

Strategic and Operational Management

MGM 630 (part 3)

Lecture 9

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LECTURE OUTLINE

1. The Shared Value Creation Framework.

- Public Stock Companies and Shareholder Capitalism
- Creating Shared Value

2. Corporate Governance.

- Agency Theory
- The Board of Directors
- Other Governance Mechanisms

3. Strategy and Business Ethics.

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LEARNING OBJECTIVES

1. Describe the shared value creation framework and its relationship to competitive advantage.
2. Explain the role of corporate governance.
3. Apply agency theory to explain why and how companies use governance mechanisms to align interests of principals and agents.
4. Evaluate the board of directors as the central governance mechanism for public stock companies.
5. Evaluate other governance mechanisms.
6. Explain the relationship between strategy and business ethics.

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9.1 The Shared Value Creation Framework

The shared value creation framework provides guidance to managers about how to reconcile the **economic** imperative of gaining and sustaining competitive advantage with corporate **social** responsibility. It helps managers create a larger pie that benefits both shareholders and other stakeholders. To develop the shared value creation framework, though, we first must understand the role of the public stock company.

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- public stock companies and shareholder capitalism:

The public stock company is an important institutional arrangement in modern, free market economies. It provides goods and services as well as employment, pays taxes, and increases the standard of living. There exists an implicit contract based on trust between society and the public stock company. Society grants the right to incorporation, but in turn expects companies to be good citizens by adding value to society.

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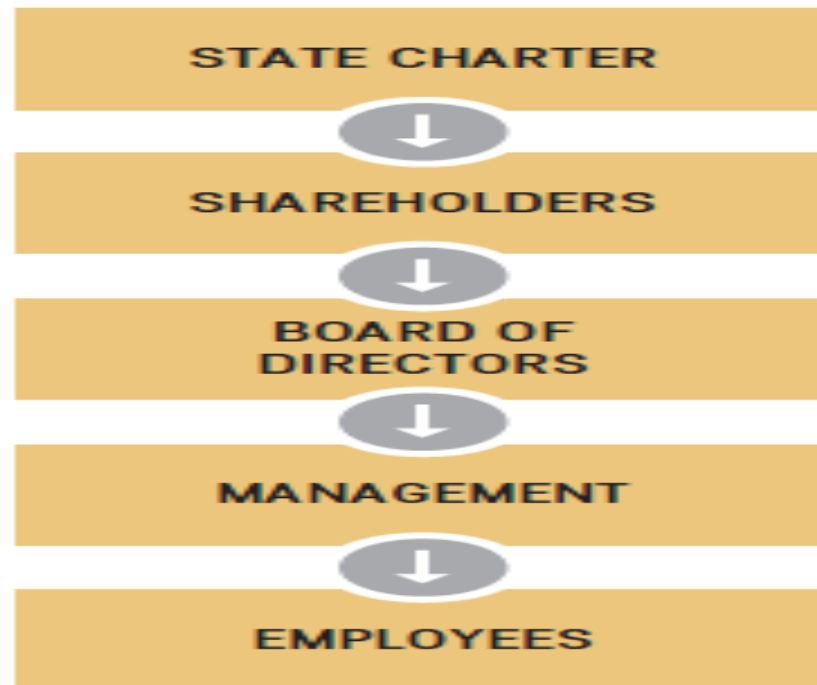
Exhibit 12.1 depicts the levels of hierarchy within a public stock company. The state or society grants a charter of incorporation to the company's shareholders—its owners, who legally own stock in the company. The shareholders appoint a board of directors to govern and oversee the firm's management. The managers hire, supervise, and coordinate employees to manufacture products and provide services. **The public stock company enjoys four characteristics that make it an attractive corporate form:**

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EXHIBIT 12.1 /
The Public Stock
Company: Hierarchy
of Authority



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1. Limited liability for investors. This characteristic means that the shareholders who provide the risk capital are liable only to the capital specifically invested, and not for other investments they may have made or for their personal wealth. Limited liability encourages investments by the wider public and entrepreneurial risk-taking.

2. Transferability of investor ownership. through the trading of shares of stock on exchanges such as the New York Stock Exchange (NYSE) and NASDAQ, or exchanges in other countries. Each share represents only a minute fraction of ownership in a company, thus easing transferability.

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3. Legal personality—that is, the law regards a non-living entity such as a for-profit firm as similar to a person, with legal rights and obligations. Legal personality allows a firm's continuation beyond the founder or the founder's family.

4. Separation of legal ownership and management control. In publicly traded companies, the stockholders (the principals, represented by the board of directors) are the legal owners of the company, and they delegate decision-making authority to professional managers (the agents).

