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Principles of

Management

Principles of Management



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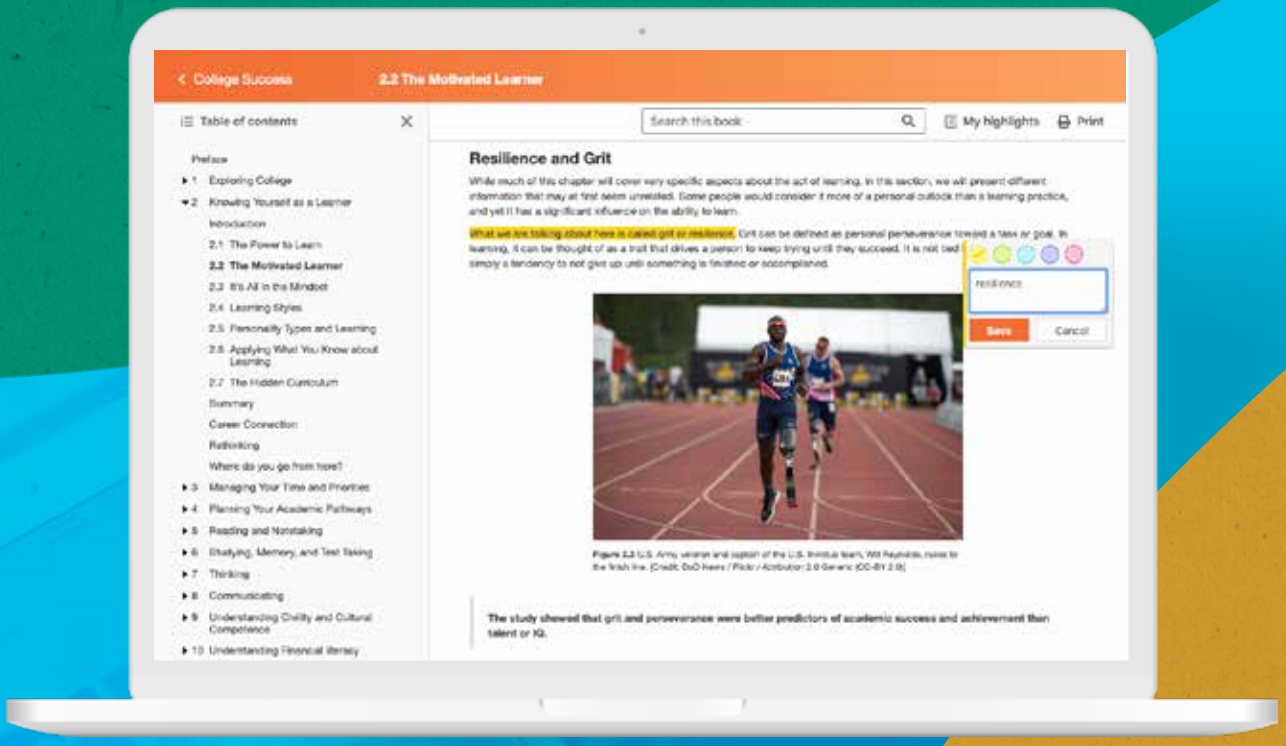

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Preface

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Format

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About *Principles of Management*

Principles of Management is designed to meet the scope and sequence requirements of the introductory course on management. This is a traditional approach to management using the leading, planning,

organizing, and controlling approach. The table of contents of this book was designed to address two main themes. What are the variables that affect how, when, where, and why managers perform their jobs? What theories and techniques are used by successful managers at a variety of organizational levels to achieve and exceed objectives effectively and efficiently throughout their careers? Management is a broad business discipline, and the Principles of Management course covers many management areas such as human resource management and strategic management, as well behavioral areas such as motivation. No one individual can be an expert in all areas of management, so an additional benefit of this text is that specialists in a variety of areas have authored individual chapters. Finally, we all made an effort to present a balanced approach to gender and diversity throughout the text in the examples used, the photographs selected, and the use of both male (odd-numbered chapters) and female (even-numbered chapters) when referring to generic managers or employees.

Pedagogical Foundation

We have taken a structured approach in the writing of the chapters that reduces inconsistencies throughout and makes selecting topics to match the course syllabus easier for faculty.

Exploring Managerial Careers. Each chapter starts with a profile that describes a manager and illustrates how the content of the chapter is vital for a successful managerial career.

Consistent, integrated learning. Targeted learning outcomes are listed at the beginning of each chapter and then repeated throughout the chapter. The learning outcomes connect to the text and the additional resources that accompany *Principles of Management*. After reading each section, students can test their retention by answering the questions in the Concept Checks. Every learning goal is further reinforced by a summary at the end of the chapter.

Hundreds of business examples to bring concepts to life. This book is designed to speak to the typical student. We have done a lot of research about student needs, abilities, experiences, and interests, and then we have shaped the text around them. We have used experiences both inside and outside the classroom to create a book that is both readable and enjoyable. We believe that the real applications found throughout every chapter set the standard for readability and understanding of key concepts.

Learning business terminology, made easy. As students begin to study management, they will explore new words and concepts. To help them learn this language, we define each new term in the chapter, display the terms in bold, and offer a complete glossary at the end of the book.

Applied Features

Rather than provide a dry recitation of facts, we illustrate concepts with contemporary examples. In addition to the in-text examples, we have several boxed features that provide more extensive examples in areas of importance in today's business environment. Each of the boxed features described below includes a series of critical thinking questions to prompt the student to consider the implications of each business strategy.

Ethics in Practice. Ethics in Practice features demonstrate how businesses are responsible not only to the bottom line, but to providing goods and services in a responsible manner.

Managing Change. The turbulent business climate requires companies to adapt their business strategies in response to a variety of economic, social, competitive, and technological forces. The Managing Change feature highlights how businesses have altered their business strategies in response to these forces.

Catching the Entrepreneurial Spirit. This feature highlights the challenges and opportunities available in small businesses and other entrepreneurial ventures.

Managerial Leadership. It is generally agreed that in a turbulent business climate leadership is an important function of management that helps to maximize efficiency and to achieve organizational goals. Leaders initiate action, motivate organizations, provide guidance, build morale, and create a sense of confidence within the

organization and to outside stakeholders.

Sustainability and Responsible Management. This feature highlights the knowledge, skills, tools, and self-awareness that are needed to become responsible managers. While the area of corporate social responsibility and sustainability has gained wide general support and commentary, these featured boxed items should provide the reader with insights of how managers can embed responsible practices in their careers.

Activities and Cases That Put Knowledge to Work

Principles of Management helps students develop a solid grounding in the skills that they can apply throughout their managerial careers. These skill-building activities and resources help build and polish competencies that future employers will value.

Chapter Review Questions. These questions provide a broad set of challenging questions that students can use to assure themselves that they have mastered the chapter concepts.

Management Skills Application Exercises. These activities at the end of each chapter present real-world challenges and provide assignment material for students to hone their business skills.

Managerial Decision Exercises. These activities provide assignment material that challenge students' decision-making processes. There are a variety of exercises for individual or team assignments.

Critical Thinking Case. The Critical Thinking case in each chapter invites students to explore business strategies of various companies, analyze business decisions, and prepare comments.

Answers to Questions in the Book

Answers are not provided for Managerial Decision Exercises or Management Skills Application Exercises. Answers to Chapter Review Questions and Critical Thinking Cases are provided only to instructors in the Instructor Answer Guide via the Instructor Resources page.

Additional Resources

Student and Instructor Resources

We've compiled additional resources for both students and instructors, including Getting Started Guides. Instructor resources require a verified instructor account, which you can apply for when you log in or create your account on openstax.org.

Instructor and student resources are typically available within a few months after the book's initial publication. Take advantage of these resources to supplement your OpenStax book.

Comprehensive instructor's manual. Each component of the instructor's manual is designed to provide maximum guidance for delivering the content in an interesting and dynamic manner. The instructor's manual includes an in-depth lecture outline, which is interspersed with lecture "tidbits" that allow instructors to add timely and interesting enhancements to their lectures.

Test bank. With nearly 2,000 true/false, multiple-choice, fill-in-the-blank, and short-answer questions in our test bank, instructors can customize tests to support a variety of course objectives. The test bank is available in Word format.

PowerPoint lecture slides. The PowerPoint slides provide images and descriptions as a starting place for instructors to build their lectures.

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1

Managing and Performing

Exhibit 1.1 (Credit: Steve Bowbrick/ flickr/ Attribution 2.0 Generic (CC BY 2.0))

Introduction

Learning Outcomes

After reading this chapter, you should be able to answer these questions:

1. What do managers do to help organizations achieve top performance?
2. What are the roles that managers play in organizations?
3. What are the characteristics that effective managers display?

EXPLORING MANAGERIAL CAREERS

You

So, you're in this course and you may have pondered, or discussed with others, what this course will be about. You probably have some preconceptions of what management is all about. You must manage your time, deciding on how much study time you will devote to your management and accounting classes, for instance. You may have had a summer or part-time job where you had a manager whom you had to report to. You may have followed news reports on successful managers like Jeff Bezos of Amazon or Sheryl Sandberg of Facebook and want to learn what made them successful so you can emulate their practices in your business career. You may have the impression (not an accurate one) that management is basically just common sense and that you really don't need to take this course except that you must meet your degree requirement.

You may be an accounting or marketing major who is taking this class because it is required for completion of your degree requirements, but you don't think that you will ever require what you learn in this class during your career since you don't plan on applying for HR jobs upon graduation. If you're believing this, you could not be more mistaken. Regardless of where you are in your career, be it as an individual contributor, project leader, or middle or senior manager, what you will get out of this course will be valuable. If your first job out of college is as an accountant, sales representative, or another entry-level

position, you will appreciate the roles that your managers, both direct and senior level, play in an organization and the behaviors and actions that will get you recognized and appreciated. Best of luck!

