Business and service organizations exist to create valued goods and services that people need or desire. Organizations may have either a profit or nonprofit orientation for the creation of these goods or services. But who decides which particular goods and services an organization should provide, and how do you divide the value that an organization creates among different groups of people such as management, employees, customers, shareholders, and other stakeholders? If people primarily behave self-interestedly, what mechanisms or procedures govern the way an organization uses its resources, and what is to stop the different groups within the organization from trying to maximize their own share of the value created, possibly at the detriment or expense of others? At a time when the issue of corporate ethics and management dishonesty and greed has come under intense scrutiny, these questions must be addressed before the issue of designing an organization to increase its effectiveness can be investigated.

After studying this chapter you should be able to:

1. Identify the various stakeholder groups and their interests or claims on an organization, its activities, and its created value.
2. Understand the choices and problems inherent in apportioning and distributing the value an organization creates.
3. Appreciate who has authority and responsibility within 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, that can be used to align managerial behaviour with organizational goals or to help control illegal and unethical managerial behaviour.
5. Discuss the vital role played by ethics in organizations.

Organizational Stakeholders, Management, and Ethics

Learning Objectives

Organizations exist because of their ability to create valued goods and services and which yield acceptable outcomes for various groups of stakeholders, people who have an interest, claim, or stake in the organization, in what it does, and in how well it performs.

Stakeholders-
People, groups or other organizations who have an interest, claim, or stake in an organization, in what it does, and in how well it performs.
Inside Stakeholders

Inside stakeholders are people who are closest to an organization and have the strongest or most direct claim on organizational resources: shareholders, managerial employees, and nonmanagerial employees.

**Shareholders** 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. The shareholders’ contribution to the organization is to invest money in it by buying the organization’s shares or stock. The shareholders’ inducement to invest is the prospective money they can earn on their investment in the form of dividends and increases in the price of the stock they have purchased. Investment in stock is risky, however, because there is no guarantee of a return. Shareholders who do not believe that the inducement (the possible return on their investment) is enough to warrant their contribution (the money they have invested) sell their shares and withdraw their support from the organization. As the following example illustrates, more and more shareholders are relying on large institutional investment companies to protect their interests and to increase their collective power to influence the activities of organizations. (See Organizational Insight 2.1.)

**Managerial Employees** Managers are the employees who are responsible for coordinating organizational resources and ensuring that an organization’s goals are successfully met. Senior managers are responsible for investing shareholder money in various areas of the organization. In return, managers are rewarded with salaries, bonuses, status, and power. Managers also receive inducements such as the opportunity to advance in their careers and to maintain high levels of job satisfaction.

<table>
<thead>
<tr>
<th>Stakeholder</th>
<th>Contribution to the Organization</th>
<th>Inducement to Contribute</th>
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<td><strong>Inside</strong></td>
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<tr>
<td>Shareholders</td>
<td>Money and capital</td>
<td>Dividends and stock appreciation</td>
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<td>Managers</td>
<td>Skills and expertise</td>
<td>Salaries, bonuses, status, and power</td>
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<tr>
<td>Workforce</td>
<td>Skills and expertise</td>
<td>Wages, bonuses, stable employment, and promotion</td>
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<td><strong>Outside</strong></td>
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<tr>
<td>Customers</td>
<td>Revenue from purchase of goods and services</td>
<td>Quality and price of goods and services</td>
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<tr>
<td>Suppliers</td>
<td>High-quality inputs</td>
<td>Revenue from purchase of inputs</td>
</tr>
<tr>
<td>Government</td>
<td>Rules governing good business practice</td>
<td>Fair and free competition</td>
</tr>
<tr>
<td>Unions</td>
<td>Free and fair collective bargaining</td>
<td>Equitable share of inducements</td>
</tr>
<tr>
<td>Community</td>
<td>Social and economic infrastructure</td>
<td>Revenue, taxes, employment, quality of life, and concern for the environment</td>
</tr>
<tr>
<td>General public</td>
<td>Customer loyalty and reputation</td>
<td>National pride</td>
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**Inducements**—Rewards such as money, power, personal accomplishment, and organizational status.

**Contributions**—The skills, knowledge, and expertise that organizations require of their members during task performance.
The high-profile corporate scandals of WorldCom, Enron, Adelphia, Global Crossing, and others in the United States, and Nortel Networks in Canada have sparked significant discussion in investor, government, media, and academic circles about the need for change to corporate governance standards and practice.

The United States government has opted for a regulative approach. On July 8, 2002, U.S. President George W. Bush introduced the Sarbanes-Oxley Act, which is intended to make corporate executives and their audit firms more accountable and responsible to shareholders. Canadian politicians are facing pressure to introduce similar legislation and are studying various options. In the meantime, though, one very important stakeholder group—institutional investors—is using its power to influence the governance practices of Canadian companies.

The Canadian Coalition for Good Governance (CCGG) is a group comprised of some 33 institutional investors. Between them, CCGG members manage $500 billion in assets. The Ontario Teachers Pension Plan and OMERS are among the CCGG’s biggest members, managing the pension plan assets of Ontario’s 252 000 public school teachers and 342 000 municipal government employees.

The CCGG formed in the spring of 2003 with an objective to jointly promote good governance practices and increased organizational performance in publicly traded Canadian companies. In very specific terms, the CCGG wants corporate boards to achieve a delicate balance between giving their management teams the freedom and incentive to pursue performance goals, while at the same time ensuring there are appropriate financial, legal, and ethical control systems in place. The group describes its approach as being able to “walk softly and carry a big stick.” By that, the CCGG means it does much of its work behind the scenes—away from the media spotlight.

Using their own in-house financial analysts, institutional investors closely monitor and assess the financial performance and governance practices of the firms whose shares they own. Because of the size of their investments in many Canadian public companies—and because of the negative impact they’d have on these share prices if they sold them suddenly—institutional investors also command a lot of attention. If they have a concern, they are more likely to be able to meet with company executives and directors to discuss the issue and possible resolutions. Until the CCGG was formed, such exchanges were occurring between institutional investors and individual companies, but now the efforts are more coordinated and will most likely have greater impact. If desired improvements aren’t forthcoming, the CCGG and its members have said they will use “the stick”—that is, they will speak publicly about their concerns. They may even go so far as to use their shareholder voting power to effect change.

The group is also working to raise the overall general awareness and understanding of corporate governance issues, making speeches before professional associations, business conferences, and educational forms. The CCGG is using the media and its own Web site to make people aware of the state of corporate governance in Canada and promotes governance standards and best practices. It is also publishing data collected by other groups, such as the Rotman School of Management’s “report card” on Canadian governance practices.

What impact will the CCGG have? It’s hard to say, since the group is still in its infancy. The CCGG has set a big task for itself in trying to align the interests of boards and management with those of shareholders, but it is an extremely important one. And with its financial clout, the CCGG will be a force difficult to ignore.
resources in order to maximize the future value of goods and services. Managers are, in effect, the agents or employees of shareholders and are appointed indirectly by shareholders through an organization’s governance structure, such as a board of directors, to manage the organization’s business.

Managers’ contributions are the skills they use to direct the organization’s response to pressures from within and outside the organization. For example, a manager’s skills at opening up global markets, identifying new product markets, or solving transaction-cost and technological problems can greatly facilitate the achievement of the organization’s goals.

Various types of rewards induce managers to perform their activities well: monetary compensation (in the form of salaries, bonuses, and stock options) and the psychological satisfaction they may get from accomplishing their work, from controlling the corporation, through exercising power, or even when taking risks with other people’s money. Managers who do not believe that the inducements meet or exceed the level of their contributions are likely to withdraw their support by either reducing their contributions or through leaving the organization.

Nonmanagerial Employees An organization’s workforce consists of nonmanagerial employees. These members of the workforce have responsibilities and duties (usually outlined in a job description) that they are responsible for performing. An employee’s contribution to the organization is the performance of his or her duties and responsibilities. How well an employee performs is, in some measure, within the employee’s control. An employee’s motivation to perform well relates to the rewards and punishments that the organization uses to influence job performance. Like managerial employees, other employees who do not feel that the inducements meet or exceed their contributions are likely to withdraw their support for the organization by reducing their contributions or the level of their performance, or by leaving the organization.

Outside Stakeholders

Outside stakeholders are people who do not own the organization (such as shareholders), are not employed by it, but do have some interest in it or its activities. Customers, suppliers, the government, trade and other unions, local communities, special interest groups, and the general public are all outside stakeholders.

Customers Customers are usually an organization’s largest outside stakeholder group. Customers are induced to select a product or service (and thus an organization) from potentially many alternative products or services. They usually do this through an estimation of what they are getting relative to what they have to pay. The money they pay for the product or service represents their contribution to the organization and reflects the value they feel they receive from the organization. As long as the organization produces a product or service whose price is equal to or less than the value customers feel they are getting, they will continue to buy the product or service and support the organization. If customers refuse to pay the price the organization is asking, they usually will withdraw their support, and the organization loses a vital stakeholder. The broadcast services of the Canadian Broadcasting Corporation are an example of the challenges involved in meeting consumer needs. (See Organizational Insight 2.2.)

Suppliers Suppliers, another important outside stakeholder group, contribute to the organization by providing reliable raw materials, component parts, or other services that allow the organization to reduce uncertainty in its technical or production operations, thus allowing for cost efficiencies. Suppliers therefore can have a direct effect on the organization’s efficiency and an indirect effect on its ability to attract customers.
In 1936, an act of parliament created the Canadian Broadcasting Corporation (CBC), Canada’s national public broadcaster. The CBC currently operates under the 1991 Broadcasting Act and is accountable to the Canadian parliament. According to the Broadcasting Act, the CBC must “provide radio and television services incorporating a wide range of programming that informs, enlightens and entertains” and that is “predominantly and distinctively Canadian.” The Broadcasting Act also directs the CBC to meet the various needs of the diverse regions of Canada. The CBC has a mandate to service the varied needs of its customers.