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- creating shared value

In contrast to Milton Friedman, Porter argues that executives should not concentrate exclusively on increasing firm profits. Rather, the strategist should focus on **creating shared value**, a concept that involves creating economic value for shareholders while also creating social value by addressing society's needs and challenges. He argues that managers need to reestablish the important relationship between superior firm performance and societal progress. This dual point of view, Porter argues, will not only allow companies to gain and sustain a competitive advantage but also reshape capitalism and its relationship to society.

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The shared value creation framework proposes that managers maintain a dual focus on shareholder value creation and value creation for society. It recognizes that markets are defined not only by economic needs but also by societal needs. It also advances the perspective that externalities such as pollution, wasted energy, and costly accidents actually create internal costs, at least in lost reputation if not directly on the bottom line. Rather than pitting economic and societal needs in a trade-off, Porter suggests that the two can be reconciled to create a larger pie. **The shared value creation framework** seeks to enhance a firm's competitiveness by identifying connections between economic and social needs, and then creating a competitive advantage by addressing these business opportunities.

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To ensure that managers can reconnect economic and societal needs, Michael Porter recommends that managers focus on three things within the shared value creation framework:

1. **Expand the customer base to bring in non-consumers** such as those at the bottom of the pyramid—the largest but poorest socioeconomic group of the world's population. The bottom of the pyramid in the global economy can yield significant business opportunities, which—if satisfied—could improve the living standard of the world's poorest.

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2. Expand traditional internal firm value chains to include more nontraditional partners such as nongovernmental organizations (NGOs).

NGOs are nonprofit organizations that pursue a particular cause in the public interest and are independent of any governments. Habitat for Humanity and Greenpeace are examples of NGOs.

3. Focus on creating new regional clusters such as Silicon Valley in the United States, Electronic City in Bangalore, India, and Chilecon Valley in Santiago, Chile.

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٩.٢ Corporate Governance

Corporate governance concerns the mechanisms to direct and control an enterprise in order to ensure that it pursues its strategic goals successfully and legally. Corporate governance is about checks and balances and about asking the tough questions at the right time. **The accounting scandals** of the early 2000s and the global financial crisis of 2008 and beyond got so out of hand because the enterprises involved did not practice effective corporate governance.

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some observers question whether **Uber** has effective corporate-governance mechanisms in place, or whether its ethically and legally questionable competitive tactics and decisions are part of a larger intended strategy to first dominate the **taxi-hailing business** and then to address any remaining stakeholder grievances.

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Corporate governance attempts to address the principal–agent problem, which can occur any time an agent performs activities on behalf of a principal. This problem can arise whenever a principal delegates decision making and control over resources to agents, with the expectation that they will act in the principal's best interest.

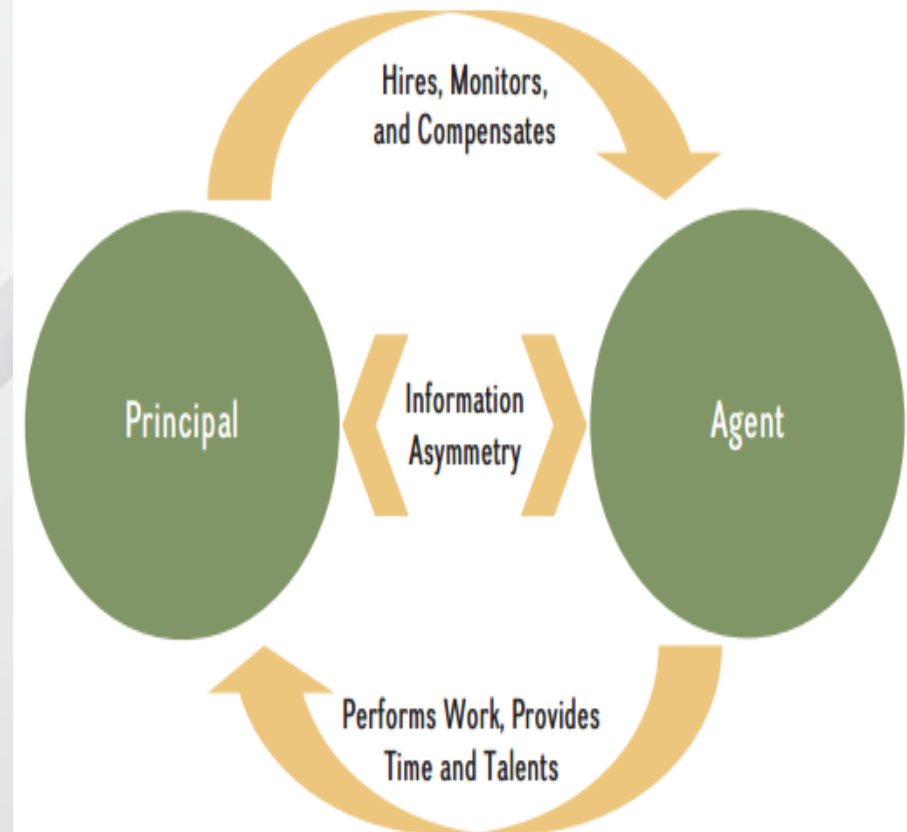
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We mentioned earlier that the separation of ownership and control is one of the major advantages of the public stock companies. This benefit, however, is also the source of the principal–agent problem. In publicly traded companies, the stockholders are the legal owners of the company, but they delegate decision-making authority to **professional managers**. The conflict arises if the agents pursue their own personal interests, which can be at odds with the principals' goals. For their part, agents may be more interested in maximizing their total compensation, including benefits, job security, status, and power. Principals desire maximization of total returns to shareholders.