Most management textbooks would say, as does this one, that managers spend their time engaged in planning, organizing, staffing, directing, coordinating, reporting, and controlling. These activities, as Hannaway found in her study of managers at work, "do not, in fact, describe what managers do."[1] At best they seem to describe vague objectives that managers are continually trying to accomplish. The real world, however, is far from being that simple. The world in which most managers work is a "messy and hectic stream of ongoing activity."[2]

1.1 What Do Managers Do?

1. What do managers do to help organizations achieve top performance?

Managers are in constant action. Virtually every study of managers in action has found that they "switch frequently from task to task, changing their focus of attention to respond to issues as they arise, and engaging in a large volume of tasks of short duration."[3] Mintzberg observed CEOs on the job to get some idea of what they do and how they spend their time. He found, for instance, that they averaged 36 written and 16 verbal contacts per day, almost every one of them dealing with a distinct or different issue. Most of these activities were brief, lasting less than nine minutes.[4]

Kotter studied a number of successful general managers over a five-year period and found that they spend most of their time with others, including subordinates, their bosses, and numerous people from outside the organization. Kotter's study found that the average manager spent just 25% of his time working alone, and that time was spent largely at home, on airplanes, or commuting. Few of them spent less than 70% of their time with others, and some spent up to 90% of their working time this way.[5]

Kotter also found that the breadth of topics in their discussions with others was extremely wide, with unimportant issues taking time alongside important business matters. His study revealed that managers rarely make "big decisions" during these conversations and rarely give orders in a traditional sense. They often react to others' initiatives and spend substantial amounts of time in unplanned activities that aren't on their calendars. He found that managers will spend most of their time with others in short, disjointed conversations. "Discussions of a single question or issue rarely last more than ten minutes," he notes. "It is not at all unusual for a general manager to cover ten unrelated topics in a five-minute conversation."[6] More recently, managers studied by Sproull showed similar patterns. During the course of a day, they engaged in 58 different activities with an average duration of just nine minutes.[7]

Interruptions also appear to be a natural part of the job. Stewart found that the managers she studied could work uninterrupted for half an hour only nine times during the four weeks she studied them.[8] Managers, in fact, spend very little time by themselves. Contrary to the image offered by management textbooks, they are rarely alone drawing up plans or worrying about important decisions. Instead, they spend most of their time interacting with others—both inside and outside the organization. If casual interactions in hallways, phone conversations, one-on-one meetings, and larger group meetings are included, managers spend about two-thirds of their time with other people.[9] As Mintzberg has pointed out, "Unlike other workers, the manager does not leave the telephone or the meeting to get back to work. Rather, these contacts are his work."[10]

The interactive nature of management means that most management work is conversational.[11] When managers are in action, they are talking and listening. Studies on the nature of managerial work indicate that managers spend about two-thirds to three-quarters of their time in verbal activity.[12] These verbal conversations, according to Eccles and Nohria, are the means by which managers gather information, stay on top of things, identify problems, negotiate shared meanings, develop plans, put things in motion, give orders,

assert authority, develop relationships, and spread gossip. In short, they are what the manager's daily practice is all about. "Through other forms of talk, such as speeches and presentations," they write, "managers establish definitions and meanings for their own actions and give others a sense of what the organization is about, where it is at, and what it is up to."[13]

CONCEPT CHECK

1. What do managers do to help organizations achieve top performance?

1.2 The Roles Managers Play

2. What are the roles that managers play in organizations?

In Mintzberg's seminal study of managers and their jobs, he found the majority of them clustered around three core management roles.

Interpersonal roles. Managers are required to interact with a substantial number of people in the course of a workweek. They host receptions; take clients and customers to dinner; meet with business prospects and partners; conduct hiring and performance interviews; and form alliances, friendships, and personal relationships with many others. Numerous studies have shown that such relationships are the richest source of information for managers because of their immediate and personal nature.[14]

Three of a manager's roles arise directly from formal authority and involve basic interpersonal relationships. First is the *figurehead role*. As the head of an organizational unit, every manager must perform some ceremonial duties. In Mintzberg's study, chief executives spent 12% of their contact time on ceremonial duties; 17% of their incoming mail dealt with acknowledgments and requests related to their status. One example is a company president who requested free merchandise for a handicapped schoolchild.[15]

Managers are also responsible for the work of the people in their unit, and their actions in this regard are directly related to their role as a leader. The influence of managers is most clearly seen, according to Mintzberg, in the leader role. Formal authority vests them with great potential power. Leadership determines, in large part, how much power they will realize.[16]

Does the leader's role matter? Ask the employees of Chrysler Corporation (now DaimlerChrysler). When Lee Iacocca took over the company in the 1980s, the once-great auto manufacturer was in bankruptcy, teetering on the verge of extinction. He formed new relationships with the United Auto Workers, reorganized the senior management of the company, and—perhaps most importantly—convinced the U.S. federal government to guarantee a series of bank loans that would make the company solvent again. The loan guarantees, the union response, and the reaction of the marketplace were due in large measure to Iacocca's leadership style and personal charisma. More recent examples include the return of Starbucks founder Howard Schultz to re-energize and steer his company, and Amazon CEO Jeff Bezos and his ability to innovate during a downturn in the economy.[17]



Exhibit 1.2 Howard Schultz Howard Schultz, executive chairman of Starbucks Corporation, speaks after receiving the Distinguished Business Leadership Award during the Atlantic Council's Distinguished Leadership Awards dinner in Washington, D.C. The awards recognize pillars of the transatlantic relationship for their achievement in the fields of politics, military, business, humanitarian, and artistic leadership. (Credit: Chairman of the Joint Chief of Staff/ flickr/ Attribution 2.0 Generic (CC BY 2.0))

Popular management literature has had little to say about the liaison role until recently. This role, in which managers establish and maintain contacts outside the vertical chain of command, becomes especially important in view of the finding of virtually every study of managerial work that managers spend as much time with peers and other people outside of their units as they do with their own subordinates. Surprisingly, they spend little time with their own superiors. In Rosemary Stewart's study, 160 British middle and top managers spent 47% of their time with peers, 41% of their time with people inside their unit, and only 12% of their time with superiors. Guest's (1956) study of U.S. manufacturing supervisors revealed similar findings.[18]

Informational roles. Managers are required to gather, collate, analyze, store, and disseminate many kinds of information. In doing so, they become information resource centers, often storing huge amounts of information in their own heads, moving quickly from the role of gatherer to the role of disseminator in minutes. Although many business organizations install large, expensive management information systems to perform many of those functions, nothing can match the speed and intuitive power of a well-trained manager's brain for information processing. Not surprisingly, most managers prefer it that way.

As monitors, managers are constantly scanning the environment for information, talking with liaison contacts and subordinates, and receiving unsolicited information, much of it as a result of their network of personal contacts. A good portion of this information arrives in verbal form, often as gossip, hearsay, and speculation.

In the disseminator role, managers pass privileged information directly to subordinates, who might otherwise have no access to it. Managers must not only decide who should receive such information, but how much of it, how often, and in what form. Increasingly, managers are being asked to decide whether subordinates, peers, customers, business partners, and others should have direct access to information 24 hours a day without having to contact the manager directly.

In the spokesperson role, managers send information to people outside of their organizations: an executive makes a speech to lobby for an organizational cause, or a supervisor suggests a product modification to a supplier. Increasingly, managers are also being asked to deal with representatives of the news media, providing both factual and opinion-based responses that will be printed or broadcast to vast unseen audiences, often directly or with little editing. The risks in such circumstances are enormous, but so too are the potential rewards in terms of brand recognition, public image, and organizational visibility.

Decisional roles. Ultimately, managers are charged with the responsibility of making decisions on behalf of both the organization and the stakeholders with an interest in it. Such decisions are often made under circumstances of high ambiguity and with inadequate information. Often, the other two managerial

roles—interpersonal and informational—will assist a manager in making difficult decisions in which outcomes are not clear and interests are often conflicting.

In the role of *entrepreneur*, managers seek to improve their businesses, adapt to changing market conditions, and react to opportunities as they present themselves. Managers who take a longer-term view of their responsibilities are among the first to realize that they will need to reinvent themselves, their product and service lines, their marketing strategies, and their ways of doing business as older methods become obsolete and competitors gain advantage.

While the entrepreneur role describes managers who initiate change, the *disturbance or crisis handler* role depicts managers who must involuntarily react to conditions. Crises can arise because bad managers let circumstances deteriorate or spin out of control, but just as often good managers find themselves in the midst of a crisis that they could not have anticipated but must react to just the same.

The third decisional role of *resource allocator* involves managers making decisions about who gets what, how much, when, and why. Resources, including funding, equipment, human labor, office or production space, and even the boss's time are all limited, and demand inevitably outstrips supply. Managers must make sensible decisions about such matters while still retaining, motivating, and developing the best of their employees.



Exhibit 1.3 Thomas F. Prendergast Thomas F. Prendergast, the president of the Metropolitan Transit Authority of New York State, updates media on today's labor negotiations with the LIRR unions. In his role negotiating a new contract with the union, he must take on several managerial roles. (Credit: Metropolitan Transit Authority of New York State/ flickr/ Attribution 2.0 Generic (CC BY 2.0))

The final decisional role is that of *negotiator*. Managers spend considerable amounts of time in negotiations: over budget allocations, labor and collective bargaining agreements, and other formal dispute resolutions. In the course of a week, managers will often make dozens of decisions that are the result of brief but important negotiations between and among employees, customers and clients, suppliers, and others with whom managers must deal.[19] A visual interpretation of the roles managers play is illustrated in **Exhibit 1.4**.

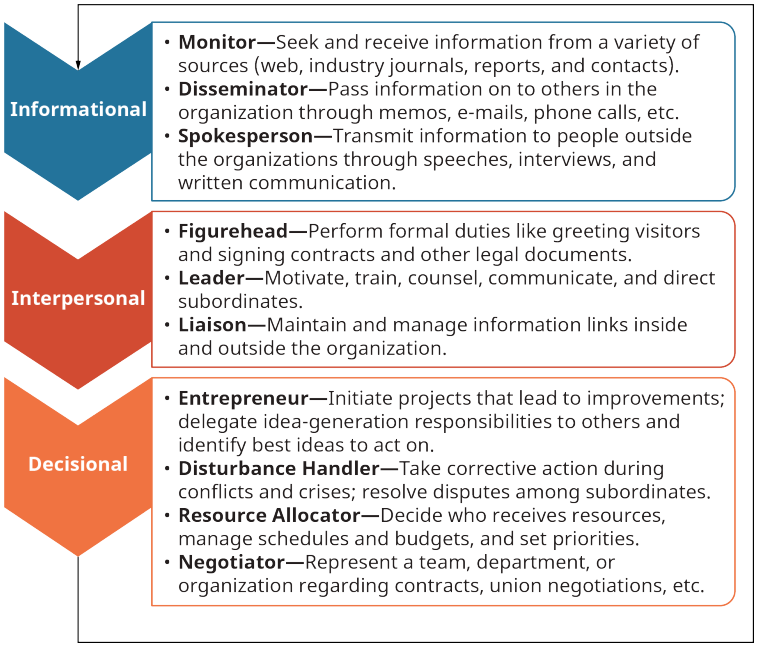

Exhibit 1.4 The Roles Managers Play (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

CONCEPT CHECK

1. Describe and explain how Mintzberg defines the manager's job.

1.3 Major Characteristics of the Manager's Job

3. What are the characteristics that effective managers display?

Time is fragmented. Managers have acknowledged from antiquity that they never seem to have enough time to get all those things done that need to be done. In the latter years of the twentieth century, however, a new phenomenon arose: demand for time from those in leadership roles increased, while the number of hours in a day remained constant. Increased work hours was one reaction to such demand, but managers quickly discovered that the day had just 24 hours and that working more of them produced diminishing marginal returns. According to one researcher, "Managers are overburdened with obligations yet cannot easily delegate their tasks. As a result, they are driven to overwork and forced to do many tasks superficially. Brevity, fragmentation, and verbal communication characterize their work."[20]

Values compete and the various roles are in tension. Managers clearly cannot satisfy everyone. Employees want more time to do their jobs; customers want products and services delivered quickly and at high quality levels. Supervisors want more money to spend on equipment, training, and product development; shareholders want returns on investment maximized. A manager caught in the middle cannot deliver to each of these people what each most wants; decisions are often based on the urgency of the need and the proximity of the problem.

The job is overloaded. In recent years, many North American and global businesses were reorganized to make them more efficient, nimble, and competitive. For the most part, this reorganization meant decentralizing many processes along with the wholesale elimination of middle management layers. Many managers who survived such downsizing found that their number of direct reports had doubled. Classical management theory suggests that seven is the maximum number of direct reports a manager can reasonably handle.