The CBC broadcasts through 104 CBC/Radio-Canada stations, 1190 CBC Radio-Canada rebroadcasters, 19 private affiliates, and 272 affiliated or community rebroadcasters. While operations of the CBC generate some additional funding through advertising revenue, it is funded primarily by the federal government. The CBC is in a unique situation and faces challenges that most companies do not have, as the CBC has continually evolved since its inception and it is accountable to a number of stakeholders. Its mandate is from the government, but its audience is its customers. It must balance financial viability against its obligations under the Broadcasting Act.

This has historically been a difficult balancing act for the CBC. To meet its regional and Canadian content mandate, it must offer programs that may actually run at a financial loss, which therefore threatens long-term financial viability. CBC television is undergoing changes that will decrease programming or eliminate entire stations for reasons of cost control. Most local supper-hour news shows will be eliminated in favour of a national news broadcast supplemented by short local inserts. Additionally, over 500 jobs will be lost to downsizing.

However, at the same time the CBC tries to make itself fiscally responsible and financially viable it also faces added pressures. A decision in January 2004 by the Canadian Radio-television and Telecommunications Commission (CRTC) made expanded regional coverage a condition of CBC-TV’s licence. This decision was met with anger by Robert Rabinovitch, the CBC president. He believes that the CRTC’s demands are not reasonable and that they are not letting the CBC manage itself.

“Can the CBC be Canadian and public and still be popular and relevant?” asks Bill Brioux of the Toronto Sun. “How long can the best newscast in the land get hammered night after night by the likes of Law & Order, CSI, ER and The Osbournes? It’s a brutally competitive TV world out there, with new networks and alternatives to TV springing up all the time. Still, CBC is driving some of its own viewers away by paying more attention to mandate than to the market.” Customers vote with their eyes and their eyes are turning elsewhere. The problems of the CBC are also compounded by the fact that its operations and its role in preserving Canadian culture remains an ongoing political issue.

An organization that has high-quality inputs can make high-quality products or deliver high-quality services and attract more customers. In turn, as demand for its products or services increases, the organization demands greater quantities of high-quality inputs or services from its suppliers.

For example, one of the reasons why Japanese cars remain so popular in North America is that they still require fewer repairs than the average North American–made
vehicle. This reliability is a result of the use of component parts that meet stringent quality control standards. In addition, Japanese parts suppliers are constantly improving their efficiency. The close relationship between the large Japanese automakers and their suppliers is a stakeholder relationship that pays long-term dividends for both parties. Car manufacturers in Canada and the U.S. have realized this and over the last decade have attempted to replicate and improve upon the Japanese model and are rapidly improving the quality and reliability of their products.

**Government** Historically, various governments have had a major influence upon both the markets and the operating environment of Canadian business. This involvement has been both proscriptive and prescriptive in nature. As business operates within, and contributes to, our society, governments have several claims on an organization. While it wants companies to compete in a fair manner and obey the rules of free competition, it also wants companies to obey agreed-upon rules and laws concerning the payment and treatment of employees, workers’ health and workplace safety, nondiscriminatory hiring practices, and other social and economic issues. Besides the purely legal aspects of business operations, governments often receive a mandate from the voting public concerning particular issues reflecting broader social concerns. The subsequent involvement of governments and their treatment of these issues may involve or affect business organizations and business conduct in various ways.

Whether it is a new regulation designed to improve accountability through changes to corporate reporting and audit procedures, legislation concerning environmental protection and guidelines for hazardous waste management, or quotas on the harvesting of natural resources, governments may enact various legislation originating at the federal, provincial, or municipal level. In this fashion, government is an organizational stakeholder, and the government makes a contribution to the other organizational stakeholders by standardizing regulations so that no one company or group of companies can obtain an unfair competitive advantage in the market. Governments also serve as mechanisms to introduce needed changes and facilitate economic growth, all while protecting and preserving our society as a whole. Consequently, governments control many of the rules of business practice and have the power to punish any company that breaks these rules.

For example, the major corporate scandals in the U.S. of the last several years have caused both provincial and federal governments to become increasingly attentive to the public’s concern over corporate governance and organizational ethics. Both these levels of government are actively working with public interest groups and industry representatives to address these growing ethical and legal concerns. In the absence of a national regulatory body (such as the U.S. Securities Exchange Commission), provincial trade ministers are working together in an attempt to develop a national standard for the regulation of publicly traded companies. It is hoped that regulations and standards developed by this process will help ensure that Canadians may avoid similar circumstances in business and organizational conduct in this country.

In addition to market and legislative governance, another result of the Canadian federated system of government has been a broader economic concern with nation building. This has lead to the historical evolution of agencies within the federal government whose role is to assist in regional economic development. While these agencies have no direct legislative role, they are designed to facilitate economic development in a number of ways. Agencies and departments such as the Atlantic Canada Opportunities Agency, the Business Development Bank of Canada, Canada Economic Development for Quebec Regions, or the Western Economic Diversification Canada may assist through market studies and analysis, seed or developmental financing for startups, or other general forms of business assistance.
Within Canada, more than many other Western nations including the U.S., government plays a major role in the protection of not only shareholder interests, but also the interest of direct and indirect stakeholders. The Canadian governments, at various levels, have historically developed a responsibility to the public to oversee or mandate changes to business practice in order to protect social interests—areas of practice that historically have been left to market forces and business practices—such as governance and oversight, environmental concerns, and the enforcement protection of evolving social standards such as nondiscriminatory practices against same-sex couples.

**Unionized Employees** The relationship between a trade or other union and an organization can be one of conflict or cooperation. The nature of the relationship has a direct effect on the productivity and effectiveness of the organization, the union membership, and even other stakeholders. Cooperation between managers and the union can lead to positive long-term outcomes if both parties agree on an equitable division of the gains from an improvement in a company’s fortunes. Managers and the union might agree, for example, to share the gains from cost savings due to productivity improvements that resulted from a flexible work schedule. However, the management–union relationship may also be antagonistic because unions’ demands for increased benefits may conflict directly with shareholders’ demands for greater company profits and thus greater returns on their investments. Or management may not be treating unionized members in accordance with the level of their contribution to the organization.

Disagreement between management and unions may also adversely impact both internal and external organizational stakeholders. In 2004, the unionized employees of the telecommunications company Aliant went on an extended strike lasting from April through September. During this time, customers could not order new services (e.g., get new phones installed) and they saw reduced customer service, so many switched to alternative phone service providers. Aliant’s stock price dropped significantly, adversely affecting corporate investors through stock-value loss. Unionized employees had to survive on strike pay—an amount well below that they would normally make on the job. Management had to take up the slack and work overtime to for the business to continue to operate. At times, the stress and tension between management and the union led to confrontations. Even after the strike action was resolved, the whole organization was affected by the tension between management and the unionized employees arising from the bitter feelings and emotions resulting from the strike.

Strikes in one organization may also affect other organizations or other stakeholders. For example, beyond the negative impact upon hockey fans, the lockout of the NHL players by the team owners in 2004 also negatively affected employees at the Canadian Broadcasting Company. Those employees who would normally have produced these televised games were laid off because there were no games to broadcast. Concession stand employees and other arena and stadium workers whose wages are directly associated with hockey games at the stadium were also affected—either laid off or having their hours reduced during the lockout. Other stakeholders were also indirectly affected, such as sports restaurants that saw a drop in clientele. On the other hand, local hockey leagues and the junior leagues saw an increase in attendance at their games.

**Local Communities** Local communities also 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. This is of particular importance in Canada due to the unique nature of the Canadian geography and demographics. Unlike the United States, Canada has many smaller businesses and
industries that are regionally based. This has important implications; for example, Ottawa’s economy closely tied to the organizational performance of Nortel and Windsor’s to those of the automakers. Many of Canada’s regional communities may have only one or two major businesses or industries that they rely upon for much of their economic activity.

While community dependency upon single organizations is changing across Canada, there are still many communities that are integrally tied to the economic fortunes of local business. When businesses shift focus or effort to keep themselves competitive in the rapidly globalizing environment, to open new markets, to create advantage through knowledge management initiatives, or to move away from a resource-based to a knowledge- or service-based focus, the surrounding community is affected. For example, when business increases its use of technology, whether for manufacturing, information processing, or service delivery, it changes the skill sets it needs in employees. This may make local college or university programs outdated or obsolete, thus affecting the educational and employment prospects of the next working generation in the community. If the community cannot adapt itself to these new needs, the business may have to close plants or offices and move to a community that can meet these needs. When this happens, jobs, salaries, and wages are removed from the community, which can have a devastating impact to the community as a whole.

**Special Interest Groups and the General Public** Canada’s public also wants its corporations and other businesses to act in a socially responsible way so that corporations generally refrain or are constrained from taking any actions that may injure or impose unreasonable or unjust costs on other stakeholders. As Canada’s social culture evolves, people become more aware of how business activity impacts the environment and social issues. Beyond elections and government mandates, many of these issues become particularly important to different subelements of the broader public or what are referred to as special interest groups. These groups may represent those with particular environmental concerns; for example, groups have lobbied to move shipping transit lanes in the Bay of Fundy to reduce ship collisions with whale populations. Groups may also be motivated by concern for those with disabilities by sponsoring initiatives to make workplaces more accessible to those with mobility impairments. While many of these special interest groups start out small, they may grow in size and influence as the issues they raise become concerns for the general public.

**Organizational Effectiveness:**

**Satisfying Stakeholders’ Goals and Interests**

An organization is used simultaneously by different groups of stakeholders to each accomplish or further their own goals. It is the collective contributions of all stakeholders that are needed for an organization to be viable and to accomplish its mission of producing valued goods and services. Each stakeholder group is motivated to contribute to the organization by its own set of goals, and each group evaluates the effectiveness of the organization by judging how well it meets the group’s specific goals.

