

## CHAPTER 2

# Stakeholder Relationships, Social Responsibility, and Corporate Governance

### SUMMARY

In this chapter, first we identify stakeholders' different roles in business ethics. We examine the relationships between businesses and various stakeholder groups and examine how a stakeholder framework can help us understand organizational ethics. Then we define social responsibility and examine the relationships between having a stakeholder orientation and social responsibility. Next, we delineate how a stakeholder orientation helps to create corporate social responsibility. We then examine corporate governance as a dimension of social responsibility and its role in structuring ethics and social responsibility in business. The ethical decision making process is covered in order to provide an understanding of the importance of oversight in responding to stakeholders. Finally, we provide the steps for implementing a stakeholder perspective in creating both social responsibility and ethical decisions in business.

### INSTRUCTOR NOTES FOR “AN ETHICAL DILEMMA”

Carla's dilemma is whether to report her superior's "moonlighting" to higher authorities. Jack had begun taking on additional work as a means of retaliating against his superiors after being denied a partner's position. Jack's outside consulting work may be taking away business from Aker & Aker Accounting (A&A), even though he claims that his outside clients are not within A&A's market area. Students may want to discuss the implied threat to Carla, as well as her own minor infractions of the rules. Most will agree that Jack's behavior is in flagrant disregard to the overall integrity of A&A's business practices. Students should also discuss Jack's rationalization of his behavior. It is common for people to make bad choices when they feel economic, family, or on-the-job pressures. Students may want to explore the ramifications of Carla exposing Jack and the potential problems that could occur if A&A decided to let her go. The instructor may wish to point out that some whistle-blowers have discouraged others from becoming whistleblowers themselves because of the tremendous physical and psychological pressures that it invokes; yet, when asked if they would do it again, the response is invariably yes. Carla may be correct in assuming that she would be retaliated against for bringing up the situation with Jack without having ample evidence first.

### LECTURE OUTLINE

- I. Stakeholders Define Ethical Issues in Business
  - A. Building effective relationships is considered one of the more important areas of business today. A stakeholder framework helps identify the internal stakeholders such as employees, boards of directors, and managers and external stakeholders such as customers, special interest groups, regulators, and others who agree, collaborate, and have confrontations on ethical issues.
  - B. In a business context, customers, investors and shareholders, employees, suppliers, government agencies, communities, and others who have a "stake" or claim in some aspect of a company's products, operations, markets, industry, and outcomes are known as **stakeholders**.

1. The relationship between companies and their stakeholders is a two-way street. Stakeholders are influenced by business, but they also have the ability to affect businesses.
    - a. Stakeholders apply their values and standards to many diverse issues—working conditions, consumer rights, environmental conservation, product safety, and proper information disclosure—that may or may not directly affect an individual stakeholder's own welfare.
    - b. Stakeholders provide both tangible and intangible resources that can be critical to a firm's long-term success.
  2. When individual stakeholders share similar expectations about desirable business conduct, they may choose to organize into communities.
  3. Ethical misconduct can damage a firm's reputation, causing stakeholders to withdraw valuable resources. This gives stakeholders power over businesses.
- C. Identifying Stakeholders
1. Stakeholders can be divided into two categories.
    - a. **Primary stakeholders** are those whose continued association is necessary for a firm's survival (employees, customers, investors, and stockholders, governments and communities that provide necessary infrastructure).
    - b. **Secondary stakeholders** do not typically engage in transactions and are not essential for its survival (the media, trade associations, and special-interest groups).
    - c. Although primary groups may present more day-to-day concerns, secondary groups cannot be ignored or given less consideration in the ethical decision-making process.
  2. The **stakeholder interaction model** indicates that there are two-way relationships between the firm and a host of stakeholders.
- D. A Stakeholder Orientation
1. The degree to which a firm understands and addresses stakeholder demands can be expressed as a stakeholder orientation.
  2. A stakeholder orientation comprises three sets of activities.
    - a. The organization-wide generation of data about stakeholder groups and assessment of the firm's effects on these groups.
    - b. The distribution of this information throughout the firm.
    - c. The organization's responsiveness as a whole to this intelligence.
  3. A stakeholder orientation is not complete unless it includes activities that address stakeholder issues.
  4. Responsiveness processes may involve the participation of the concerned stakeholder groups. It can be viewed as a continuum as firms adopt a stakeholder orientation to varying degrees.
- II. Social Responsibility and the Importance of a Stakeholder Orientation
- A. From the perspective of social responsibility, business ethics embodies values, norms, and expectations that reflect concerns of major stakeholders, including consumers, employees, shareholders, suppliers, competitors, and the community.
  - B. Many businesspeople and scholars have questioned the role of ethics and social responsibility in business because legal and economic responsibilities are accepted as the most important determinants of performance.
    1. Adam Smith's original form of capitalism, which reemphasizes stakeholder concerns and issues, is regaining popularity in the 21<sup>st</sup> century.
    2. Ethics and social responsibility cannot be just a reactive approach to issues as they arise.
    3. A description of corporate social responsibility should include rights and duties, consequences and values.