Today, high-speed information technology and remarkably efficient telecommunication systems mean that many managers have as many as 20 or 30 people reporting to them directly.

Efficiency is a core skill. With less time than they need, with time fragmented into increasingly smaller units during the workday, with the workplace following many managers out the door and even on vacation, and with many more responsibilities loaded onto managers in downsized, flatter organizations, efficiency has become the core management skill of the twenty-first century.

What Varies in a Manager's Job? The Emphasis

The entrepreneur role is gaining importance. Managers must increasingly be aware of threats and opportunities in their environment. Threats include technological breakthroughs on the part of competitors, obsolescence in a manager's organization, and dramatically shortened product cycles. Opportunities might include product or service niches that are underserved, out-of-cycle hiring opportunities, mergers, purchases, or upgrades in equipment, space, or other assets. Managers who are carefully attuned to the marketplace and competitive environment will look for opportunities to gain an advantage.

So is the leader role gaining importance. Managers must be more sophisticated as strategists and mentors. A manager's job involves much more than simple caretaking in a division of a large organization. Unless organizations are able to attract, train, motivate, retain, and promote good people, they cannot possibly hope to gain advantage over the competition. Thus, as leaders, managers must constantly act as mentors to those in the organization with promise and potential. When organizations lose a highly capable worker, all else in their world will come to a halt until they can replace that worker. Even if they find someone ideally suited and superbly qualified for a vacant position, they must still train, motivate, and inspire that new recruit, and live with the knowledge that productivity levels will be lower for a while than they were with their previous employee.

Managerial Responsibilities

An important question often raised about managers is: What responsibilities do managers have in organizations? According to our definition, managers are involved in planning, organizing, directing, and controlling. Managers have described their responsibilities that can be aggregated into nine major types of activity. These include:

1. *Long-range planning*. Managers occupying executive positions are frequently involved in strategic planning and development.
2. *Controlling*. Managers evaluate and take corrective action concerning the allocation and use of human, financial, and material resources.
3. *Environmental scanning*. Managers must continually watch for changes in the business environment and monitor business indicators such as returns on equity or investment, economic indicators, business cycles, and so forth.
4. *Supervision*. Managers continually oversee the work of their subordinates.
5. *Coordinating*. Managers often must coordinate the work of others both inside the work unit and out.
6. *Customer relations and marketing*. Certain managers are involved in direct contact with customers and potential customers.
7. *Community relations*. Contact must be maintained and nurtured with representatives from various constituencies outside the company, including state and federal agencies, local civic groups, and suppliers.
8. *Internal consulting.* Some managers make use of their technical expertise to solve internal problems, acting as inside consultants for organizational change and development.
9. *Monitoring products and services*. Managers get involved in planning, scheduling, and monitoring the design, development, production, and delivery of the organization's products and services.

As we shall see, not every manager engages in all of these activities. Rather, different managers serve different roles and carry different responsibilities, depending upon where they are in the organizational hierarchy. We

will begin by looking at several of the variations in managerial work.

Variations in Managerial Work

Although each manager may have a diverse set of responsibilities, including those mentioned above, the amount of time spent on each activity and the importance of that activity will vary considerably. The two most salient perceptions of a manager are (1) the manager's level in the organizational hierarchy and (2) the type of department or function for which he is responsible. Let us briefly consider each of these.

Management by Level. We can distinguish three general levels of management: executives, **middle management**, and **first-line management** (see Exhibit 1.5). **Executive managers** are at the top of the hierarchy and are responsible for the entire organization, especially its strategic direction. Middle managers, who are at the middle of the hierarchy, are responsible for major departments and may supervise other lower-level managers. Finally, first-line managers supervise rank-and-file employees and carry out day-to-day activities within departments.[21]

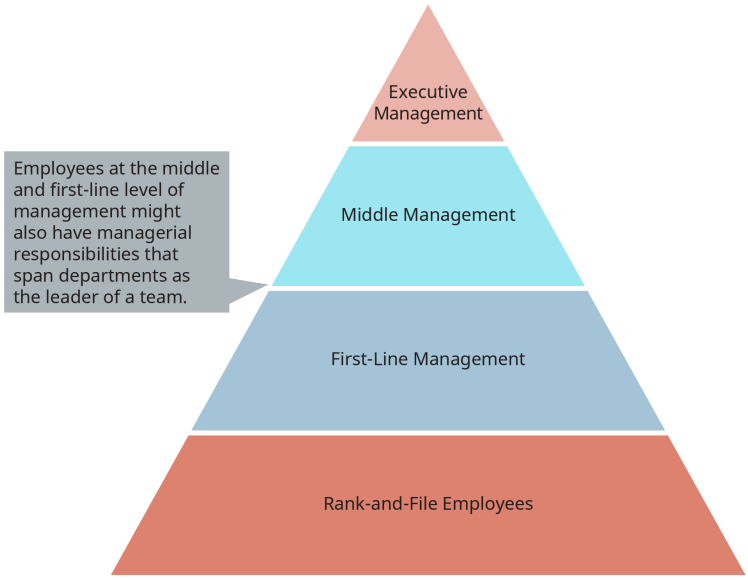

Exhibit 1.5 Levels in the Management Hierarchy (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

Exhibit 1.6 shows differences in managerial activities by hierarchical level. Senior executives will devote more of their time to conceptual issues, while front-line managers will concentrate their efforts on technical issues. For example, top managers rate high on such activities as **long-range planning**, monitoring business indicators, coordinating, and internal consulting. Lower-level managers, by contrast, rate high on supervising because their responsibility is to accomplish tasks through rank-and-file employees. Middle managers rate near the middle for all activities. We can distinguish three types of managerial skills:

1. *Technical skills*. Managers must have the ability to use the tools, procedures, and techniques of their special areas. An accountant must have expertise in accounting principles, whereas a production manager must know operations management. These skills are the mechanics of the job.
2. *Human relations skills*. Human relations skills involve the ability to work with people and understand employee motivation and group processes. These skills allow the manager to become involved with and lead his group.
3. *Conceptual skills*. These skills represent a manager's ability to organize and analyze information in order to improve organizational performance. They include the ability to see the organization as a whole and to understand how various parts fit together to work as an integrated unit. These skills are required to coordinate the departments and divisions successfully so that the entire organization can pull together.

As shown in Exhibit 1.6, different levels of these skills are required at different stages of the managerial

hierarchy. That is, success in executive positions requires far more conceptual skill and less use of technical skills in most (but not all) situations, whereas first-line managers generally require more technical skills and fewer conceptual skills. Note, however, that human relations skills, or people skills, remain important for success at all three levels in the hierarchy.

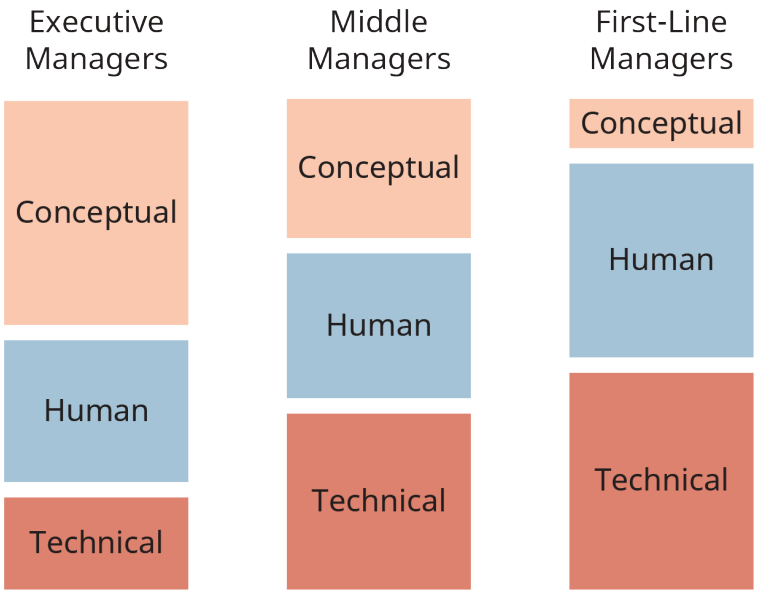

Exhibit 1.6 Difference in Skills Required for Successful Management According to Level in the Hierarchy (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

Management by Department or Function. In addition to level in the hierarchy, managerial responsibilities also differ with respect to the type of department or function. There are differences found for quality assurance, manufacturing, marketing, accounting and finance, and human resource management departments. For instance, manufacturing department managers will concentrate their efforts on products and services, controlling, and supervising. Marketing managers, in comparison, focus less on planning, coordinating, and consulting and more on customer relations and external contact. Managers in both accounting and human resource management departments rate high on long-range planning, but will spend less time on the organization's products and service offerings. Managers in accounting and finance are also concerned with controlling and with monitoring performance indicators, while human resource managers provide consulting expertise, coordination, and external contacts. The emphasis on and intensity of managerial activities varies considerably by the department the manager is assigned to.

At a personal level, knowing that the mix of conceptual, human, and technical skills changes over time and that different functional areas require different levels of specific management activities can serve at least two important functions. First, if you choose to become a manager, knowing that the mix of skills changes over time can help you avoid a common complaint that often young employees want to think and act like a CEO before they have mastered being a first-line supervisor. Second, knowing the different mix of management activities by functional area can facilitate your selection of an area or areas that best match your skills and interests.

In many firms managers are rotated through departments as they move up in the hierarchy. In this way they obtain a well-rounded perspective on the responsibilities of the various departments. In their day-to-day tasks they must emphasize the right activities for their departments and their managerial levels. Knowing what types of activity to emphasize is the core of the manager's job. In any event, we shall return to this issue when we address the nature of individual differences in the next chapter.

CONCEPT CHECK

1. Describe and explain the different levels of management.
2. Describe and explain the three types of managerial skills and how they relate to each level of management.

Key Terms

Decisional role One of the three major roles that a manager assumes in the organization.
executive managers Generally, a *team* of individuals at the highest level of *management* of an organization.
first-line management The level of management directly managing nonmanagerial employees.
Informational role One of the three major roles that a manager assumes in the organization.
Interpersonal role One of the three major roles that a manager assumes in the organization.
middle management The managers in an organization at a level just below that of senior executives.

Summary of Learning Outcomes

1.1 What Do Managers Do?

1. What do managers do to help organizations achieve top performance?

In order to help their organizations to achieve top performance, managers must adapt their roles and actions to unique and changing circumstances. Their most common activities involve spending time with others in brief, unplanned, verbal conversations. As a result, managers must have strong listening and speaking skills, and must be able to record and act on fragmented information.

1.2 The Roles Managers Play

2. What are the roles that managers play in organizations?

Managers perform a variety of roles in organizations, but amongst one of the most important functions they perform is communicating with direct reports to help their organizations achieve and exceed goals. Managers perform three major types of roles within organizations, interpersonal roles, informational roles, and decisional roles. the extent of each of these roles depends on the manager's position within the organizational hierarchy.

1.3 Major Characteristics of the Manager's Job

3. What are the characteristics that effective managers display?

Management is the process of planning, organizing, directing, and controlling the activities of employees in combination with other resources to accomplish organizational goals. Managerial responsibilities include long-range planning, controlling, environmental scanning, supervision, coordination, customer relations, community relations, internal consulting, and monitoring of products and services. These responsibilities differ by level in the organizational hierarchy and by department or function. The twenty-first-century manager will differ from most current managers in four ways. In essence, he will be a global strategist, a master of technology, a good politician, and a premier leader-motivator.