Shareholders evaluate an organization by the return they receive on their investment; customers, by the reliability and value of its products relative to their price; and managers and employees, by their salaries, stock options, conditions of employment, and career prospects. Often these goals conflict, and stakeholder groups must bargain over the appropriate balance between the inducements that they should receive and the contributions that they should make. For this reason, organizations are often regarded as alliances or coalitions of stakeholder groups that directly (and indirectly)
bargain with each other and use their power and influence to alter the balance of inducements and contributions in their favour. An organization is viable as long as a dominant coalition of stakeholders has control over sufficient inducements so that it can obtain the contributions it needs from other stakeholder groups. However, when stakeholders refuse to participate, the organization is placed into peril. In the United States, the spectacular collapse of Enron and WorldCom occurred when their illegal actions became public and their stakeholders refused to contribute: Shareholders sold their stock, banks refused to lend money, and debtors called in their loans.

There is no reason to assume, however, that all stakeholders will be equally satisfied with the balance between inducements and contributions. Indeed, the implications of the coalition view of organizations are that some stakeholder groups have priority over others. To be effective, however, an organization must at least minimally satisfy the interests of all the groups that have a stake in the organization. The claims of each group must be addressed; otherwise, a group might withdraw its support and injure the future performance of the organization, such as when banks refuse to lend a company money, or a group of employees goes out on strike. When all stakeholder interests are minimally satisfied, the relative power of a stakeholder group to control the distribution of inducements determines how the organization will attempt to satisfy different stakeholder goals and what criteria stakeholders will use to judge the organization’s effectiveness.

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-term and long-term goals.

**Competing Goals**

Organizations exist to satisfy stakeholders’ goals, but who decides which goals to strive for and which goals are most important? An organization’s choice of goals often has economic, political, and social implications. In most countries that have a capitalistic economy, it has been taken for granted that shareholders, the owners of the organization’s accumulated wealth or capital—its machines, buildings, land, and goodwill—have first claim on the value created by the organization. According to this view, the job of managers is to maximize shareholder wealth, and the best way to do this is to maximize the organization’s return on investment.

Is maximizing shareholder wealth always management’s primary goal? According to one argument, it is not. When shareholders delegate to managers the right to coordinate and use organizational skills and resources, a divorce of ownership and control occurs. Although in theory managers are the employees of shareholders, in practice managers’ control over organizational resources gives them real control over the corporation even though the shareholders are actually the owners. A result of this dichotomy (real versus espoused control) is that managers may follow goals that promote their own interests but not the interests of shareholders.

An attempt to maximize shareholder wealth, for example, may involve taking risks into uncharted territory and making investments in R&D that may bear fruit only in the long term, as new inventions and discoveries generate new products and hence new revenues. Managers, however, may prefer to maximize short-term profits because that is the goal on which they are evaluated by their peers and by market analysts who do not take the long-term view.

Another view is that managers prefer a quiet life in which risks are small, and that they have no incentive to be entrepreneurial because they control their own
salaries. Moreover, because managers’ salaries are closely correlated with organizational size and growth, managers may prefer to pursue these goals even though they are only loosely associated with profitability and return on shareholders’ investment.

As these examples suggest, the goals of managers and shareholders may compete, and because managers are in the organizational driver’s seat, shareholder goals are not the ones most likely to be followed. But even when there is no competition between different stakeholders over whose goals should be followed, selecting goals that will enhance an organization’s chances of survival and future prosperity is no easy task.

Suppose managers decide that the primary goal is to maximize shareholder wealth. What should be done to achieve this goal? Should managers try to increase efficiency and reduce costs to improve profitability? Should they increase the organization’s ability to influence its outside stakeholders and perhaps become a global company? Should they invest all organizational resources in new R&D projects that will increase its competencies? An organization could take any of these actions to achieve the goal of maximizing shareholder wealth.

As you can see, there are no easy rules to follow. In many ways, being effective means making more right choices than wrong choices. One thing is certain, however: An organization that does not pay attention to its stakeholders and does not attempt at least minimally to satisfy their interests will lose legitimacy in their eyes and be doomed to failure. The importance of using organizational ethics to avoid this outcome is taken up at the end of the chapter.

Allocating Rewards

Another major problem that an organization has to face is how to allocate the rewards it gains as a result of being effective. How should an organization allocate inducements among various stakeholder groups? An organization needs to minimally satisfy the expectation of each group. But when rewards are more than enough to meet each group’s minimum need, how should the “extra” rewards be allocated? How much should the workforce or managers receive relative to shareholders? What determines the appropriate reward for managers? Most people answer that managerial rewards should be determined by the organization’s effectiveness. But this answer raises another question: What are the best indicators of effectiveness on which to base managerial rewards? Short-term profit? Long-term wealth maximization? Organizational growth? The choice of different criteria leads to different answers to the question. Indeed, in the 1980s a CEO’s average salary was about 40 times greater than the average worker; by 2002 the CEOs salary was 400 times greater! Can this kind of huge increase be justified? More and more, given the many examples of corporate greed, analysts are saying no, and some have called for an across-the-board decrease in CEO salaries and other remuneration mechanisms.

The same kinds of consideration are true for other organizational members. What are the appropriate rewards for a middle manager who invents a new process that earns the organization millions of dollars a year, or for the workforce as a whole when the company is making record profits? Should they be given short-term bonuses, or should the organization guarantee long-term or lifetime employment as the ultimate inducement for good performance? Similarly, should shareholders receive dividends, or should all profits be invested in the organization to increase its skills and resources? How various organizational and personal goals or rewards are balanced against the interests of other organizational stakeholders can be a daunting and challenging task.
The allocation of rewards, or inducements, is an important component of organizational effectiveness because the inducements offered to stakeholders now determine their motivation—that is, the form and level of their contributions—in the future. Stakeholders' future investment decisions depend on the return they expect from their investments, whether the returns are in the form of dividends, stock options, bonuses, or wages. It is in this context that the role of top managers and the board of directors become important, because they are the stakeholder groups which possess the power that determines how much reward or inducements each group—including themselves—will ultimately receive. This is an important function of management with critical implications for the organization and its stakeholders. When carried out equitably, most organizational employees and stakeholders benefit. When carried out inequitably (whether for reason of incompetence, greed, or otherwise), there can be serious financial and social consequences for the organization and stakeholders alike. As the employees and shareholders of collapsed firms such as Enron (who lost all the value of their pensions and shares) found out, directors and top managers often do not perform this role well.

**SENIOR MANAGEMENT AND ORGANIZATIONAL AUTHORITY**

Since senior management is the stakeholder group that has the primary responsibility for setting company goals and objectives, and for allocating organizational resources to achieve these objectives, it is useful to take a closer look at top managers. Who are they, what roles and functions do they perform, and how do managers cooperate to run a company’s business?

Authority is the power to hold people accountable for their actions and to influence directly what they do and how they do it. The stakeholder group with ultimate authority over the use of a corporation’s resources is shareholders. Legally, they own the company and exercise control over it through their representatives, the board of directors. Through the board, shareholders delegate to managers the legal authority and responsibility to use the organization’s resources to create value and to meet goals (see Figure 2-1). Accepting this authority and responsibility from shareholders and the board of directors makes corporate managers accountable for the way they use resources and for how much value the organization creates.

The board of directors monitors corporate managers’ activities and rewards corporate managers who pursue activities that satisfy stakeholder goals. The board has the legal authority to hire, fire, and discipline corporate management. The chair of the board of directors is the principal representative of the shareholders and, as such, has the most authority in an organization. Through the executive committee, which consists of the organization’s most important directors and top managers, the chair has the responsibility for monitoring and evaluating the way corporate managers use organizational resources. The position of the chair and the other directors is one of trusteeship: They act as trustees to protect the interests of shareholders and other stakeholders. The salary committee sets the salaries and terms of employment for corporate managers.

There are two kinds of directors: inside directors and outside directors. Inside directors are directors who also 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 boards of many companies, or are executives of other companies who sit on other companies’ boards. The goal of having outside directors is to bring objectivity to a company’s decision making, and to balance the power of inside directors, who obviously side with an orga-
In practice, however, boards tend to be dominated by inside directors because these people have access to the most information about the company, and can use that information to influence decision making in management’s favour. Moreover, many outside directors tend to be passive, and serve as a rubber stamp for management’s decisions. It has been claimed that many of the problems that arose in the Enron debacle and similar cases were the result of passive directors, appointed by the CEO, who failed to exercise adequate supervision. Directors of some companies have been sued for their failure to do so.

Corporate-level management is the inside stakeholder group that has ultimate responsibility for setting company goals and objectives, for allocating organizational

![FIGURE 2-1]
The Top-Management Hierarchy.
This chart shows the ranking of the positions in the hierarchy, not necessarily the typical reporting relationships.
resources to achieve objectives, and for designing the organization’s structure. Who are the corporate managers? What exactly do they do, and what roles do they play? Figure 2-1 shows the typical hierarchy of management titles and the chain of command, that is, the system of reporting relationships of a large corporation. A hierarchy is a vertical ordering of organizational roles according to their relative authority.

**The Chief Executive Officer**

The chief executive officer (CEO) is the person ultimately responsible for setting organizational strategy and policy. Even though the CEO reports to the chair of the board (who has the most legal authority), in a real sense the CEO is the most powerful person in the corporation because he or she controls the allocation of resources needed by others in the organization. The CEO also has authority and considerable influence in the allocation of rewards to management and other employees within the company. The combination of resource and reward allocation can give the CEO considerable power within the organization. The board of directors gives the CEO the power to set the organization’s strategy and use its resources to create value. Often the same person is both CEO and chair of the board. A person who occupies both positions wields considerable power and directly links the board to corporate management.