## III. Social Responsibility and Ethics

- A. The concepts of ethics and social responsibility are often used interchangeably, although each has a distinct meaning.
  - 1. Social responsibility is an organization's obligation to maximize its positive impact on stakeholders and minimize negative impacts. It can be viewed as a contract with society
  - 2. Business ethics involves carefully thought out rules or heuristics of business conduct that guide decision making.
- B. Employee satisfaction, consumer loyalty, and other stakeholder concerns can be quantified to a limited degree.
  - 1. The International Organization for Standardization (ISO) has tried to establish a corporate responsibility guideline, the ISO 26000, which is meant to promote a common understanding of social responsibility.
  - 2. ISO 14000 is an environmental regulation standard businesses can adopt to help them reduce their carbon footprints, pollution, and waste.
- C. There are four levels of social responsibility—economic, legal, ethical, and philanthropic—and they can be viewed as steps.
- D. The term **corporate citizenship** is often used to express the extent to which businesses strategically meet the economic, legal, ethical, and philanthropic responsibilities placed on them by their various stakeholders.
  - 1. Corporate citizenship has four interrelated dimensions:
    - a. Strong sustained economic performance
    - b. Rigorous compliance
    - c. Ethical actions beyond what the law requires
    - d. Voluntary contributions that advance the reputation and stakeholder commitment of the organization.
  - 2. **Reputation** is one of an organization's greatest intangible assets with tangible value. The value of a positive reputation is difficult to quantify, but it is very important.

## IV. Corporate Governance Provides Formalized Responsibility to Stakeholders

- A. Today, the failure to balance stakeholder interests can result in a failure to maximize shareholders' wealth. Directors and corporate officers have a duty of care, or *duty of diligence*, to make informed and prudent decisions on behalf of their stakeholders and the organization.
- B. To remove the opportunity for employees to make unethical decisions, most companies have developed formal systems of accountability, oversight, and control—known as **corporate governance**.
  - 1. *Accountability* refers to how closely workplace decisions are aligned with a firm's stated strategic direction and its compliance with ethical and legal considerations. *Oversight* provides a system of checks and balances that limit employees' and managers' opportunities to deviate from policies and strategies and that prevent unethical and illegal activities. *Control* is the process of auditing and improving organizational decisions and actions.
  - 2. A clear delineation of accountability helps employees, customers, investors, government regulators, and other stakeholders understand why and how the organization chooses and achieves its goals.
  - 3. Corporate governance establishes fundamental systems and processes for preventing and detecting misconduct, for investigating and disciplining, and for recovery and continuous improvement. It should interface with the corporation's governance structure.
- C. Views of Corporate Governance
  - 1. The **shareholder model of corporate governance** is founded in classic economic precepts, including the goal of maximizing wealth for investors and owners.
    - a. Focuses on developing and improving the formal system for maintaining performance accountability between top management and the firms' shareholders.

- b. A shareholder orientation should drive a firm's decisions toward serving the best interests of investors.
  - 2. The **stakeholder model of corporate governance** adopts a broader view of the purpose of business because it must answer to other stakeholders, including employees, suppliers, government regulators, communities, and special-interest groups.
    - 1. Because of limited resources, companies must determine which of their stakeholders are primary.
- D. The Role of Boards of Directors
  - 1. For public corporations, boards of directors hold the ultimate responsibility for their firms' success or failure, as well as for the ethics of their actions. Board members have a fiduciary duty to act in the best interests of those they serve
  - 2. Traditionally, boards of directors rarely perform the management function. Are concerned with monitoring the decisions made by executives on behalf of the company.
  - 3. Compensation, both of organizational executives and board members themselves, is a difficult ethical area because board members may place self-interest above those of shareholders.
  - 4. Greater Demands for Accountability and Transparency
    - a. Directors are chosen for their expertise, competence, and ability to bring diverse perspectives to strategic discussions.
    - b. Outside directors are thought to bring more independence to the monitoring function.
    - c. Many of the corporate scandals uncovered in recent years might have been prevented if each of the companies' boards of directors had been better qualified, more knowledgeable, and less biased.
    - d. The concept of board members being linked to more than one company is known as **interlocking directorate**. The practice is legal unless it involves a direct competitor.
  - 5. **Executive Compensation**
    - a. Many boards spend more time discussing compensation than they do ensuring the integrity of the firm's financial reporting systems.
    - b. The most recent financial meltdown and high bonuses for executives of failed firms re-ignited the public debate over compensation issues.
    - c. The topic of executive compensation is important to boards because it receives much attention in the media, sparks shareholder concern, and is hotly debated in discussions of corporate governance.
    - d. One area for board members to consider is the extent to which executive compensation is linked to company performance.
    - e. Issues related to high compensation are excessive risk-taking, a focus on short-term financial performance, and reduced transparency at the expense of long-term growth.
- V. Implementing a Stakeholder Perspective
  - A. An organization that develops effective corporate governance and understands the importance of business ethics and social responsibility in achieving success should develop processes for managing these important concerns. Although there are many different approaches, there are some steps to follow that are effective in utilizing the stakeholder framework in managing responsibility and business ethics.
    - 1. Step 1: Assessing the Corporate Culture
      - a. To enhance organizational fit, a social responsibility program must align with the corporate culture of the organization.
      - b. The purpose of this step is to identify the organizational mission, values, and norms that are likely to have implications for social responsibility.
    - 2. Step 2: Identifying Stakeholder Groups