Chapter Review Questions

1. What are the characteristics and traits that you possess that are common to all successful managers?
2. Why should management be considered an occupation rather than a profession?
3. How do managers learn how to perform the job?
4. Explain the manager's job according to Henry Mintzberg.
5. What responsibilities do managers have towards people within the organization? How do they express these responsibilities?
6. How do managers perform their job according to John Kotter?
7. How do managers make rational decisions?
8. How does the nature of management change according to one's level and function in the organization?
9. Discuss the role of management in the larger societal context. What do you think the managers of the future will be like?

10. Identify what you think are the critical issues facing contemporary management. Explain.

Management Skills Application Exercises

1. During this and your other courses, there will likely be products of your and team-based assignments that can illustrate specific competencies such as the ability to prepare a spreadsheet application, write programming code, or show your communication abilities that demonstrate your skills in a video. It is a good practice to catalog and save these artifacts in a portfolio that will be a useful in demonstrating your skills in future job interviews.
2. Time management is an important skill that will impact your future as a manager. You can categorize the time that you spend as either required or discretionary. You can assess your time management skills by keeping track of your time using a schedule calendar and breaking down the time devoted to each activity over a week. After a week of logging the activity, note whether each activity was required or discretionary and whether the time was used productively or unproductively using a 10-point scale in which 10 is very productive and 1 is completely unproductive. Now write up a plan on how to manage your time by coming up with a list of what to start doing and stop doing and what you can do to manage your discretionary time more productively.

Managerial Decision Exercises

1. You are a manager at a local convenience store that has been the victim of graffiti. Identify the roles you will undertake with both internal employees and others.
2. Here are three job titles. Rank which job would devote the most of its time to conceptual, human, and technical skills.
    a. Vice president of finance at a Fortune 100 company
    b. Coding for a video game producer
    c. General manager at a local McDonald's franchise

Critical Thinking Case

New Management Challenges for the New Age

Today's news is littered with scandals, new allegations of sexual assault, and tragedy. Since 2017 and the #metoo Movement, stemming from the Harvey Weinstein scandal, more and more public figures have been put into the spotlight to defend themselves against allegations from women around the globe.

Not only publically, but privately in companies around the world, there have been firings, and investigations into misconduct from co-workers, managers, and CEOs. It is a relevant topic that is getting long overdue publicity and encouraging more men and women to come forward to discuss openly rather than hide the events and injustices of the past. Other events showcase the tumultuous and on-edge society we are living in, such as the Charlottesville, VA attack, that left 1 dead and 19 injured when a person drove a car through a crowd of protestors during a White nationalist gathering.

With events on a daily business, it is important for companies to take a stand against racial hatred, harassment of any kind, and have firm policies when such events occur. Take Netflix for example, who in July of 2018 fired chief communications officer for saying the "N-word" in full form. This event occurred during an internal meeting, not directing the slur at anyone specific, but claimed it was being made as an emphatic point about offensive words in comedy programming. The "Netflix way", the culture that is built around radical candor and transparency was put to the test during this occurrence.

The offender, Jonathan Friedland attempted to apologize for his misdeed, hoping it would fade away and his apology would be accepted. However, it didn't work that way, instead the anger was palpable between co-workers, and eventually led to the firing of Friedland after a few months of inaction.

Netflixers are given a high level of freedom and responsibility within their “Netflix way” culture. Blunt feedback is encouraged, trust and discretion is the ultimate gate keeper, as employees have access to sensitive information, and are ultimately trusted for how they expense items and take vacation time.

Between the insanely fast-paced streaming services industry, it is hard to keep this culture at a premium, but it is imperative for the success of the company overall. “As you scale a company to become bigger and bigger how do you scale that kind of culture?” said Colin Estep, a former senior engineer who left voluntarily in 2016. “I don’t know that we ever had a good answer.”

In order to keep up, sometimes the company is seen as harsh in their tactics to keep the best of the best. “I think we’re transparent to a fault in our culture and that can come across as cutthroat,” said Walta Nemariam, an employee in talent acquisition at Netflix, in the video.

Netflix has stayed true to their cultural values despite the pressures and sometimes negative connotations associated with this “cutthroat” environment. Their ability to remain agile, while displaying no tolerances for societal injustices makes them at the forefront of new age companies. It is a difficult pace to stay in line with, but it seems that they are keeping in stride and remaining true to who they are, for now.

Critical Thinking Questions:

1. How have the current cultural environment of our country shaped the way that companies are looking at their own corporate cultural standards?
2. What are the potential downfalls and positive influences of the “Netflix way”?
3. How does Netflix’s internal culture negatively or positively affect their ability to stay competitive and deliver cutting edge content?

Sources: B. Stelter, "The Weinstein Effect: Harvey Weinstein scandal sparks movements in Hollywood and beyond," CNN Business, October 20, 2017, https://money.cnn.com/2017/10/20/media/weinstein-effect-harvey-weinstein/; https://www.washingtonpost.com/; L. Hertzler, " Talking #MeToo, one year after bombshell Weinstein allegations," Penn Today, October 30, 2018, https://penntoday.upenn.edu/news/talking-me-too-one-year-later; S. Ramachandran and J. Flint, " At Netflix, Radical Transparency and Blunt Firings Unsettle the Ranks," Wall Street Journal, October 25, 2018, https://www.wsj.com/articles/at-netflix-radical-transparency-and-blunt-firings-unsettle-the-ranks-1540497174



2

Managerial Decision-Making

Exhibit 2.1 (i_yudai/ flickr/ Attribution 2.0 Generic (CC BY 2.0))

Introduction

Learning Outcomes

After reading this chapter, you should be able to answer these questions:

1. What are the basic characteristics of managerial decision-making?
2. What are the two systems of decision-making in the brain?
3. What is the difference between programmed and nonprogrammed decisions?
4. What barriers exist that make effective decision-making difficult?
5. How can a manager improve the quality of her individual decision-making?
6. What are the advantages and disadvantages of group decision-making, and how can a manager improve the quality of group decision-making?

EXPLORING MANAGERIAL CAREERS

Up, Up, and Away: How Stephanie Korey and Jen Rubio founded their luggage company

Jen Rubio and Stephanie Korey faced a number of important decisions in starting their luggage company, Away—beginning with the decision to start a business! That decision came about after Rubio's luggage broke on a trip. She found it frustrating that all the luggage options were either inexpensive ($100 or less) but low quality, or high quality but incredibly expensive ($400 and above). There was no midrange option. So in 2015 Rubio and her friend Stephanie Korey began researching the luggage industry. They found that much of the reason for the high prices on quality luggage was because of how it was distributed and sold, through specialty retail shops and department stores. If they opted instead for a model in which they sold directly to consumers, they could provide high-quality luggage at more of a midrange ($200-$300) price. After considerable research, the two were convinced that they had an idea worth pursuing. Rubio and Korey settled on the company name "Away," which is intended to invoke the pleasure that comes from travelling.

Both of the founders had prior experience working for a start-up in the e-commerce space (Warby Parker), which helped them with making sound choices. Rubio's background was more in branding and marketing, while Korey's was in operations and supply chain management—so each was able to bring great expertise to various aspects of the business. They raised money initially from friends and family, but within a few months they sought venture capital funding to ensure that they had enough money to get off to a successful start.

A big decision that Rubio and Korey had to make fairly early in the process of establishing their business was to settle on an initial design for the product. This decision required extensive marketing and consumer research to understand customer needs and wants. They asked hundreds of people what they liked about their existing luggage, and what they found most irritating about their existing luggage. They also contracted with a two-person design team to help create the first prototype. This research and development ultimately led to the design of an attractive hard case that is surprisingly lightweight. It also boasts extremely high-quality wheels (four of them, not two) and high-quality zippers. As a bonus, the carry-on includes a built-in battery for charging phones and other devices.

The two founders also had to choose a partner to manufacture their product. Because their product had a hard, polycarbonate shell, Rubio and Korey discovered that manufacturing in the United States was not a viable option—the vast majority of luggage manufacturers using a polycarbonate shell were based in Asia. They researched a number of possible business partners and asked lots of questions. In addition, they eventually visited all of the factories on their list of options to see what they were actually like. This was an important piece of research, because the companies that looked best on paper didn't always turn out to be the best when they visited in person. Rubio and Korey ended up working with a manufacturing partner in China that also produces luggage for many high-end brands, and they have been extremely pleased with the partnership. They continue to devote time to building and maintaining that relationship, which helps to avoid issues and problems that might otherwise come up.

By the end of 2015, Rubio and Korey had developed their first product. Because the luggage was not going to be available in time for the holiday shopping season, they decided to allow customers to preorder the luggage. To drum up interest, the duo engaged in a unique storytelling effort. They interviewed 40 well-respected members of the creative community about their travel experiences and created a hardcover book of travel memoirs called *The Places We Return To*. Not only was the book interesting and engaging, it also made lots of people in the creative community aware of Away luggage. Starting in November 2015, the travel memoir book was available for free with the purchase of a gift card that could be redeemed in February 2016 for luggage. The book project generated tremendous advance interest in the product, and the 1,200 printed copies sold out. Away generated $12 million in first-year sales.

Stephanie Corey and Jen Rubio faced many important and novel decisions in initially developing and building their business. They have been successful in part because they made those decisions wisely—by relying on shared knowledge, expertise, and lots of research before reaching a decision. They will continue to face many decisions, big and small. They have expanded their product line from one piece of luggage to four, with more luggage—and other travel accessories—in the works for the future. Their company, which is based in New York, has grown to over 60 employees in the first two years. These employees include the two design-team members who were contracted to help create their first prototype; Rubio and Korey appreciated working with them so much, they offered them full-time positions with Away. Each new hire represents new decisions—decisions about what additional work needs to be done and who they should hire to do it. Each new product also brings additional decisions—but it seems Rubio and Korey have positioned themselves (and their business) well for future successes.

Sources: Kendall Baker, "An Interview With the Co-Founder of Away," *The Hustle*, December 5, 2016, https://thehustle.co/episodes; Bond Street Blog, "Up and Away," *Bond Street*, https://bondstreet.com/blog/

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Managers and business owners—like Jen Rubio and Stephanie Korey—make decisions on a daily basis. Some are big, like the decision to start a new business, but most are smaller decisions that go into the regular running of the company and are crucial to its long-term success. Some decisions are predictable, and some are unexpected. In this chapter we look at important information about decision-making that can help you make better decisions and, ultimately, be a better manager.

2.1 Overview of Managerial Decision-Making

1. What are the basic characteristics of managerial decision-making?

Decision-making is the action or process of thinking through possible options and selecting one.

It is important to recognize that managers are continually making decisions, and that the quality of their decision-making has an impact—sometimes quite significant—on the effectiveness of the organization and its **stakeholders**. Stakeholders are all the individuals or groups that are affected by an organization (such as customers, employees, shareholders, etc.).