How does a CEO actually affect the way an organization operates? A CEO can influence organizational effectiveness and decision making in five principal ways:

1. **The CEO is responsible for setting the organization’s goals and designing its structure.** The CEO allocates authority and task responsibilities so that resources are coordinated and motivated to achieve organizational goals. Different organizational structures promote different methods of coordinating and motivating resources.

2. **The CEO selects key executives to occupy the topmost levels of the managerial hierarchy.** This sort of staffing is a vital part of the CEO’s job because the quality of decision making is directly affected by the abilities of the organization’s top managers. The CEO of General Electric, for example, personally selects and promotes GE’s 100 top managers and approves the promotions of 600 other executives. By choosing key personnel, the CEO heavily influences the values, norms, and culture that emerge in the organization. The culture determines the way organization members approach problems and make decisions: Are they entrepreneurial or are they conservative?

3. **The CEO determines top management’s rewards and incentives.** The CEO influences the motivation of top managers to pursue organizational goals effectively.

4. **The CEO controls the allocation of scarce resources such as money and decision-making power among the organization’s functional areas or business divisions.** This control gives the CEO enormous power to influence the direction of the organization’s future value creation activities—the kinds of products the company will make, the markets in which it will compete, and so on. Henry Ford III won back the CEO’s job at Ford after its former CEO, Jacques Nasser, came under criticism after spending tens of billions on countless global projects that had done little to increase the company’s profitability. Similarly, Apple’s Steve Jobs was returned to the company to repair the harm of its previous CEO for similar reasons. Both Jobs’s and Ford’s managerial philosophy is that managers must prove their projects will make money before they will allow organizational resources to be committed.

5. **The CEO’s actions and reputation have a major impact on inside and outside stakeholders’ views of the organization and affect the organization’s ability to attract resources from its environment.** A CEO’s personality and charisma can influence an organization’s ability to obtain money from banks and shareholders and influence cus-
tomers’ desire to buy a company’s products. So can a reputation for honesty and integrity and a track record of making sound, ethical business decisions.

The ability to influence organizational decision making and managerial behaviour gives the CEO enormous power to directly influence organizational effectiveness. This power is also indirect, for CEOs influence decision making through the people they appoint or the organizational structure or culture they create and leave behind them as their legacy. Thus the top-management team that the CEO creates is critical not only to the organization’s success now, but in the future.

The Top-Management Team

After the chair and CEO, the chief operating officer (COO), who is next in line for the CEO’s job, or president, who may or may not be the CEO’s successor, is the next most important executive. The COO or president reports directly to the CEO, and together they share the principal responsibility for managing the business. In most organizations, a division of labour takes place at the top between these two roles. Normally, the CEO has primary responsibility for managing the organization’s relationship with external stakeholders and for planning the long-term strategic objectives of the organization as a whole and all its business divisions. The COO or president has primary responsibility for managing the organization’s internal operations to make sure that they conform to the organization’s strategic objectives. In a large company, the COO may also oversee the organization’s most important business divisions.

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. An executive vice president, for example, might have overall responsibility for overseeing the performance of all 200 of a company’s chemical divisions or all of a company’s international divisions. A staff role is held by managers who are in charge of a specific organizational function such as sales or R&D. For example, the executive vice president for finance manages an organization’s overall financial activities, and the executive vice president for R&D oversees a company’s research operations. Staff roles are advisory only; they have no direct production responsibilities, but their occupants possess enormous influence on decision making.

The CEO, COO, and the executive vice presidents are at the top of an organization’s power structure. Collectively, managers in these positions form a company’s senior- or 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.

The way the CEO handles the top-management team and appoints people to it is a vital part of the CEO’s job. When, for example, the CEO appoints the COO, he or she is sending a clear signal to the top-management team about the kinds of issues and events that are of most importance to the organization. Often, for example, an organization will pick a new CEO, or appoint a COO who has the functional and managerial background that can deal with the most pressing issues facing a corporation. Many companies are carefully selecting a successor to the CEO to develop a long-term orientation, and obviously appointment to the top-management team is the first step in this process of developing the future CEO. More and more, the composition of the top-management team is becoming one of the main priorities of the CEO and of a company’s board of directors.
Other Managers

At the next level of management are a company’s senior vice presidents and vice presidents, senior corporate-level managers in both line and staff functions. Large companies such as Maple Leaf Foods Inc., TransCanada, Nortel, CanWest, and Molson may have hundreds or more corporate-level managers. Also, at this level are those managers who head one of a company’s many operating companies or divisions and who are known as general managers. In practice, general managers of the divisions commonly have the title of CEO of their divisions because they have direct line responsibility for their division’s performance and normally report to the corporate CEO or COO. However, they set policy only for the division they head, not for the whole corporation, and are divisional managers, not corporate managers.

An organization or a division of an organization may have functional managers with titles such as marketing manager or production manager. Functional managers are responsible for developing the functional skills and capabilities that collectively provide the core competencies that give the organization its competitive advantage. Each division, for example, has a set of functional managers who report to the general or divisional manager.

AN AGENCY THEORY PERSPECTIVE

Agency theory offers a useful way of understanding the complex authority relationship between top management and the board of directors. An agency relation arises whenever one person (the principal) delegates decision making authority or control over resources to another (the agent). Starting at the top of a company’s hierarchy of authority, shareholders are the principals; top management are their agents, appointed by shareholders to utilize organizational resources most effectively. The average shareholder, for example, has no in-depth knowledge of a particular industry or how to run a company. They appoint experts in the industry—managers—to perform this work for them. However, in delegating authority to managers an agency problem—a problem in determining managerial accountability—arises. This is because if you employ an expert manager, by definition that person must know more than you; how then can you question the decisions of the expert and the way managers are running the company? Moreover, the results of managers’ performance can be evaluated only after considerable time has elapsed. Consequently, it is very difficult to hold managers accountable for what they do. Most often shareholders don’t until it is too late, when it becomes obvious (usually after the fact) that the company has lost profitability, market share, or customer loyalty. In delegating authority, to a large extent shareholders reduce their ability to influence managerial decision making.

The issue is that shareholders or principals are at an information disadvantage as compared to top managers. It is very difficult for them to judge the effectiveness of a top-management team’s actions, especially as this can only be judged over several years. Moreover, as noted earlier, there may be a divergence in the goals and interests of managers and shareholders. Managers may prefer to pursue courses of action that lead to short-term profits, or short-term control over the market, while shareholders might prefer actions that lead to long-term profitability, such as increased efficiency and long-term innovation.

The Moral Hazard Problem

When these two conditions exist and a principal finds it (1) very difficult to evaluate how well the agent has performed because the agent possess an information advan-
tage, and (2) the agent has an incentive to pursue goals and objectives that are different from the principal’s, a moral hazard problem exists. Here, agents have the opportunity and incentive to pursue their own interests. For example, in 2002 the French conglomerate Vivendi came under attack because its CEO had made many acquisitions, which had not led to increased innovation, efficiency, or higher profits. Shareholders felt Vivendi’s top-management team was pursuing the wrong strategies to make the company profitable. Shareholders felt its top managers were avoiding confronting the hard issues. They demanded a change in top management to change (1) the direction and goals of the company and (2) to give them more information so that they could overcome their information disadvantage. In short, they wanted more control over the affairs of the corporation to overcome the agency problem. They won when the CEO and top-management team resigned and many of its businesses were put up for sale.

**Solving the Agency Problem**

In agency theory, the central issue is to overcome the agency problem by using **governance mechanisms**, or forms of control that align the interests of principal and agent so that both parties have the incentive to work together to maximize organizational effectiveness. There are many different kinds of governance mechanisms.

First, the principal role of the board of directors is to monitor top managers’ activities, question their decision making and strategies, and to intervene when necessary. Some have argued for a clear separation between the role of CEO and chair to curb the CEO’s power, arguing that the huge increase in CEO pay is evidence of the need to prevent abuses of power. Another vital task here is to reinforce and develop the organization’s code of ethics, as discussed later.

The next step in solving the agency problem is to find the right set of incentives to align the interests of managers and shareholders. Recall that it is very difficult for shareholders to monitor and evaluate the effectiveness of managers’ behaviours because the results of their behaviours can often be seen only after several years have elapsed. Thus, basing rewards on behaviours is often not an effective alignment strategy. The most effective way of aligning interests between management and shareholders is to make managers’ rewards contingent on the outcomes of their actions, that is, making the rewards dependant upon some measure of organizational performance. There are several ways of doing this, each of which has advantages and disadvantages.

**Stock-Based Compensation Schemes** Stock-based compensation schemes are one way of achieving this objective. Here, managers receive a large part of their monetary reward in the form of stocks or stock options that are linked to the company’s performance. If the company does well, then the value of their stock options and monetary compensation is much enhanced. Effectively, interests are aligned because managers become shareholders. This strategy has been used in various companies like Bombardier, Nortel, GM, and IBM, where traditionally top managers had very low stock ownership in the corporation. The board of directors insisted that top managers purchase stock in the companies, and awarded stock options as a means of increasing top managers’ stake in the company’s long-term performance.

**Promotion Tournaments and Career Paths** Incentives can also take other forms. 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. The power of the CEO role is something that many top managers aspire to, and a board of directors, by demoting some top executives and promoting or hiring new ones, often from the outside, can send a clear signal to top managers about what kinds of behav-
ours would be rewarded in the future. All organizations have “promotion tournaments” where executives compete for limited promotion opportunities by displaying their superior skills and competencies. By directly linking promotion to performance, the board of directors can send out a clear signal about future managerial behaviours that would lead to promotion—and make managers focus on long-term, not short-term, objectives.