The risk of opportunism on behalf of agents is exacerbated by information asymmetry: the agents are generally better informed than the principals. Exhibit 12.3 depicts the principal–agent relationship. Managers, executives, and board members tend to have access to *private information* concerning important company developments that outsiders, especially investors, are not privy to. Often this informational advantage is based on timing—insiders are the first to learn about important developments before the information is released to the public.

EXHIBIT 12.3 / The Principal–Agent Problem



- Agency theory

The principal–agent problem is a core part of **agency theory**, which views the firm as a nexus of legal contracts. In this perspective, corporations are viewed merely as a set of legal contracts between different parties. Conflicts that may arise are to be addressed in the legal realm. Agency theory finds its everyday application in employment contracts, for example.

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Besides dealing with the relationship between shareholders and managers, principal–agent problems also cascade down the organizational hierarchy (shown in Exhibit 12.3). Senior executives, such as the CEO, face agency problems when they delegate authority of strategic business units to general managers. **Uber headquarters** staff in the United States claimed that the sexist ad campaign launched by its French office was based on an agency problem, explaining it as a “clear misjudgment of the local team.” The local team, however, thought that this type of ad campaign would serve Uber in France well.

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Employees who perform the actual operational labor are agents who work on behalf of the managers. Such frontline employees often enjoy an informational advantage over management. They may tell their supervisor that it took longer to complete a project or serve a customer than it actually did, **for example**. Some employees may be tempted to use such informational advantage for their own self-interest (e.g., spending time on Facebook during work hours, watching YouTube videos, or using the company's computer and Internet connection for personal business).

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The managerial implication of agency theory relates to the management functions of organization and control: The firm needs to design work tasks, incentives, and employment contracts and other control mechanisms in ways that minimize opportunism by agents. Such governance mechanisms are used to align incentives between principals and agents.

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- The board of directors

The shareholders of public stock companies appoint a board of directors to represent their interests. The board of directors is the centerpiece of corporate governance in such companies. The shareholders' interests, however, are not uniform. The goals of some shareholders, such as institutional investors (e.g., retirement funds, governmental bodies, and so on), are generally the long-term viability of the enterprise combined with profitable growth. Long-term viability and profitable growth should allow consistent dividend payments and result in stock appreciation over time.

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The goals of other shareholders, such as hedge funds, are often to **profit from short-term movements of stock prices**. These more proactive investors often demand changes in a firm's strategy, such as spinning out certain divisions or splitting up companies into parts to enhance overall performance. Votes at shareholder meetings, generally in proportion to the amount of ownership, determine whose representatives are appointed to the board of directors.

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The day-to-day business operations of a publicly traded stock company are conducted by its managers and employees, under the direction of the chief executive officer (CEO) and the oversight of the board of directors. The board of directors is composed of inside and outside directors who are elected by the shareholders:

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■ **Inside directors** are generally part of the company's senior management team, such as the chief financial officer (CFO) and the chief operating officer (COO). They are appointed by shareholders to provide the board with necessary information pertaining to the company's internal workings and performance. Without this valuable inside information, the board would not be able to effectively monitor the firm. As senior executives, however, inside board members' interests tend to align with management and the CEO rather than the shareholders.

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■ **Outside directors**, on the other hand, are not employees of the firm. They frequently are senior executives from other firms or full-time professionals, who are appointed to a board and who serve on several boards simultaneously. Given their independence, they are more likely to watch out for the interests of shareholders.

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- Other governance mechanisms

While the board of directors is the central governance piece for a public stock company, several other corporate mechanisms are also used to align incentives between principals and agents, including

- Executive compensation.
- The market for corporate control.
- Financial statement auditors, government regulators, and industry analysts.