- a. In managing this stage, it is important to recognize stakeholder needs, wants, and desires.
  - b. Stakeholders have some level of power over a business because they are in the position to withhold, or at least threaten to withhold, organizational resources.
- 3. Step 3: Identifying Stakeholder Issues
  - a. This step involves understanding the nature of the main issues of concern to primary stakeholders.
- 4. Step 4: Assessing Organizational Commitment to Social Responsibility
  - a. Step 4 brings the previous three steps together to arrive at an understanding of social responsibility that specifically matches the organization of interest.
- 5. Step 5: Identifying Resources and Determining Urgency
  - a. The prioritization of stakeholders and issues, along with the assessment of past performance, provides guidance for allocating resources.
  - b. Two main criteria should be considered:
    - i) the level of financial and organizational investments required by different actions.
    - ii) the urgency when prioritizing social responsibility challenges.
- 6. Step 6: Gaining Stakeholder Feedback
  - a. Stakeholder feedback can be generated through a variety of means.
    - i) Satisfaction or reputation surveys
    - ii) Assessment of stakeholder-generated media (blogs, websites, podcasts, and newsletters)
    - iii) Formal research using focus groups, observation, and surveys

#### VI. Contributions of a Stakeholder Perspective

- A. Balancing stakeholder interests requires good judgment because broader societal interests can create conflicts.
- B. This chapter provides a good overview of the issues, conflicts, and opportunities of understanding more about stakeholder relationships. The stakeholder framework helps recognize issues, identify stakeholders, and examine the role of boards of directors and managers in promoting ethics and social responsibility.

## DEBATE ISSUE: TAKE A STAND

Have your students split into two teams. One team will argue for the first point, and the other will argue for the opposing view. The purpose is to get students to realize that there are no easy answers to many of these issues. This particular issue deals with whether a socially irresponsible product—in this case, a product that promotes adultery—should be sold if it is legal. Students on the first team could argue that as long as the product is legal and allows for freedom of choice, there should be no barriers to selling it. Students on the other team could argue that the product causes emotional harm to people. Since it is a detriment to society, it should be banned.

## “RESOLVING ETHICAL BUSINESS CHALLENGES” NOTES

In this case, Karl is being pressured by his boss, parents, and wife about the marketing campaign for Bounce Corporation’s new Web browser-based game called “Breakaway.” He has been at Bounce for two years and Breakaway was his first big project. The reader first goes through a brief overview of the fierce competition that is present in the gaming industry. Karl’s previous work at Bounce was conducting market research on the gaming industry and what consumers want. He finds that consumers want more violence, distinct character roles, multiple levels of difficulty, and in-game rewards. Instructors may want to pause to ask students whether these are characteristics of games they also

desire. Karl also found that regular gamers exhibit the same characteristics as compulsive gamblers and are willing to pay as they go to purchase credits that allow them to play longer. Karl also noticed that social networking games that gave positive reinforcements to the consumer, such as encouraging messages after a completed task, were played much more frequently than others were.

The Breakaway game fits the criteria for games that consumers will find attractive, according to Karl's previous research. The game is made even more appealing by 3-D technology and a female character who removes articles of her clothing as the player advances through the game. At this point, many students will determine that this is the ethical issue; however, the pivotal issue of this case is promoting a product that may be detrimental to the consumer. Some students may consider this video game a form of gambling. Other students may find the nudity objectionable, as Karl does in the case. Students should discuss the acceptability of gambling, nudity, and violence in products for the U.S. culture, relative to other cultures. Finally, students should think about the family and community pressures influencing Karl's decision.

In this case, Karl weighed his father's comments against the potentially detrimental effects of a game that promotes nudity and violence, and he concluded that the nudity is a bad idea. Will, the company's president, agrees, and has arranged to sell the game on the Internet as a standalone adult product. Karl and Will also consider toning down the more offensive aspects and selling the game in Mexico. However, Will states that the Taiwanese market wants an even more graphic game.

The Internet is now rife with "adult" content software. Students could discuss how these behaviors (gambling, sexual exploitation, and violence) affect a society. In this situation, all of the items marketed are legal, yet studies have shown that promotion of such activities can harm the fabric of a society. The issue for students is whether or not to market products and services that are legal but personally objectionable.

Care should be taken to allow students to explain their reasoning. Students will attempt to disassociate themselves from these situations, so the instructor should prompt them to discuss the situation as if they were Karl. Discussion can also revolve around whether the student has any reservations about marketing such products in their own culture versus other cultures.