The reward from promotion to the top is not just the long-term monetary package that goes with promotion, but also the opportunity to exercise power over resources, and the prestige, status, and intrinsic satisfaction that accompany the journey to the top of the organization.

Another alternative is to blend reward mechanisms. For example, one component would consist of salary, one component would be a quarterly or year-end bonus calculated upon short-term market gains, and a final component would be a stock option mechanism for the longer two-to three-year term. A mixed reward structure attempts to more fully balance managerial and shareholder goals in both the short and longer terms.

While there are no obvious immediate solutions to the agency issues raised, there is work being done to develop new and more effective ways for governance of organizations. The financial scandals involving CEOs, top management, and accounting firms over the last few years have given rise to new government initiatives and renewed consumer interest in regulating the behaviours of CEOs and top management. The public is also calling for more transparency in CEO salary and bonus information, and new controls on how corporate governance structures, such as boards of directors or governors, are set up.

MANAGERS, EMPLOYEES, AND ORGANIZATIONAL ETHICS

A very important mechanism of corporate governance, and one that has become increasingly important for a board of directors to emphasize after the recent corporate scandals, is to reinforce an organization’s code of ethics, and to insist managers use these ethics to guide their decision making. Ethics are moral principles or beliefs about what is right or wrong. These beliefs guide individuals in their dealings with other individuals and groups (stakeholders) and provide a basis for deciding whether a particular decision or behaviour is right and proper. Ethics help people determine moral responses to situations in which the best course of action is unclear. Ethics guide managers and employees 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, particularly in light of the often competing interests.

As we discussed earlier, in guiding a company’s business, both its dealings with outside and inside stakeholders, top managers are constantly making choices about what is the right or appropriate way to deal with these stakeholders. For example, a company might wonder whether it should give advance notice to its employees and middle managers about big impending layoffs or plant closings, or whether it should issue a recall of its cars because of a known defect that may cause harm or injury to passengers; or whether it should allow its managers to pay bribes to government officials in foreign countries where corruption is the accepted way of doing business. In all these situations managers are in a difficult situation because they have to balance their interests, and the interests of the “organization,” against the interests of other stakeholder groups. Essentially, they have to decide how to apportion the “helps and harms” that arise from an organization’s actions between stakeholder groups. Sometimes, making a decision is easy because some obvious standard, value, or norm.
of behaviour applies. In other cases, managers have trouble deciding what to do and experience an ethical dilemma when weighing or comparing the competing claims or rights of various stakeholder groups.

Philosophers have debated for centuries about the specific criteria that should be used to determine whether decisions are ethical or unethical. Three models of what determines whether a decision is ethical—the utilitarian, moral rights, and justice models—are summarized in Table 2-2.

| Table 2-2 |
| UTILITARIAN, MORAL RIGHTS, AND JUSTICE MODELS OF ETHICS |

<table>
<thead>
<tr>
<th>Utilitarian model.</th>
<th>An ethical decision is a decision that produces the greatest good for the greatest number of people.</th>
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</thead>
<tbody>
<tr>
<td>Managerial implications.</td>
<td>Managers should compare and contrast alternative courses of action based on the benefits and costs of these alternatives for different organizational stakeholder groups. They should choose the course of action that provides the most benefits to stakeholders. For example, managers should locate a new manufacturing plant at the place that will most benefit its stakeholders.</td>
</tr>
<tr>
<td>Problems for managers.</td>
<td>How do managers decide on the relative importance of each stakeholder group? How are managers to measure precisely the benefits and harms to each stakeholder group? For example, how do managers choose between the interests of shareholders, workers, and customers?</td>
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<tr>
<th>Moral rights model.</th>
<th>An ethical decision is a decision that best maintains and protects the fundamental rights and privileges of the people affected by it. For example, ethical decisions protect people’s rights to freedom, life and safety, privacy, free speech, and freedom of conscience.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Managerial implications.</td>
<td>Managers should compare and contrast alternative courses of action based on the effect of these alternatives on stakeholders’ rights. They should choose the course of action that best protects stakeholders’ rights. For example, decisions that would involve significant harm to the safety or health of employees or customers are unethical.</td>
</tr>
<tr>
<td>Problems for managers.</td>
<td>If a decision will protect the rights of some stakeholders and hurt the rights of others, how do managers choose which stakeholder rights to protect? For example, in deciding whether it is ethical to snoop on an employee, does an employee’s right to privacy outweigh an organization’s right to protect its property or the safety of other employees?</td>
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<tr>
<th>Justice model.</th>
<th>An ethical decision is a decision that distributes benefits and harms among stakeholders in a fair, equitable, or impartial way.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Managerial implications.</td>
<td>Managers should compare and contrast alternative courses of action based on the degree to which the action will promote a fair distribution of outcomes. For example, employees who are similar in their level of skill, performance, or responsibility should receive the same kind of pay. The allocation of outcomes should not be based on arbitrary differences such as gender, race, or religion.</td>
</tr>
<tr>
<td>Problems for managers.</td>
<td>Managers must learn not to discriminate against people because of observable differences in their appearance or behaviour. Managers must also learn how to use fair procedures to determine how to distribute outcomes to organizational members. For example, managers must not give people they like bigger raises than they give to people they do not like or bend the rules to help their favourites.</td>
</tr>
</tbody>
</table>
In theory, each model offers a different and complementary way of determining whether a decision or behaviour is ethical, and all three models should be used to sort out the ethics of a particular course of action. Ethical issues, however, are seldom clear cut, and the interests of different stakeholders are often conflicting, so it is frequently extremely difficult for a decision maker to use these models to ascertain the most ethical course of action. For this reason many experts on ethics propose this practical guide to determine whether a decision or behaviour is ethical. A decision is probably acceptable on ethical grounds if a manager can answer “yes” to each of these questions:

1. Does my decision fall within the accepted values or standards that typically apply in the organizational environment?
2. Am I willing to see the decision communicated to all stakeholders affected by it—for example, by having it reported in newspapers or on television?
3. Would the people with whom I have a significant personal relationship, such as family members, friends, or even managers in other organizations, approve of the decision?

From a management perspective, an ethical decision is a decision that reasonable or typical stakeholders would find acceptable because it aids stakeholders, the organization, or society. By contrast, an unethical decision is a decision a manager would prefer to disguise or hide from other people because it enables a company or a particular individual to gain at the expense of society or other stakeholders. How ethical problems arise, and how different companies respond to them, is profiled in Organizational Insight 2.3.

Ethical rules develop over time through negotiation, compromise, and bargaining among stakeholders. Ethical rules also can evolve from outright conflict and competition between different stakeholder groups where the ability of one group to impose its solution on another group decides which ethical rules will be followed. For example, employees might exert moral pressure on management to improve their working conditions or to give them warning of possible layoffs. Shareholders might demand that top management not invest their capital in countries that practise racism, or that employ children in factories under conditions close to slavery. Over time, many ethical rules and values are codified into the law of a society, and from that point on, unethical behaviour becomes illegal behaviour. Individuals and organizations are required to obey these legal rules and can be punished for not doing so.

Sources of Organizational Ethics

In order to understand the nature of an organization’s ethical values, it is useful to discuss the sources of ethics. There are three principal sources of ethical values that influence organizational ethics: (1) societal, (2) group or professional, and (3) individual.

Societal Ethics

One important determinant of organizational ethics is societal ethics. 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. Many ethical norms and values are followed automatically by people in a society because people have internalized society’s values and made them part of their own. These internalized norms and values, in turn, reinforce what is taken as custom and practice in a society in people’s dealings with one another. For example, ethics concerning the human rights of individuals are the result of decisions made by members of a society about how they want to be treated by others. The Canadian Charter of Rights and Freedoms is an example of the codification of social values. Ethics governing the use of bribery and corruption, or the general standards of doing business in a society, are
the result of decisions made and enforced by people deciding what is appropriate in a society. These standards differ from one society to another, and ethical values accepted in Canada may be similar to those of other countries such as the United States or the United Kingdom, but may not be accepted in many other countries. One issue of particular ethical concern on a global level is whether it is ethical to use child labour, as profiled in Organizational Insight 2.4.

When societal ethics are codified into law, and then judged by the ethical standards of a society, all illegal behaviour may be regarded as unethical behaviour. An organization, its managers, and employees are legally required to follow all the laws of a society, and to behave toward individuals and stakeholders according to these laws. It is one of top management’s main responsibilities to ensure that managers and employees throughout the organization are obeying the law, for top managers can be held accountable in certain situations for the performance of their subordinates. However, not all organizations behave according to the law. The typical kinds of crimes committed by these organizations are not only illegal: They may be also regarded as unethical to the extent they harm other stakeholder groups.

ORGANIZATIONAL INSIGHT 2.3

The Use of Animals in Cosmetics Testing

Along with other large cosmetics companies, Gillette, the well-known maker of razors and shaving-related products, has come under increasing attack for its use of animals in product testing to determine the safety and long-term effects of new product formulations. Gillette’s managers have received hundreds of letters from angry adults and children who object to the use of animals in cosmetics testing because they regard such testing as cruel and unethical. Managers at several other companies have tried to avoid this ethical issue, but Gillette’s managers have approached the problem head on. Gillette’s ethical stance is that the health of people is more important than the health of animals and no other reliable method that would be accepted by a court of law exists to test the properties of new formulations. Thus, if the company is to protect the interests of its shareholders, employees, and customers and develop new, safe products that consumers want to buy, it must conduct animal testing.

Gillette’s managers respond to each letter protesting this policy, and often even telephone children at home to explain their ethical position. They emphasize that they use animals only when necessary, and they discuss their ethical position with their critics. Other cosmetics companies, such as The Body Shop, do not test their products on animals, however, and their managers are equally willing to explain their ethical stance to the general public: They think animal testing is unethical. However, even though The Body Shop does not directly test its products on animals, some of the ingredients in its products have been tested on animals by Gillette and other companies to ensure their safety.

