. The supervisor does not know that the worker overheard the conversation. Discuss what the worker should do. Use the utilitarian, moral rights, and justice models to compare solutions from different perspectives.

3. In light of the recent corporate scandals, make sure the students really understand the value of behaving ethically. Point out that huge companies like Arthur Andersen really can't afford to have a bad image. The global economy is too competitive, and consumers have too many choices. Point out that a few bad decisions at Arthur Andersen effectively shut the company down.

4. Visit the Johnson & Johnson Web site and look at their credo. Discuss with the class how simple, yet profoundly effective, this philosophy is.

5. The mortgage crisis was caused, in part, by loan officers who were not held accountable for bad loans. Discuss how ethics played a role, or could have played a larger role, in preventing this situation.