Members of the top management team regularly make decisions that affect the future of the organization and all its stakeholders, such as deciding whether to pursue a new technology or product line. A good decision can enable the organization to thrive and survive long-term, while a poor decision can lead a business into bankruptcy. Managers at lower levels of the organization generally have a smaller impact on the organization's survival, but can still have a tremendous impact on their department and its workers. Consider, for example, a first-line supervisor who is charged with scheduling workers and ordering raw materials for her department. Poor decision-making by lower-level managers is unlikely to drive the entire firm out of existence, but it can lead to many adverse outcomes such as:

- reduced productivity if there are too few workers or insufficient supplies,
- increased expenses if there are too many workers or too many supplies, particularly if the supplies have a limited shelf life or are costly to store, and
- frustration among employees, reduced morale, and increased turnover (which can be costly for the organization) if the decisions involve managing and training workers.

Deciding When to Decide

While some decisions are simple, a manager's decisions are often complex ones that involve a range of options and uncertain outcomes. When deciding among various options and uncertain outcomes, managers need to gather information, which leads them to another necessary decision: how much information is needed to make a good decision? Managers frequently make decisions without complete information; indeed, one of the hallmarks of an effective leader is the ability to determine when to hold off on a decision and gather more information, and when to make a decision with the information at hand. Waiting too long to make a decision can be as harmful for the organization as reaching a decision too quickly. Failing to react quickly enough can lead to missed opportunities, yet acting too quickly can lead to organizational resources being poorly allocated to projects with no chance of success. Effective managers must decide when they have gathered enough information and must be prepared to change course if additional information becomes available that makes it clear that the original decision was a poor one. For individuals with fragile egos, changing course can be

challenging because admitting to a mistake can be harder than forging ahead with a bad plan. Effective managers recognize that given the complexity of many tasks, some failures are inevitable. They also realize that it's better to minimize a bad decision's impact on the organization and its stakeholders by recognizing it quickly and correcting it.

What's the Right (Correct) Answer?

It's also worth noting that making decisions as a manager is not at all like taking a multiple-choice test: with a multiple-choice test there is always one right answer. This is rarely the case with management decisions. Sometimes a manager is choosing between multiple good options, and it's not clear which will be the best. Other times there are multiple bad options, and the task is to minimize harm. Often there are individuals in the organization with competing interests, and the manager must make decisions knowing that someone will be upset no matter what decision is reached.

What's the Right (Ethical) Answer?

Sometimes managers are asked to make decisions that go beyond just upsetting someone—they may be asked to make decisions in which harm could be caused to others. These decisions have ethical or moral implications. Ethics and morals refer to our beliefs about what is right vs. wrong, good vs. evil, virtuous vs. corrupt. Implicitly, ethics and morals relate to our interactions with and impact on others—if we never had to interact with another creature, we would not have to think about how our behaviors affected other individuals or groups. All managers, however, make decisions that impact others. It is therefore important to be mindful about whether our decisions have a positive or a negative impact. "Maximizing shareholder wealth" is often used as a rationalization for placing the importance of short-term profits over the needs of others who will be affected by a decision—such as employees, customers, or local citizens (who might be affected, for example, by environmental decisions). Maximizing shareholder wealth is often a short-sighted decision, however, because it can harm the organization's financial viability in the future.[1] Bad publicity, customers boycotting the organization, and government fines are all possible long-term outcomes when managers make choices that cause harm in order to maximize shareholder wealth. More importantly, increasing the wealth of shareholders is not an acceptable reason for causing harm to others.

As you can see from these brief examples, management is not for the faint of heart! It can, however, be incredibly rewarding to be in a position to make decisions that have a positive impact on an organization and its stakeholders. We see a great example of this in the *Sustainability and Responsible Management* box.

SUSTAINABILITY AND RESPONSIBLE MANAGEMENT

Brewing Sustainable Success

The focus of a manager or a business owner is often primarily on doing well (making a profit). Sometimes, though, organizational leaders choose to pursue two big goals at once: doing well, and simultaneously doing good (benefiting society in some way). Why? Generally because they think it's an important thing to do. The business provides an opportunity to pursue another goal that the founders, owners, or managers are also passionate about. In the case of New Belgium Brewing, the company's cofounders, Jeff Lebesch and Kim Jordan, were passionate about two things: making great beer and environmental stewardship. So it should come as no surprise that their brewery is dedicated to reducing its environmental footprint. The brewery has created a culture that fosters sustainability in a wide range of ways, such as by giving employees a bicycle on their one-year anniversary as a way to encourage them to ride bicycles to work. The organization is also active in advocacy efforts, such as the "Save the Colorado" (river) campaign, and it works hard to promote responsible decision-making when it comes to environmental issues. In fact, in 1999, following an employee vote, the brewery began to purchase all of its electricity from wind power, even

though it was more expensive than electricity from coal-burning power plants (which meant reduced profitability and less money for employee bonuses).

While the brewery still relies primarily on wind power, it also now generates a portion of its electricity onsite—some from rooftop solar panels, and even more from biogas, the methane gas byproduct that is created by microbes in the brewery's water treatment plant. The company cleans the wastewater generated from beer production, and in doing so it generates the biogas, which is captured and used for energy to help run the brewery.

Brewing is water intensive, so New Belgium works hard to reduce water consumption and to recycle the water that it does use. The company also reduces other types of waste by selling used grain, hops, and yeast to local ranchers for cattle feed. The company, which has been employee owned since 2013, also works with the local utility through a Smart Meter program to reduce their energy consumption at peak times.

All of these efforts at doing good must come at a cost, right? Actually, research shows that companies that are committed to sustainability have superior financial performance, on average, relative to those that are not. In coming up with creative ways to reduce, reuse, and recycle, employees often also find ways to save money (like using biogas). In addition, organizations that strive to do good are often considered attractive and desirable places to work (especially by people who have similar values) and are also valued by the surrounding communities. As a result, employees in those organizations tend to be extremely committed to them, with high levels of engagement, motivation, and productivity. Indeed, it seems clear that the employees at the New Belgium Brewery are passionate about where they work and what they do. This passion generates value for the organization and proves that it is, in fact, possible to do well while having also made the decision to do good. And in the case of New Belgium Brewery, that means working to protect the environment while also making delicious beer.

Discussion Questions

1. What challenges does New Belgium Brewery face in pursuing environmental goals?
2. Can you think of any other examples of companies that try to "do good" while also doing well?
3. Would you like to work for an organization that is committed to something more than just profitability, even if it meant your salary or bonus would be smaller?

Sources: Karen Crofton, "How New Belgium Brewery leads Colorado's craft brewers in energy," *GreenBiz*, August 1, 2014, https://www.greenbiz.com/. Darren Dahl, "How New Belgium Brewing Has Found Sustainable Success," *Forbes*, February 8, 2016, https://www.forbes.com/. Jenny Foust, "New Belgium Brewing Once Again Named Platinum-Level Bicycle Friendly Business by the League of American Bicyclists," Craft Beer.com, February 18, 2016. Robert G. Eccles, Ioannis Ioannou, & George Serafeim, "The Impact of Corporate Sustainability on Organizational Processes and Performance," *Management Science*, 60, 2014, https://doi.org/10.1287/mnsc.2014.1984. New Belgium Brewery Sustainability web page, http://www.newbelgium.com/sustainability, accessed September 18, 2017.

CONCEPT CHECK



1. What are some positive outcomes of decision-making for an organization? What are some possible negative outcomes?
2. How is managerial decision-making different from a multiple-choice test?
3. In addition to the owners of a business, who are some of the other stakeholders that managers should consider when making decisions?

2.2 How the Brain Processes Information to Make Decisions: Reflective and Reactive Systems

2. What are the two systems of decision-making in the brain?

The human brain processes information for decision-making using one of two routes: a reflective system and a reactive (or reflexive) system.[2,3] The **reflective system** is logical, analytical, deliberate, and methodical, while the **reactive system** is quick, impulsive, and intuitive, relying on emotions or habits to provide cues for what to do next. Research in neuropsychology suggests that the brain can only use one system at a time for processing information [Darlow & Sloman] and that the two systems are directed by different parts of the brain. The prefrontal cortex is more involved in the reflective system, and the basal ganglia and amygdala (more primitive parts of the brain, from an evolutionary perspective) are more involved in the reactive system.[4]

Reactive Decision-Making

We tend to assume that the logical, analytical route leads to superior decisions, but whether this is accurate depends on the situation. The quick, intuitive route can be lifesaving; when we suddenly feel intense fear, a fight-or-flight response kicks in that leads to immediate action without methodically weighing all possible options and their consequences. Additionally, experienced managers can often make decisions very quickly because experience or expertise has taught them what to do in a given situation. These managers might not be able to explain the logic behind their decision, and will instead say they just went with their "gut," or did what "felt" right. Because the manager has faced a similar situation in the past and has figured out how to deal with it, the brain shifts immediately to the quick, intuitive decision-making system.[5]

Reflective Decision-Making

The quick route is not always the best decision-making path to take, however. When faced with novel and complex situations, it is better to process available information logically, analytically, and methodically. As a manager, you need to think about whether a situation requires not a fast, "gut" reaction, but some serious thought prior to making a decision. It is especially important to pay attention to your emotions, because strong emotions can make it difficult to process information rationally. Successful managers recognize the effects of emotions and know to wait and address a volatile situation after their emotions have calmed down. Intense emotions—whether positive or negative—tend to pull us toward the quick, reactive route of decision-making. Have you ever made a large "impulse" purchase that you were excited about, only to regret it later? This speaks to the power our emotions exert on our decision-making. Big decisions should generally not be made impulsively, but reflectively.

The Role of Emotions

Being aware of the role emotions play in decision-making does not mean that we should ignore them. Emotions can serve as powerful signals about what we should do, especially in situations with ethical implications. You can read more about this particular type of decision-making in the *Ethics in Practice* box later in this chapter. Thinking through how we feel about the possible options, and why we feel that way, can greatly enhance our decision-making.[6] Effective decision-making, then, relies on both logic *and* emotions. For this reason, the concept of emotional intelligence has become popular as a characteristic of effective managers. **Emotional intelligence** is the ability to recognize, understand, pay attention to, and manage one's own emotions and the emotions of others. It involves self-awareness and self-regulation—essentially, this is a toggling back and forth between emotions and logic so that we analyze and understand our own emotions and then exert the necessary control to manage them as appropriate for the situation. Emotional intelligence also involves empathy—the ability to understand other peoples' emotions (and an interest in doing so). Finally, emotional intelligence involves social skills to manage the emotional aspects of relationships with others. Managers who are aware of their own emotions can think through what their emotions mean in a given situation and use that information to guide their decision-making. Managers who are aware of the emotions of others can also utilize that information to help groups function more effectively and engage in better group

decision-making. While emotional intelligence seems to come easily to some people, it is something that we can develop and improve on with practice. A model of emotional intelligence is presented in Exhibit 2.2.