Clearly, the ethics of animal testing is a difficult issue, as are most other ethical questions. The view of the typical stakeholder at present seems to be that animal testing is an acceptable practice as long as it can be justified in terms of benefits to people. At the same time, most stakeholders believe such testing should minimize the harm done to animals and be used only when necessary.
In recent years, the number of Canadian 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. In many developing or transition economies children as young as age six work long hours in deplorable conditions to make rugs and carpets for export to Western countries. Children in poor countries throughout Africa, Asia, and South America work in similar conditions. Is it ethical to employ children in factories, and should companies buy or sell products made by these children?

Many Canadian retailers source their clothing and other products from low-cost foreign suppliers. Managers in these companies have had to take their own ethical stance on issues such as child labour practices in other countries. Managers in Wal-Mart, Sears, Marks Work Wearhouse and the Hudson’s Bay Company have developed and adopted voluntary codes of practice in this regard. The Retail Council of Canada, the Canadian Apparel Manufactures, and the Canadian Shoe Manufacturers are all actively engaged in promoting a “fair trade practices” philosophy in business through initiatives such as the formation of Canadian Retailers Advancing Responsible Trade (CRART). The Hudson’s Bay Company has a well-developed code of social responsibility that it uses to guide managerial and corporate decisions when choosing suppliers. The company will not deal with suppliers that engage in forced labour, child labour practices, or that do not treat their employees fairly in terms of wages, hours of work, overtime, and safe working conditions. The Hudson’s Bay Company uses third-party compliance audits to ensure that its foreign business partners and suppliers adhere to the company’s policies in this regard. This type of socially responsible corporate behaviour is a growing trend in business in Canada and elsewhere.

Apparently, however, retailers differ widely in the way they choose to enforce this policy. Wal-Mart and some other companies take a tough stance and immediately sever links with suppliers who break their rule. But it has been estimated, for example, that more than 300,000 children under age 14 are being employed in garment factories in Guatemala, a popular low-cost location for clothing manufacturers that supply the North American market. These children frequently work more than 60 hours a week and often are paid less than US$2.80 a day, the minimum wage in Guatemala. If organizations are to be true to their ethical stance on this and troubling issue, they cannot ignore the fact that they are buying clothing or other products made by children, and they must do more to regulate the conditions under which these children work.

However the opinions about the ethics of dealing with foreign firms and social issues such as child labour vary widely around the world. For example, Robert Reich, an economist and former secretary of labour in the United States for the first Clinton administration, believes that the practice is totally reprehensible and should be outlawed on a global level. Another view, championed in business circles by The Economist magazine, is that, while nobody wants to see children employed in factories, citizens of 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 labour) might produce a greater wrong (poverty). Instead, The Economist favours regulating the conditions under which children are employed and hope that over time, as poor countries become richer, the need for child employment will disappear.

Is It Right to Use Child Labour?
Professional Ethics

Professional ethics are the moral rules and values that a group of people uses to control the way they perform a task or use resources. For example, medical ethics influence the way that doctors and nurses are expected to perform their tasks and how they treat and deal with their patients. Doctors are expected not to perform unnecessary medical procedures, to exercise due diligence, and to act in the patient’s interest, not in their own. Scientific and technical researchers are expected to behave ethically in preparing and presenting their results in order to ensure the validity of their conclusions. As with society, most professional groups can enforce the ethics of their profession. For example, doctors and lawyers can be disbarred should they break the rules and put their own interests first.

In an organization, there are many groups of employees whose behaviour is governed by professional ethics, such as lawyers, researchers, and accountants. These cause them to follow certain principles in deciding how to act in the organization. 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

Individual ethics are the personal and moral standards used by individuals to structure their interactions with other people. Based upon these ethics, a person may or may not perform certain actions or make certain decisions. Many behaviours that one person may find unethical another person may find ethical. If those behaviours are not illegal, individuals may agree to disagree about their ethical beliefs or they may try to impose those beliefs on other people, and try to make their ethical beliefs the law. If personal ethics conflict with law, a person may be subject to legal sanction. Many personal ethics follow society’s ethics and have their origin in law. Personal ethics are also the result of a person’s upbringing and may stem from family, friends, membership in a church, or other significant social institutions. Personal ethics influence how a person will act in an organization. For example, managers’ behaviour toward other managers and toward subordinates will depend on the personal values and beliefs they individually hold as a result of their upbringing, their education, and their experience.

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, a topic discussed in detail in Chapter 7. However, many ethical rules go beyond the boundaries of any individual company. Companies, collectively, are expected to follow the ethical practices and legal rules of society because of the advantages that are produced for a society and its members when its organizations and institutions behave ethically.

Why Do Ethical Rules Develop?

One of the most important reasons why ethical rules governing action develop is to slow down or temper the pursuit of self-interest. One of the best ways of understanding the self-interest issue is to discuss the “tragedy of the commons” problem. When common land (i.e., land owned by everyone) exists, it is rational for every person to maximize his or her use of it because it is a free resource. So all will graze their cattle on the land to promote their individual interests. But if everybody does this, what happens to the land itself, the common resource? The answer is that it is often destroyed by overuse as erosion from overgrazing leaves it defenceless to the effects of wind and
rain and makes the land useless. Thus the rational pursuit of individual self-interest results in a collective disaster. The same is true in many other organized situations: Left to their own devices, people will often pursue their own goals at the expense of collective goals.

Ethical laws and rules emerge to control self-interested behaviour by individuals and organizations that threatens society’s collective interests. For example, the reason why laws establishing what is good or appropriate business practice develop is because they are designed to provide benefits or protection to most everybody. Free and fair competition among organizations is only possible when rules and standards exist that constrain the self-interested actions that people can take in a certain situation. As a businessperson, it is ethical for Dave to compete with a rival and maybe drive that person out of business if he does so by legal means such as by producing a cheaper, better, or more reliable product. However, it is not ethical for Dave to deliberately lie or give false information concerning his rival’s products, or through other unethical or illegal means. Competition by quality or price generally results in increased value for the consumer; competition by force results in monopoly and hurts the customer and the public interest. This is not to say that nobody gets hurt—the rival Dave forces out of business gets hurt—but the harm he does against the rival has to be weighed against the gain to consumers and to Dave himself.

Ethical issues are inherently complex ones where the problem is to distribute the helps and harms between different stakeholders. The issue is to try to act as people of goodwill and to try to follow the moral principles that seem to produce the most good. Ethical rules and moral codes develop to increase the value that can be produced by people when they interact with each other in order to protect and benefit everyone involved. Without these rules, free and fair competition often degenerates into conflict and warfare, and everybody loses. Another way of putting this is to say that ethical rules reduce the costs people have to bear to decide what is right or appropriate. Following an ethical rule avoids expending time and effort in deciding what is the right thing to do. In other words, 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. For example, how do you trust the other person to behave ethically when you don’t know that person? It is here again that the power of ethics in establishing the rules to be followed is so important. For if you can rely on the other person to follow the rules, you do not need to expend effort in monitoring the other person. Monitoring wastes time and effort and is largely unproductive. So, when people share common ethics this helps to reduce transaction costs.

Behaviour that follows accepted ethical rules confers a reputation effect on an individual or an organization that also reduces transaction costs. If an organization over time is known for engaging in illegal acts, how will people view that organization? Most likely with suspicion and hostility. However, suppose an organization always follows the rules and is known for its ethical business practices over and above strict legal requirements. It will have gained a reputation and this is valuable because people will want to deal with it. Unethical organizations over time are therefore penalized as people refuse to deal with them so that there are constraints on organizations beyond those of the law.

Reputation effects also help explain why managers and employees who work in organizations also follow ethical rules. Suppose an organization behaves unethically; what will be the position of its employees? To outsiders, employees come to be branded with the same reputation as the unethical organization because they are assumed to have performed according to its code of ethics. Even if the organization’s unethical behaviour was the product of a few self-seeking individuals, this will affect
and harm all employees. For example, in Japan in the stock crash of the 1990s many brokerage firms went bankrupt with irate clients suing these firms for disguising the real risks associated with investment in the inflated stock market. Employees of these firms found it very difficult to obtain jobs in other organizations because they were branded with the “shame” of having worked for these companies. Thus employees have an incentive for their firm to behave ethically because their fortunes are tied up with those of the organization. An organization’s ill reputation will hurt its own employees as well. This is true at Arthur Andersen, Enron, and other disgraced companies whose employees are suffering from their companies’ bad reputations.

One intangible reward that comes from behaving ethically is feeling good about one’s behaviour, and enjoying the good conscience that comes with doing so. Success by stealth and deceit does not provide the same intangible reward as success from behaving ethically because it is not a fair test of ability or personal qualities. Personal reputation is the outcome of behaving ethically, and the esteem or respect of one’s peers has always been a reward that people desire.

In sum, acting ethically promotes the good of a society, and the well-being of its members. More value is created in societies where people follow ethical rules, and where criminal and unethical behaviour are prevented by law and by custom and practice from emerging. Nevertheless, individuals and organizations do perform unethical and illegal acts.

Why Does Unethical Behaviour Occur?

While there are good reasons for individuals and organizations to behave ethically, there are also many reasons why unethical behaviour takes place at the individual, group, or organizational levels. For a multilayered example, see Organizational Insight 2.5.

ORGANIZATIONAL INSIGHT 2.5

Conflicting Interests in Health Care

In Canada, medical care is delivered in an environment that consists of a complex web of relationships between various users, providers, and other stakeholders. These include patients, doctors, insurance companies, pharmaceutical companies, and different levels of government. Consequently, a relational web of considerations exists between and across the stakeholders, particularly in light of the complex federal and provincial mechanisms in place for the public funding and distribution of drugs and other pharmaceuticals. It is quite common for pharmaceutical companies to lobby provincial governments in order to get their drugs covered by provincial health plans.