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- **Executive Compensation.** The board of directors determines executive compensation packages. To align incentives between shareholders and management, the board frequently grants **stock options** as part of the compensation package. This mechanism is based on agency theory and gives the recipient the right, but not the obligation, to buy a company's stock at a predetermined price sometime in the future. If the company's share price rises above the negotiated strike price, which is often the price on the day when compensation is negotiated, the executive stands to reap significant gains.

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The topic of executive compensation—and CEO pay, in particular—has attracted significant attention in recent years. Two issues are at the forefront:

1. The absolute size of the CEO pay package compared with the pay of the average employee.
2. The relationship between CEO pay and firm performance.

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- **The market for Corporate Control.** Whereas the board of directors and executive compensation are internal corporate-governance mechanisms, the market for corporate control is an important external corporate-governance mechanism. It consists of activist investors who seek to gain control of an underperforming corporation by buying shares of its stock in the open market. To avoid such attempts, corporate managers strive to protect shareholder value by delivering strong share-price performance or putting in place poison pills.

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- **Auditors, government regulators, and industry analysts.** Auditors, government regulators, and industry analysts serve as additional external-governance mechanisms. All public companies listed on the U.S. stock exchanges must file a number of financial statements with the Securities and Exchange Commission (SEC), a federal regulatory agency whose task it is to oversee stock trading and enforce federal securities laws. To avoid the misrepresentation of financial results, all public financial statements must follow generally accepted accounting principles (GAAP) and be audited by certified public accountants.

9.3 Strategy and Business Ethics

Multiple, high-profile accounting scandals and the global financial crisis have placed business ethics center stage in the public eye. **Business ethics** are an agreed-upon code of conduct in business, based on societal norms. Business ethics lay the foundation and provide training for “behavior that is consistent with the principles, norms, and standards of business practice that have been agreed upon by society.”

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These principles, norms, and standards of business practice differ to some degree in different cultures around the globe.

But a large number of research studies have found that some notions—such as fairness, honesty, and reciprocity—are universal norms. As such, many of these values have been codified into law.

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Law and ethics, however, are not synonymous. This distinction is important and not always understood by the general public. Staying within the law is a minimum acceptable standard. A note of caution is therefore in order: A manager's actions can be completely legal, but ethically questionable. **For example**, consider the actions of mortgage loan officers who—being incentivized by commissions—persuaded unsuspecting consumers to sign up for exotic mortgages, such as “option ARMs.”

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These mortgages offer borrowers the choice to pay less than the required interest, which is then added to the principal while the interest rate can adjust upward. Such actions may be legal, but they are unethical, especially if there are indications that the borrower might be unable to repay the mortgage once the interest rate moves up.

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To go beyond the minimum acceptable standard codified in law, many organizations have explicit codes of conduct. These codes go above and beyond the law in detailing how the organization expects an employee to behave and to represent the company in business dealings. **Codes of conduct** allow an organization to overcome moral hazards and adverse selections as they attempt to resonate with employees' deeper values of justice, fairness, honesty, integrity, and reciprocity.

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Since business decisions are not made in a vacuum but are embedded within a societal context that expects ethical behavior, **managers can improve their decision making by also considering:**

- **When facing an ethical dilemma**, a manager can ask whether the intended course of action falls within the acceptable norms of professional behaviors outlined in the organization's code of conduct and defined by the profession at large.

Some people believe that unethical behavior is limited to a few “bad apples” in organizations. The assumption is that the vast majority of the population—and by extension, **organizations—are good**, and that we need only safeguard against abuses by a few bad actors. **According to agency theory**, it’s the “bad agents” who act opportunistically, and principals need to be on guard against bad actors.

- The manager should imagine whether he or she would feel comfortable explaining and defending the decision in public. How would the media report the business decision if it were to become public? How would the company's stakeholders feel about it?

To foster ethical behavior in employees, boards must be clear in their ethical expectations, and top management must create an organizational structure, culture, and control system that values and encourages desired behavior. Furthermore, a company's formal and informal cultures must be aligned, and executive behavior must be in sync with the formally stated vision and values. Employees will quickly see through any duplicity. Actions by executives speak louder than words in vision statements.

Other leading professions have accepted codes of conduct (e.g., the bar association in the practice of law and the Hippocratic oath in medicine); management has not. Some argue that management needs an accepted code of conduct, holding members to a high professional standard and imposing consequences for misconduct. Misconduct by an attorney, **for example**, can result in being disbarred and losing the right to practice law. Likewise, medical doctors can lose their professional accreditations if they engage in misconduct.

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Thank You