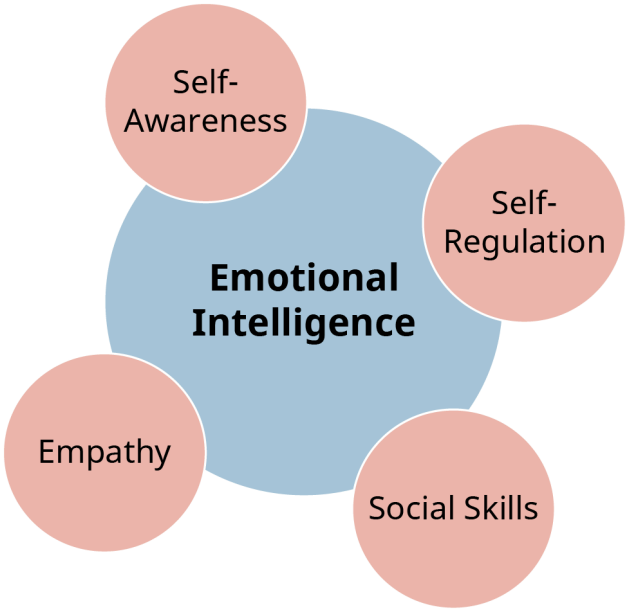

Exhibit 2.2 Emotional Intelligence (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

CONCEPT CHECK

1. Explain the two systems used by the brain in decision-making.
2. What is emotional intelligence, and why is it important for decision-making?

2.3 Programmed and Nonprogrammed Decisions

3. What is the difference between programmed and nonprogrammed decisions?

Because managers have limited time and must use that time wisely to be effective, it is important for them to distinguish between decisions that can have structure and routine applied to them (called programmed decisions) and decisions that are novel and require thought and attention (nonprogrammed decisions).

Programmed Decisions

Programmed decisions are those that are repeated over time and for which an existing set of rules can be developed to guide the process. These decisions might be simple, or they could be fairly complex, but the criteria that go into making the decision are all known or can at least be estimated with a reasonable degree of accuracy. For example, deciding how many raw materials to order should be a programmed decision based on anticipated production, existing stock, and anticipated length of time for the delivery of the final product. As another example, consider a retail store manager developing the weekly work schedule for part-time employees. The manager must consider how busy the store is likely to be, taking into account seasonal fluctuations in business. Then, they must consider the availability of the workers by taking into account requests for vacation and for other obligations that employees might have (such as school). Establishing the schedule might be complex, but it is still a programmed decision: it is made on a regular basis based on well-understood criteria, so structure can be applied to the process. For programmed decisions, managers often develop **heuristics**, or mental shortcuts, to help reach a decision. For example, the retail store manager may not know how busy the store will be the week of a big sale, but might routinely increase staff by 30% every

time there is a big sale (because this has been fairly effective in the past). Heuristics are efficient—they save time for the decision maker by generating an adequate solution quickly. Heuristics don't necessarily yield the optimal solution—deeper cognitive processing may be required for that. However, they generally yield a good solution. Heuristics are often used for programmed decisions, because experience in making the decision over and over helps the decision maker know what to expect and how to react. Programmed decision-making can also be taught fairly easily to another person. The rules and criteria, and how they relate to outcomes, can be clearly laid out so that a good decision can be reached by the new decision maker. Programmed decisions are also sometimes referred to as *routine* or *low-involvement* decisions because they don't require in-depth mental processing to reach a decision. High- and low-involvement decisions are illustrated in **Exhibit 2.3**.

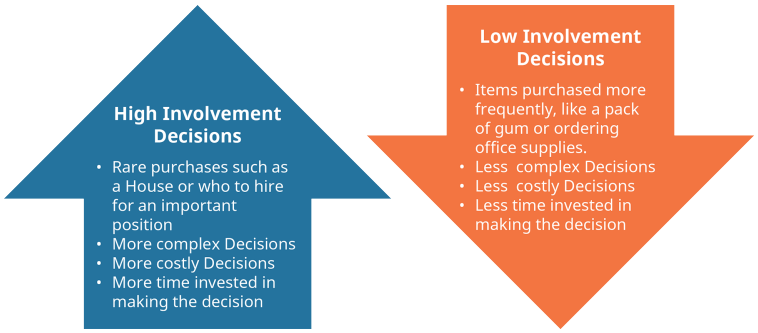

Exhibit 2.3 High-Involvement and Low-Involvement Decisions. (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

Nonprogrammed Decisions

In contrast, **nonprogrammed decisions** are novel, unstructured decisions that are generally based on criteria that are not well-defined. With nonprogrammed decisions, information is more likely to be ambiguous or incomplete, and the decision maker may need to exercise some thoughtful judgment and creative thinking to reach a good solution. These are also sometimes referred to as *nonroutine* decisions or as *high-involvement* decisions because they require greater involvement and thought on the part of the decision maker. For example, consider a manager trying to decide whether or not to adopt a new technology. There will always be unknowns in situations of this nature. Will the new technology really be better than the existing technology? Will it become widely accepted over time, or will some other technology become the standard? The best the manager can do in this situation is to gather as much relevant information as possible and make an educated guess as to whether the new technology will be worthwhile. Clearly, nonprogrammed decisions present the greater challenge.

The Decision-Making Process

While decisions makers can use mental shortcuts with programmed decisions, they should use a systematic process with nonprogrammed decisions. The decision-making process is illustrated in **Exhibit 2.4** and can be broken down into a series of six steps, as follows:

1. Recognize that a decision needs to be made.
2. Generate multiple alternatives.
3. Analyze the alternatives.
4. Select an alternative.
5. Implement the selected alternative.
6. Evaluate its effectiveness.

While these steps may seem straightforward, individuals often skip steps or spend too little time on some steps. In fact, sometimes people will refuse to acknowledge a problem (Step 1) because they aren't sure how to address it. We'll discuss the steps more later in the chapter, when we review ways to improve the quality of decision-making.

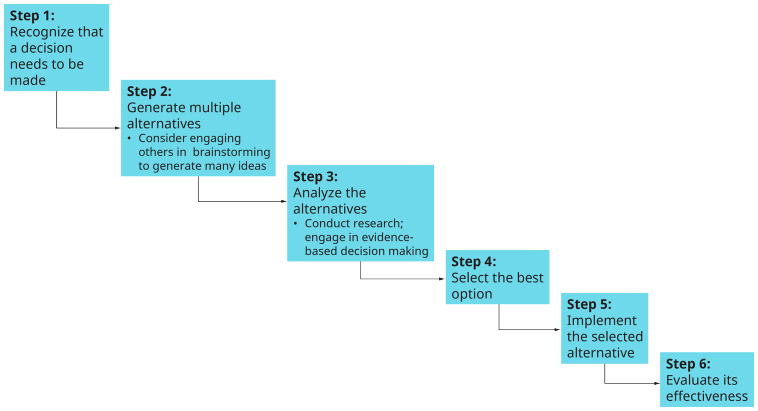

Exhibit 2.4 The Decision-Making Process. (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

You may notice similarities between the two systems of decision-making in our brains and the two types of decisions (programmed and nonprogrammed). Nonprogrammed decisions will generally need to be processed via the reflective system in our brains in order for us to reach a good decision. But with programmed decisions, heuristics can allow decision makers to switch to the quick, reactive system and then move along quickly to other issues.

CONCEPT CHECK

1. Give an example of a programmed decision that a manager might face.
2. Give an example of a nonprogrammed decision.
3. What are heuristics, and when are they helpful?
4. How are programmed and nonprogrammed decisions connected to the reflective and reactive systems in the brain?

2.4 Barriers to Effective Decision-Making

4. What barriers exist that make effective decision-making difficult?

There are a number of barriers to effective decision-making. Effective managers are aware of these potential barriers and try to overcome them as much as possible.

Bounded Rationality

While we might like to think that we can make completely rational decisions, this is often unrealistic given the complex issues faced by managers. Nonrational decision-making is common, especially with nonprogrammed decisions. Since we haven't faced a particular situation previously, we don't always know what questions to ask or what information to gather. Even when we have gathered all the possible information, we may not be able to make rational sense of all of it, or to accurately forecast or predict the outcomes of our choice. **Bounded rationality** is the idea that for complex issues we cannot be completely rational because we cannot fully grasp all the possible alternatives, nor can we understand all the implications of every possible alternative. Our brains have limitations in terms of the amount of information they can process. Similarly, as was alluded to earlier in the chapter, even when managers have the cognitive ability to process all the relevant information, they often must make decisions without first having time to collect all the relevant data—their information is incomplete.

Escalation of Commitment

Given the lack of complete information, managers don't always make the right decision initially, and it may not

be clear that a decision was a bad one until after some time has passed. For example, consider a manager who had to choose between two competing software packages that her organization will use on a daily basis to enhance efficiency. She initially chooses the product that was developed by the larger, more well-established company, reasoning that they will have greater financial resources to invest in ensuring that the technology is good. However, after some time it becomes clear that the competing software package is going to be far superior. While the smaller company's product could be integrated into the organization's existing systems at little additional expense, the larger company's product will require a much greater initial investment, as well as substantial ongoing costs for maintaining it. At this point, however, let's assume that the manager has already paid for the larger company's (inferior) software. Will she abandon the path that she's on, accept the loss on the money that's been invested so far, and switch to the better software? Or will she continue to invest time and money into trying to make the first product work? **Escalation of commitment** is the tendency of decision makers to remain committed to poor decision, even when doing so leads to increasingly negative outcomes. Once we commit to a decision, we may find it difficult to reevaluate that decision rationally. It can seem easier to "stay the course" than to admit (or to recognize) that a decision was poor. It's important to acknowledge that not all decisions are going to be good ones, in spite of our best efforts. Effective managers recognize that progress down the wrong path isn't really progress, and they are willing to reevaluate decisions and change direction when appropriate.

Time Constraints

Managers often face time constraints that can make effective decision-making a challenge. When there is little time available to collect information and to rationally process it, we are much less likely to make a good nonprogrammed decision. Time pressures can cause us to rely on heuristics rather than engage in deep processing. While heuristics save time, however, they don't necessarily lead to the best possible solution. The best managers are constantly assessing the risks associated with acting too quickly against those associated with not acting quickly enough.

Uncertainty

In addition, managers frequently make decisions under conditions of uncertainty—they cannot know the outcome of each alternative until they've actually chosen that alternative. Consider, for example, a manager who is trying to decide between one of two possible marketing campaigns. The first is more conservative but is consistent with what the organization has done in the past. The second is more modern and edgier, and might bring much better results . . . or it might be a spectacular failure. The manager making the decision will ultimately have to choose one campaign and see what happens, without ever knowing what the results would have been with the alternate campaign. That uncertainty can make it difficult for some managers to make decisions, because committing to one option means forgoing other options.

Personal Biases

Our decision-making is also limited by our own biases. We tend to be more comfortable with ideas, concepts, things, and people that are familiar to us or similar to us. We tend to be less comfortable with that which is unfamiliar, new, and different. One of the most common biases that we have, as humans, is the tendency to like other people who we think are similar to us (because we like ourselves).[7] While these similarities can be observable (based on demographic characteristics such as race, gender, and age), they can also be a result of shared experiences (such as attending the same university) or shared interests (such as being in a book club together). This "similar to me" bias and preference for the familiar can lead to a variety of problems for managers: hiring less-qualified applicants because they are similar to the manager in some way, paying more attention to some employees' opinions and ignoring or discounting others, choosing a familiar technology over a new one that is superior, sticking with a supplier that is known over one that has better quality, and so on.