Once certain drugs are approved, patients have access to them and to the treatment regimes using them. This advances the sales of these drugs. While most pharmaceutical companies operate above board, some controversy surrounds incidents involving pharmaceutical companies and the manner in which they represent the benefits of their drugs to doctors or to patients. Doctors may be enticed by free samples of new pharmaceuticals, or by free meals and
entertainment, or even by free trips sponsored and paid for by drug companies. One firm, the Boehringer Ingelheim Company, offered expensive vacation trips to Jamaica for doctors and their spouses—all without charge. In return for the “free” vacation, the doctors had simply to agree to attend several company seminars designed to educate them on the benefits of some of the firm’s new arthritis drugs.

The pharmaceutical companies argue that this practice helps educate the medical community about the latest and best medicines available thus contributes to the health-care capacity available to patients. Others, however, argue that offering free enticements to doctors within a publicly funded health-care system appears as a blatant effort to sway or influence opinions and choices in the pursuit of profits.

In Canada there is an increasing trend for drug companies to specifically target and lobby patients indirectly through their trusted health advocacy groups. The ethical challenge is that if patient groups are funded by a company that has an interest in having their drugs covered by provincial health funding, then the advocacy group’s neutrality may be placed in question because almost every high-profile disease advocacy group relies on the financial backing of the drug industry.

Perhaps it is somewhat less known that doctors themselves have directly lobbied provincial governments on behalf of various pharmaceutical companies. This type of relationship also raises serious concerns about conflicts of interest among stakeholders. For an example of this type of conflict, consider the case of Fabry’s disease, an inheritable condition affecting the body’s ability to process and store fat. Individuals with Fabry’s disease are prone to pain, disfigurement, and early death due to heart attack or stroke. In Lunenburg, Nova Scotia, there was a small group of individuals who suffered from this condition. Recently, university-based research resulted in a drug that would greatly improve the quality of life for these patients through amelioration of many of the worst symptoms. Initially, the drug was supplied without cost to these patients by one of two pharmaceutical companies that had begun to produce the drug. However, once initial treatments had begun, and once the patients had enjoyed the benefits of the drug, the company warned patients that payment was required to continue receiving this life-enhancing drug. At a price tag of about $250 000 per year per patient, this cost was far beyond the patients’ ability to manage and they turned to the health-care system for help. This meant that as the system, the doctors, drug companies, provincial governments, and insurance companies tried to decide if, how, when, and by whom the drugs would be paid for, the patients’ health was placed in jeopardy. The patients could not afford to pay, the insurance companies did not want to pay, and the provincial government was unsure whether the public system could or should bear this great a cost in times of fiscal restraint. While the various stakeholders tried to resolve the issue, the patients waited.

Perhaps it is situations such as these that motivate doctors to lobby the government in order to spare patient suffering—to help desperate patients get the drug they obviously could not afford on their own. On the other hand, perhaps the pharmaceutical companies should not have offered free drugs to these patients without warning them of the future costs. What is evident is that stakeholder relationships are complex, that less-than-ethical practices in pursuit of stakeholder interest may arise, and that these usually come at the expense of the interests of other stakeholders.

**Personal Ethics** In theory, people learn ethical principles and moral codes as they mature as individuals in a society. Ethics are obtained from such sources as family and friends, churches, education, and professional training, and from organizations of all kinds. From these, people learn to differentiate what is considered right from wrong in a society or in a social group. However, suppose you are the son or daughter of a criminal, or an enormously wealthy family, and your upbringing and education takes place in
such a context. You may come to believe that it is ethical to do anything and perform any act, up to and including murder, if it benefits your family’s interests. These are the ethics you have learned. These are obviously not the ethics of the wider society and as such are subject to sanction by society if and when they are broken. Similarly, managers in an organization may come to believe that any actions that promote or protect the organization, or any one group of organizational stakeholders, are more important than consideration of the impacts on others, or for the potential harms that may be done to others.

**Self-Interest** We normally confront ethical issues when we are weighing our personal interests against the effects of our actions on others. Suppose you know that you will get a promotion to vice president of your company if you can secure a $100 million contract, but you know that to get the contract you must bribe the contract-giver with $1 million. What would you do? On one hand, your career and future seems to be assured by performing this act, and what harm would it do? Bribery is common anyway, and if you don’t pay the $1 million, you can be sure that somebody else will. So what do you do? Research seems to suggest that people who realize they have most at stake in a career sense or a monetary sense are the ones most likely to act unethically. Similarly it has been shown that organizations that are doing badly in an economic sense and are struggling to survive are the ones most likely to commit unethical and illegal acts such as collusion, price fixing, or bribery.

**Outside Pressure** It has been found in many studies that the likelihood of a person’s engaging in unethical or criminal behaviour is much greater when outside pressure exists for that person to do so. In Sears, for example, top managers’ desires to increase performance led them to create a reward system that had the intentional or unintentional effect of making employees act unethically and overcharge consumers. Top managers can feel themselves to be under similar pressures from shareholders if company performance is deteriorating, and under the threat of losing their jobs they may engage in unethical behaviours to satisfy shareholders.

If all these pressures work in the same direction, we can easily understand how unethical organizational cultures, such as those of Enron, WorldCom, and Arthur Andersen, can develop as managers bought into unethical acts and a generalized climate of “the end justifies the means” permeated these organizations. The organization becomes more defensive as organization members pull together to disguise their unethical actions and to protect one another from prosecution.

The temptation for organizations collectively to engage in unethical and illegal anticompetitive behaviour is very great. Industry competitors can see quite clearly the advantages to acting together to raise prices because of the extra profits they will earn. The harm they inflict is much more difficult to see because their customers may number in the millions, and since each customer is perceived to be affected in such a small way, from the perspective of the organization they are hardly hurt at all. However, if every company in every industry behaved this way, and they all tried to extract money from their customers, customers would suffer severe harm.

The true social costs of various forms of unethical behaviour may be very hard to measure in the short term, but they can be easily seen over the long run in the form of mismanaged organizations that commit harm to employees, customers, and stakeholders of all types.

**CREATING AN ETHICAL ORGANIZATION**

In what ways can ethical behaviour be promoted so that, at the very least, organizational members resist the temptation to engage in illegal or unethical acts that pro-
mote personal or organizational interests at the expense of society’s interests? Ultimately, an organization is ethical if the people inside it are ethical. How can people judge if they are making ethical decisions and thus acting ethically? The first way is to use the rule discussed earlier concerning a person’s willingness to have his or her action or decision shared with other people.

Beyond personal considerations, an organization can encourage people to act ethically by putting in place incentives for ethical behaviour and disincentives to punish those who behave unethically. Because the board and top managers have the ultimate responsibility for setting policy, they can help establish the ethical culture or climate of the organization. There are many ways in which they can influence organizational ethics and an ethical climate. For example, a manager or board member outlining a company’s position on business ethics acts as a figurehead and personifies the organization’s ethical position. As a leader, a manager can promote moral values that result in the specific ethical rules and norms that people use to make decisions. Employees contribute to the ethical climate by their own decisions and actions. This also helps develop social norms of behaviour that reinforce good ethics in the workplace. Outside the organization, as a liaison or spokesperson, a manager can inform prospective customers and other stakeholders about the organization’s ethical values and demonstrate those values through behaviour toward stakeholders—such as by being honest and acknowledging errors. A manager can also help align other employees’ incentives to reinforce ethical behaviour and can develop rules and norms that state the organization’s ethical position. Finally, a manager should make decisions to allocate organizational resources and pursue policies based on the organization’s ethical position with due regard to for other stakeholders and the public at large.

Designing an Ethical Structure and Control System

Ethics influence the choice of the structure and culture that coordinate resources and motivate employees. Managers can design an organizational structure that reduces the incentives for people to behave unethically. The creation of authority relationships and rules that promote ethical behaviour and punish unethical acts, for example, will encourage members to behave in a socially responsible way.

Whistle-blowing occurs when an employee informs an outside person or agency, such as a government agency, a newspaper, or television reporter, about an organization’s (its managers’) illegal or immoral behaviour. Employees typically become whistle-blowers when they feel powerless to prevent an organization from committing an unethical act or when they fear retribution from the company if they voice their concerns. However, an organization can take steps to make whistle-blowing an acceptable and rewarded activity. Procedures that allow subordinates access to upper-level managers to voice concerns about unethical organizational behaviour can be set up. The position of ethics officer can be established to investigate claims of unethical behaviour, and ethics committees can make formal ethical judgments. Ten percent of Fortune 500 companies have ethics officers who are responsible for keeping employees informed about organizational ethics, for training employees, and for investigating breaches of ethical conduct. While most stated organizational ethical values flow down from the top of the organization, they are strengthened or weakened by the design of the organizational structure and how individuals within the organization are rewarded.

Creating an Ethical Culture

The values, rules, and norms that define an organization’s ethical position are part of its culture. The behaviour 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. But neither culture nor structure can make an organization ethical if its top managers or other employees do not behave ethically. The creation of an ethical organizational culture requires commitment at all levels of an organization, from the most senior to the most junior employee.

**Supporting the Interests of Stakeholder Groups**

Shareholders are the owners of an organization. Through the board of directors they have the power to hire and fire top management and thus in theory can discipline managers who engage in unethical behaviour. Shareholders want higher profits, but do they want them to be gained by unethical behaviour? In general, the answer is no, because unethical behaviour will make a company a riskier investment and may bring harm to others. If an organization behaves unethically and brings harm to others, it may damage its reputation, or suffer the consequences of the behaviour (e.g., lawsuits or fines). Once the organization’s reputation is damaged, the value of its shares may fall below the value of shares offered by similar organizations that do behave ethically. In addition, many shareholders do not want to hold stock in companies that engage in socially questionable activities, and other stakeholders may pressure the organization, shareholders, customers, or governments to hold the organization, or specific persons within it, accountable.