It can be incredibly difficult to overcome our biases because of the way our brains work. The brain excels at

organizing information into categories, and it doesn't like to expend the effort to re-arrange once the categories are established. As a result, we tend to pay more attention to information that confirms our existing beliefs and less attention to information that is contrary to our beliefs, a shortcoming that is referred to as **confirmation bias**.[8]

In fact, we don't like our existing beliefs to be challenged. Such challenges feel like a threat, which tends to push our brains towards the reactive system and prevent us from being able to logically process the new information via the reflective system. It is hard to change people's minds about something if they are already confident in their convictions. So, for example, when a manager hires a new employee who they really like and are convinced is going to be excellent, they will tend to pay attention to examples of excellent performance and ignore examples of poor performance (or attribute those events to things outside the employee's control). The manager will also tend to trust that employee and therefore accept their explanations for poor performance without verifying the truth or accuracy of those statements. The opposite is also true; if we dislike someone, we will pay attention to their negatives and ignore or discount their positives. We are less likely to trust them or believe what they say at face value. This is why politics tend to become very polarized and antagonistic within a two-party system. It can be very difficult to have accurate perceptions of those we like and those we dislike. The effective manager will try to evaluate situations from multiple perspectives and gather multiple opinions to offset this bias when making decisions.

Conflict

Finally, effective decision-making can be difficult because of conflict. Most individuals dislike conflict and will avoid it when possible. However, the best decision might be one that is going to involve some conflict. Consider a manager who has a subordinate who is often late to work, causing others to have to step away from their responsibilities in order to cover for the late employee. The manager needs to have a conversation with that employee to correct the behavior, but the employee is not going to like the conversation and may react in a negative way. Both of them are going to be uncomfortable. The situation is likely to involve conflict, which most people find stressful. Yet, the correct decision is still to have the conversation even if (or especially if) the employee otherwise is an asset to the department.



Exhibit 2.5 Dante Disparte Dante Disparte is the founder and CEO of Risk Cooperative and also coauthor of *Global Risk Agility and Decision Making*. He suggests that unforeseen and unanticipated risks are becoming more frequent and less predictable and are having a greater impact on more people at one time. Credit (New America/ flickr/ Attribution 2.0 Generic (CC BY 2.0))

If the bad behavior is not corrected, it will continue, which is going to cause more problems in the workplace in the long run. Other employees may recognize that this behavior is allowed, and they may also start coming to work late or engaging in other negative behaviors. Eventually, some employees may become sufficiently frustrated that they look for another place to work. It's worth noting that in this situation, the best employees will find new jobs the most quickly. It's important for managers to recognize that while conflict can be

uncomfortable (especially in the short-term), there are times when it is necessary for the group, department, or organization to function effectively in the long run.

It is also helpful to think about conflict in terms of process conflict or relationship conflict.[9] **Process conflict,** conflict about the best way to do something, can actually lead to improved performance, as individuals explore various options together in order to identify superior solutions. **Relationship conflict** is conflict between individuals that is more personal and involves attacks on a person rather than an idea. This kind of conflict is generally harmful and should be quelled when possible. The harm from relationship conflict arises at least in part because feeling personally attacked will cause an individual to revert to the reactive system of the brain.

Effective managers should be particularly aware of the possibility of relationship conflict when giving feedback and should keep feedback focused on behaviors and activities (how things are done) rather than on the individual. Being aware of and dealing with relationship conflict points to why emotional intelligence and empathy are beneficial in organizational leaders. Such leaders are more likely to be attentive to the harmful consequences of relationship conflict. The "Managerial Leadership" segment shows how one CEO encourages empathetic collaboration and how that effort is proving beneficial.

MANAGERIAL LEADERSHIP



Satya Nadella's Transformation of Microsoft

When Satya Nadella became the CEO of Microsoft in 2014, he set in motion a major transformation of the organization's culture. He wanted it to shift from a culture that valued "know-it-alls" to one that values "learn-it-all." Instead of employees feeling the need to prove that they were the smartest person in the room, he wanted them to become curious and effective listeners, learners, and communicators. Only through continual learning and collaboration with one another, and with customers, would Microsoft remain able to develop and provide great technology solutions.

One of Nadella's first mandates as CEO was to ask all the members of the top management team to read the book *Nonviolent Communication* by Marshall Rosenberg. The primary focus of the book is on empathetic communication—a kinder, gentler approach than Microsoft employees were accustomed to. Nadella believes that developing empathy leads to a heightened understanding of consumer needs and wants and an enhanced ability to develop better products and services through collaboration.

Nadella has also embraced diversity and inclusion initiatives, though he readily acknowledges that there is more to be done. This is, in part, an extension of his focus on empathy. However, it's also good business, because increasing the diversity of perspectives can help to drive innovation.

This cultural shift is reflected in Microsoft's new mission statement: "To empower every person and every organization on the planet to achieve more." Empowering every person includes Microsoft's own employees. Achieving diversity is particularly a challenge in an industry that is male dominated, and Nadella admits that he has made mistakes based on his own biases. At a Women in Computing conference early in his tenure as CEO, Nadella suggested that women did not need to ask for raises when they deserved them; the system, he said, would work it out. He later admitted that he was wrong and used the mistake as a platform for making greater strides in this arena.

Senior management team meetings at Microsoft have apparently changed dramatically as a result of the culture change driven by Nadella. Previously, members felt the need to constantly prove that they knew all the right answers at team meetings. Nadella has established different norms; he seeks out honest opinions from team members and gives positive feedback on a regular basis. By moving the focus away from always being right and toward a focus of continual learning, the culture at Microsoft has become more collaborative, and employees are more willing to take risks to create something amazing. The culture shift

seems to be paying off: Microsoft's products are being described as "cool" and "exciting," its cloud-computing platform is outperforming the competition, and its financial performance has improved dramatically. Transforming the culture of an organization is a massive undertaking, but Nadella's leadership of Microsoft clearly shows that it's a decision that can pay off.

Discussion Questions

1. Do you think a culture focused on learning makes sense for Microsoft? Why or why not?
2. What are the advantages of a culture that emphasizes empathetic communication? Can you think of any disadvantages?
3. The job of CEO means making big decisions that impact the entire organization—like deciding to change the culture. How do you think you prepare for that job?

Sources: Kendall Baker, "Confirmed: Microsoft is a legit threat to Apple," *The Hustle*, March 16, 2017. Bob Evans, "10 Powerful examples of Microsoft CEO Satya Nadella's Transformative Vision," Forbes, July 26, 2017. Harry McCraken, "Satya Nadella Rewrites Microsoft's Code," *Fast Company*, September 18, 2017, https://www.fastcompany.com/40457458/satya-nadella-rewrites-microsofts-code. Annie Palmer, "Microsoft has been reborn under CEO Satya Nadella," *The Street*, September 20, 2017.

CONCEPT CHECK

1. Explain the concept of confirmation bias.
2. List and describe at least three barriers to effective decision-making.
3. When is conflict beneficial, and when is it harmful? Why?

2.5 Improving the Quality of Decision-Making

5. How can a manager improve the quality of her individual decision-making?

Managers can use a variety of techniques to improve their decision-making by making better-quality decisions or making decisions more quickly. Table 2.1 summarizes some of these tactics.

Summary of Techniques That May Improve Individual Decision-Making

Type of Decision	Technique	Benefit
Programmed decisions	Heuristics (mental shortcuts)	Saves time
	Satisficing (choosing first acceptable solution)	Saves time
Nonprogrammed decisions	Systematically go through the six steps of the decision-making process.	Improves quality
	Talk to other people.	Improves quality: generates more options, reduces bias

Table 2.1 (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

Summary of Techniques That May Improve Individual Decision-Making		
Type of Decision	**Technique**	**Benefit**
	Be creative.	Improves quality: generates more options
	Conduct research; engage in evidence-based decision-making.	Improves quality
	Engage in critical thinking.	Improves quality
	Think about the long-term implications.	Improves quality
	Consider the ethical implications.	Improves quality

Table 2.1 (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

The Importance of Experience

An often overlooked factor in effective decision-making is experience. Managers with more experience have generally learned more and developed greater expertise that they can draw on when making decisions. Experience helps managers develop methods and heuristics to quickly deal with programmed decisions and helps them know what additional information to seek out before making a nonprogrammed decision.

Techniques for Making Better Programmed Decisions

In addition, experience enables managers to recognize when to minimize the time spent making decisions on issues that are not particularly important but must still be addressed. As discussed previously, heuristics are mental shortcuts that managers take when making programmed (routine, low-involvement) decisions. Another technique that managers use with these types of decisions is satisficing. When **satisficing**, a decision maker selects the first *acceptable* solution without engaging in additional effort to identify the *best* solution. We all engage in satisficing every day. For example, suppose you are shopping for groceries and you don't want to overspend. If you have plenty of time, you might compare prices and figure out the price by weight (or volume) to ensure that every item you select is the cheapest option. But if you are in a hurry, you might just select generic products, knowing that they are cheap enough. This allows you to finish the task quickly at a reasonably low cost.

Techniques for Making Better Nonprogrammed Decisions

For situations in which the quality of the decision is more critical than the time spent on the decision, decision makers can use several tactics. As stated previously, nonprogrammed decisions should be addressed using a systematic process. We therefore discuss these tactics within the context of the decision-making steps. To review, the steps include the following:

1. Recognize that a decision needs to be made.
2. Generate multiple alternatives.
3. Analyze the alternatives.
4. Select an alternative.
5. Implement the selected alternative.
6. Evaluate its effectiveness.

Step 1: Recognizing That a Decision Needs to Be Made

Ineffective managers will sometimes ignore problems because they aren't sure how to address them. However, this tends to lead to more and bigger problems over time. Effective managers will be attentive to problems and to opportunities and will not shy away from making decisions that could make their team, department, or organization more effective and more successful.

Step 2: Generating Multiple Alternatives

Often a manager only spends enough time on Step 2 to generate two alternatives and then quickly moves to Step 3 in order to make a quick decision. A better solution may have been available, but it wasn't even considered. It's important to remember that for nonprogrammed decisions, you don't want to rush the process. Generating many possible options will increase the likelihood of reaching a good decision. Some tactics to help with generating more options include talking to other people (to get their ideas) and thinking creatively about the problem.

Talk to other people

Managers can often improve the quality of their decision-making by involving others in the process, especially when generating alternatives. Other people tend to view problems from different perspectives because they have had different life experiences. This can help generate alternatives that you might not otherwise have considered. Talking through big decisions with a mentor can also be beneficial, especially for new managers who are still learning and developing their expertise; someone with more experience will often be able to suggest more options.

Be creative

We don't always associate management with creativity, but creativity can be quite beneficial in some situations. In decision-making, creativity can be particularly helpful when generating alternatives. **Creativity** is the generation of new or original ideas; it requires the use of imagination and the ability to step back from traditional ways of doing things and seeing the world. While some people seem to be naturally creative, it is a skill that you can develop. Being creative requires letting your mind wander and combining existing knowledge from past experiences in novel ways. Creative inspiration may come when we least expect it (in the shower, for example) because we aren't intensely focused on the problem—we've allowed our minds to wander. Managers who strive to be creative will take the time to view a problem from multiple perspectives, try to combine information in new ways, search for overarching patterns, and use their imaginations to generate new solutions to existing problems. We'll review creativity in more detail in future chapters.

Step 3: Analyzing Alternatives

When implementing Step 3, it is important to take many factors into consideration. Some alternatives might be more expensive than others, for example, and that information is often essential when analyzing options. Effective managers will ensure that they have collected sufficient information to assess the quality of the various options. They will also utilize the tactics described below: engaging in evidence-based decision-making, thinking critically, talking to other people, and considering long-term and ethical implications.