Pressure from outside stakeholders can also promote ethical organizational behaviour. The government and its agencies, industry councils and regulatory bodies, consumers, and consumer watchdog groups all play a role in establishing the ethical rules that organizations should follow when doing business. Outside regulation sets the rules of competition and, as noted earlier, plays an important part in creating and sustaining ethics in society.

**SUMMARY**

Organizations are embedded in a complex social context that is driven by the needs and desires of its stakeholders. The interests of all stakeholders have to be considered when designing an organizational structure and culture that promotes effectiveness and curtails the ability of managers and employees to use organizational resources for their own ends or which damages the interests of other stakeholders. Creating an ethical culture, and making sure organizational members use ethical rules in their decision making, is a vital task for all those who have authority over organizational resources. The chapter has made the following main points:

1. 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.

2. 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.

3. 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.

4. The agency problem and moral hazard arise when shareholders delegate authority to man-
agers, and governance mechanisms must be created to align the interests of shareholders and managers to ensure managers behave in the interests of all stakeholders.

5. 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.

6. 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.

DISCUSSION QUESTIONS

1. Give some examples of how the interests of different stakeholder groups may conflict.
2. What is the role of the top-management team?
3. What is the agency problem? What steps can be taken to solve it?
4. Why is it important for managers and organizations to behave ethically?
5. Ask a manager to describe an instance of ethical behaviour that he or she observed, and an instance of unethical behaviour. What caused these behaviours, and what were the outcomes?
6. Search business magazines such as Canadian Business, Fortune, or Business Week for an example of ethical or unethical behaviour, and use the material in this chapter to analyze it.

ORGANIZATIONAL THEORY IN ACTION

Practising Organizational Theory

Form groups of three to five people, and appoint one group member as the spokesperson who will communicate your findings to the class when called on by the instructor. Then discuss the following scenario.

You are the managers of the functions of a large chain of supermarkets, and you have been charged with the responsibility for developing a code of ethics to guide the members of your organization in their dealings with stakeholders. To guide you in creating the ethical code, do the following:

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

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?

The Ethical Dimension #2

Think about the last time that a person treated you unethically or you observed someone else being treated unethically, and then answer these questions.

1. What was the issue? Why do you think that person acted unethically?
2. What prompted him or her to behave in an unethical fashion?
3. Was the decision maker aware that he or she was acting unethically?
4. What was the outcome?

**Analyzing the Organization: Design Module #2**

In this module you will identify your organization’s major stakeholders, analyze the top management structure, investigate its code of ethics, and try to uncover its ethical stance.

**ASSIGNMENT**

1. Draw a stakeholder map that identifies your organization’s major stakeholder groups. What kind of conflicts between its stakeholder groups would you expect to occur the most?
2. Using information on the company’s Web site, draw a picture of its hierarchy of authority. Try to identify the members of the top-management team. Is the CEO also the chair of the board of directors?
3. Does the company have divisional managers? What functional managers seem to be most important to the organization in achieving a competitive advantage? What is the functional background of the top-management team?
4. Does the organization have a published code of ethics or ethical stance? What kinds of issues does it raise in this statement?
5. Search for information about your organization concerning the ethical or unethical behaviour of its managers. What does this tell you about its ethical stance?

**Company Profiles #2**

Choose one or more of the organizations (e.g., companies, government agencies, or nonprofit organizations) that are profiled in this chapter. Do an Internet search to get up-to-date information on each organization you have selected, and answer the following questions.

1. What does the new information tell you about the organization’s current ethical behaviour?

2. How does the information compare with the earlier information provided in the text and what does that tell you about organizations (e.g., does the organization appear to be judged more or less ethical than before, and how do you explain this)?

**Alternative Perspectives #2**

Critical and mainstream organizational theorists alike are paying increased attention to the concept of “stakeholding,” including new theorization concerning both internal and external stakeholders and their relationships with the organization. Historically, shareholders where viewed as the primary organizational stakeholders, and monetary returns to the shareholder held primacy. However, given the recent spate of ethical issues, fraudulent behaviours, and various detrimental impacts that organizational actions have had on society and the environment, a broader more inclusive focus is now developing. Read one or more of the following readings and list the advantages and disadvantages of having more or less, direct and indirect, relations with stakeholders. In small groups, discuss whether it is possible for organizations to achieve their “for-profit” mandate as well as remain ethically responsible to their various stakeholders.

**Reading List**


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* The authors would like to receive information from student groups and instructors on any companies where there have been dramatic changes to the information published in this text. We would be happy to publish the best of these changes in a subsequent edition, where we will focus on changing company profiles.
Just what is a corporate reputation worth these days? If you ask the Canadian Imperial Bank of Commerce (CIBC) that question, you’d likely hear it’s worth millions—at least $50 million anyway. That’s the amount CIBC announced it’s spending to introduce new ethics training and a whistle-blowers hotline within the bank. The programs are part of an US$80 million agreement struck by CIBC with Canadian and U.S. regulators over the role played by the bank in contributing to the collapse of energy trader Enron. But, there was another ethical scandal involving company’s employees that is also to be addressed by the new programs. Let’s look at the company more closely.

CIBC was established as a retail bank in 1867—the same year Canada became a nation. In 2003, with assets totalling $277 billion, CIBC’s 37,000 employees served more than 9 million personal banking and business customers around the world via its electronic and branch banking network. A publicly owned company with shares trading on both the Toronto and New York Stock Exchanges, CIBC had a very profitable 2003. Its share price had increased 57 percent over the year, and the company announced all-time record profits of $2.1 billion. It should have been hailed as an extremely good year for the company, but less positive news about the company also appeared in the media during the year.

The first scandal to make the headlines was news of CIBC’s involvement in the demise of Enron. Investigations into the collapse of the energy giant revealed that six banks—identified as the company’s Tier 1 banks—helped Enron through a series of financial transactions to wrongfully record on its financial statements at least US$1 billion in profits and US$9 billion in cash flow, and to understate its debt by some US$11 billion. In exchange for helping the company, the banks and investment firms received healthy fees and commissions. CIBC is reported to have earned some US$24 million from its dealing with Enron from 1998 to 2001.

The second blow to CIBC’s reputation came with the news that a senior executive from its investment-banking group had been arrested on charges of fraud related to a U.S. mutual fund scandal. The former CIBC executive was charged with defrauding two U.S. mutual funds of more than US$2 million through illegal trading and deceptive timing of market transactions. If convicted, the individual could face 25 years in prison and a lifetime ban on working in the industry. And more bad news could still come, since the bank and several other employees are still being investigated as part of the case.
With all the negative publicity, CIBC needed to act. One of its first steps was to announce the departure of the executive who had overseen the groups involved in the Enron and mutual fund scandals. Shortly thereafter, CIBC announced a $50 million investment in governance and reputational risk programs.

The money was earmarked for a number of initiatives. A big focus was on providing support for the employees of CIBC so that the company could meet its stated goal of having “everyone doing the right thing—always.” Online training, focusing on legal risk and reputational issues, was announced for the bank’s entire workforce. An ethics hotline was also introduced to provide employees with a vehicle to safely report ethical concerns. CIBC’s telephone-based program would be operated by an independent third-party and its toll-free number managed by specially trained staff at a call centre operating 24 hours a day, seven days a week. Details of employee concerns would be relayed confidentially and anonymously by the third party to company officials.

Other funds were allocated for process-related concerns. For example, a thorough review of the bank’s procedures for approving financial transactions was announced, and new procedures and protocols were said to be forthcoming. And, CIBC executives have openly been speaking about the problems and the steps being taken to address them. John Hunkin, the CEO, acknowledged, “We stumbled where it counts... in trust and reputation.” He added, “Our reputation is at the core of everything we do... We see this investment as critical to CIBC’s success.”

Wayne Fox, the CIBC executive in charge of risk management, has also been speaking out about the company’s experiences. He commented that CIBC has historically made the “management of risk, reputation, compliance, and financial reporting a top priority” and yet, as he pointed out, “that we have accomplished so much and yet stumbled so publicly with recent events like Enron is meaningful” for moving CIBC forward. In Fox’s view, what is necessary to address problems of this nature is a “culture of governance.” He believes that CIBC already has a strong foundation for such a culture with its existing governance rules, processes, and procedures—many of them considered best practices—and that there isn’t a need for “an emergency, wholesale overhaul.” Instead, Fox suggests that it is critical to make sure employees understand that this objective is not “just another flavour of the month” and that they have an important role to play in ensuring “doing the right things always” is the company standard. So Fox and the rest of the CIBC management team are actively communicating that there’s a “zero tolerance for misconduct.”

So far, Fox is positive about the message being heard: “... our people are responding. They’re learning this, believing this and acting accordingly every day. Their belief and actions, in hand with CIBC’s knowledge, desire and tools, are causing our governance culture to flourish and strengthening our ability to do the right thing, always.”

DISCUSSION QUESTIONS

1. Why is corporate reputation important to any company? Is it of any greater concern to the stakeholders of a financial institution than another type of firm? Is there any relationship between the type of good or service a firm produces, its customers, and whether it needs to emphasize a culture of ethics?

2. What do you think of CIBC’s approach? Do you think the bank is right to focus on development of a governance culture? Will the steps CIBC has announced help develop such a culture? Will CIBC be more or less ethical than before?

3. Are there any other actions that CIBC, or a similar firm in similar circumstances, could take? Whose interests are being served when a firm engages in a “program of ethics”?
REFERENCES


14. Hill and Jones, Strategic Management, Ch. 2.


18. Ibid., p. 155.