Do you have the best-quality data and evidence?

Evidence-based decision-making is an approach to decision-making that states that managers should systematically collect the best evidence available to help them make effective decisions. The evidence that is collected might include the decision maker's own expertise, but it is also likely to include external evidence, such as a consideration of other stakeholders, contextual factors relevant to the organization, potential costs and benefits, and other relevant information. With evidence-based decision-making, managers are encouraged to rely on data and information rather than their intuition. This can be particularly beneficial for new managers or for experienced managers who are starting something new. (Consider all the research that Rubio and Korey conducted while starting Away).

Talk to other people

As mentioned previously, it can be worthwhile to get help from others when generating options. Another good time to talk to other people is while analyzing those options; other individuals in the organization may help you assess the quality of your choices. Seeking out the opinions and preferences of others is also a great way to maintain perspective, so getting others involved can help you to be less biased in your decision-making (provided you talk to people whose biases are different from your own).

Are you thinking critically about the options?

Our skill at assessing alternatives can also be improved by a focus on **critical thinking**. Critical thinking is a disciplined process of evaluating the quality of information, especially data collected from other sources and arguments made by other people, to determine whether the source should be trusted or whether the argument is valid.

An important factor in critical thinking is the recognition that a person's analysis of the available information may be flawed by a number of *logical fallacies* that they may use when they are arguing their point or defending their perspective. Learning what those fallacies are and being able to recognize them when they occur can help improve decision-making quality. See **Table 2.2** for several examples of common logical fallacies.

Common Logical Fallacies			
Name	**Description**	**Examples**	**Ways to Combat This Logical Fallacy**
Non sequitur (does not follow)	The conclusion that is presented isn't a logical conclusion or isn't the only logical conclusion based on the argument(s).	Our biggest competitor is spending more on marketing than we are. They have a larger share of the market. Therefore, we should spend more on marketing. *The unspoken assumption:* They have a larger share of the market BECAUSE they spend more on marketing.	• Examine all the arguments. Are they reasonable? • Look for any assumptions that are being made in the argument sequence. Are they reasonable? • Try to gather evidence that supports or refutes the arguments and/or assumptions. *In this example, you should ask:* Are there any other reasons, besides their spending on marketing, why our competitor has a larger share of the market?
False cause	Assuming that because two things are related, one caused the other	"Our employees get sick more when we close for holidays. So we should stop closing for holidays."	This is similar to non sequitur; it makes an assumption in the argument sequence. • Ask yourself whether the first thing really causes the second, or if something else may be the cause. In this case, most holidays for which businesses close are in the late fall and winter (Thanksgiving, Christmas), and there are more illnesses at this time of year because of the weather, not because of the business being closed.
Ad hominem (attack the man)	Redirects from the argument itself to attack the person making the argument	"You aren't really going to take John seriously, are you? I heard his biggest client just dropped him for another vendor because he's all talk and no substance." *The goal:* if you stop trusting the person, you'll discount their argument.	• Does the second person have something to gain, a hidden agenda, in trying to make you distrust the first person? • If the first person's argument came from someone else, would it be persuasive?

Table 2.2 (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

Common Logical Fallacies			
Name	**Description**	**Examples**	**Ways to Combat This Logical Fallacy**
Genetic fallacy	You can't trust something because of its origins.	"This was made in China, so it must be low quality." "He is a lawyer, so you can't trust anything he says."	This fallacy is based on stereotypes. Stereotypes are generalizations; some are grossly inaccurate, and even those that are accurate in SOME cases are never accurate in ALL cases. Recognize this for what it is—an attempt to prey on existing biases.
Appeal to tradition	If we have always done it one particular way, that must be the right or best way.	"We've always done it this way." "We shouldn't change this; it works fine the way it is."	• Consider whether the situation has changed, calling for a change in the way things are being done. • Consider whether new information suggests that the traditional viewpoint is incorrect. Remember, we used to think that the earth was flat.
Bandwagon approach	If the majority of people are doing it, it must be good.	"Everybody does it." "Our customers don't want to be served by people like that."	• Remember that the majority is sometimes wrong, and what is popular isn't always what is right. • Ask yourself whether "following the pack" is going to get you where you want to be. • Remember that organizations are usually successful by being better than their competitors at something . . . so following the crowd might not be the best approach to success.
Appeal to emotion	Redirects the argument from logic to emotion	"We should do it for [recently deceased] Steve; it's what they would have wanted."	• Develop your awareness of your own emotions, and recognize when someone is trying to use them. • Ask yourself whether the argument stands on its own without the appeal to your emotions.

Table 2.2 (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

Have you considered the long-term implications?

A focus on immediate, short-term outcomes—with little consideration for the future—can cause problems. For example, imagine that a manager must decide whether to issue dividends to investors or put that money into research and development to maintain a pipeline of innovative products. It's tempting to just focus on the short-term: providing dividends to investors tends to be good for stock prices. But failing to invest in research and development might mean that in five years the company is unable to compete effectively in the

marketplace, and as a result the business closes. Paying attention to the possible long-term outcomes is a crucial part of analyzing alternatives.

Are there ethical implications?

It's important to think about whether the various alternatives available to you are better or worse from an ethical perspective, as well. Sometimes managers make unethical choices because they haven't considered the ethical implications of their actions. In the 1970s, Ford manufactured the Pinto, which had an unfortunate flaw: the car would easily burst into flames when rear-ended. The company did not initially recall the vehicle because they viewed the problem from a financial perspective, without considering the ethical implications.[10] People died as a result of the company's inaction. Unfortunately, these unethical decisions continue to occur—and cause harm—on a regular basis in our society. Effective managers strive to avoid these situations by thinking through the possible ethical implications of their decisions. The decision tree in **Exhibit 2.6** is a great example of a way to make managerial decisions while also taking ethical issues into account.

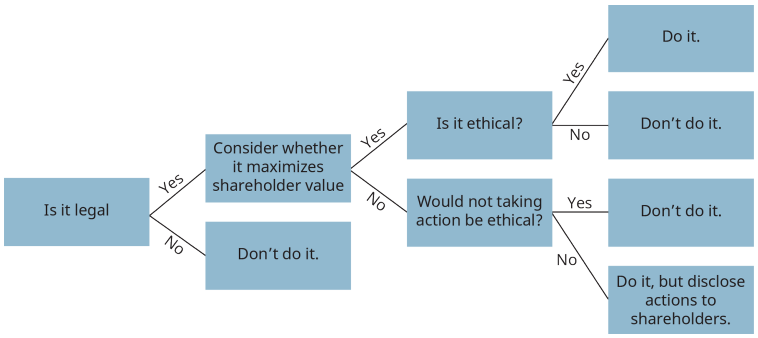

Exhibit 2.6 Ethical Decision Tree (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

Thinking through the steps of ethical decision-making may also be helpful as you strive to make good decisions. James Rest's ethical decision-making model[11] identifies four components to ethical decision-making:

1. Moral sensitivity—recognizing that the issue has a moral component;
2. Moral judgment—determining which actions are right vs. wrong;
3. Moral motivation/intention—deciding to do the right thing; and
4. Moral character/action—actually doing what is right.

Note that a failure at any point in the chain can lead to unethical actions! Taking the time to identify possible ethical implications will help you develop moral sensitivity, which is a critical first step to ensuring that you are making ethical decisions.

Once you have determined that a decision has ethical implications, you must consider whether your various alternatives are right or wrong—whether or not they will cause harm, and if so, how much and to whom. This is the moral judgment component. If you aren't sure about whether something is right or wrong, think about how you would feel if that decision ended up on the front page of a major newspaper. If you would feel guilty or ashamed, don't do it! Pay attention to those emotional cues—they are providing important information about the option that you are contemplating.

The third step in the ethical decision-making model involves making a decision to do what is right, and the fourth step involves following through on that decision. These may sound straightforward, but consider a situation in which your boss tells you to do something that you know to be wrong. When you push back, your boss makes it clear that you will lose your job if you don't do what you've been told to do. Now, consider that you have family at home who rely on your income. Making the decision to do what you know is right could come at a substantial cost to you personally. In these situations, your best course of action is to find a way to persuade your boss that the unethical action will cause greater harm to the organization in the long-term.

Step 4: Selecting an Alternative

Once alternative options have been generated and analyzed, the decision maker must select one of the options. Sometimes this is easy—one option is clearly superior to the others. Often, however, this is a challenge because there is not a clear "winner" in terms of the best alternative. As mentioned earlier in the chapter, there may be multiple good options, and which one will be best is unclear even after gathering all available evidence. There may not be a single option that doesn't upset some stakeholder group, so you will make someone unhappy no matter what you choose. A weak decision maker may become paralyzed in this situation, unable to select among the various alternatives for lack of a clearly "best" option. They may decide to keep gathering additional information in hopes of making their decision easier. As a manager, it's important to think about whether the benefit of gathering additional information will outweigh the cost of waiting. If there are time pressures, waiting may not be possible.

Recognize that perfection is unattainable

Effective managers recognize that they will not always make optimal (best possible) decisions because they don't have complete information and/or don't have the time or resources to gather and process all the possible information. They accept that their decision-making will not be perfect and strive to make good decisions overall. Recognizing that perfection is impossible will also help managers to adjust and change if they realize later on that the selected alternative was not the best option.

Talk to other people

This is another point in the process at which talking to others can be helpful. Selecting one of the alternatives will ultimately be your responsibility, but when faced with a difficult decision, talking through your choice with someone else may help you clarify that you are indeed making the best possible decision from among the available options. Sharing information verbally also causes our brains to process that information differently, which can provide new insights and bring greater clarity to our decision-making.

Step 5: Implementing the Selected Alternative

After selecting an alternative, you must implement it. This may seem too obvious to even mention, but implementation can sometimes be a challenge, particularly if the decision is going to create conflict or dissatisfaction among some stakeholders. Sometimes we know what we need to do but still try to avoid actually doing it because we know others in the organization will be upset—even if it's the best solution. Follow-through is a necessity, however, to be effective as a manager. If you are not willing to implement a decision, it's a good idea to engage in some self-reflection to understand why. If you know that the decision is going to create conflict, try to think about how you'll address that conflict in a productive way. It's also possible that we feel that there is no good alternative, or we are feeling pressured to make a decision that we know deep down is not right from an ethical perspective. These can be among the most difficult of decisions. You should always strive to make decisions that you feel good about—which means doing the right thing, even in the face of pressures to do wrong.

Step 6: Evaluating the Effectiveness of Your Decision

Managers sometimes skip the last step in the decision-making process because evaluating the effectiveness of a decision takes time, and managers, who are generally busy, may have already moved on to other projects. Yet evaluating effectiveness is important. When we fail to evaluate our own performance and the outcomes of our decisions, we cannot learn from the experience in a way that enables us to improve the quality of our future decisions.

Attending fully to each step in the decision-making process improves the quality of decision-making and, as we've seen, managers can engage in a number of tactics to help them make good decisions. Take a look at the *Ethics in Practice* box to see an example of how one particular manager puts these techniques into practice to make good decisions.

ETHICS IN PRACTICE



Rob Ault, Project Manager, Bayside Community Church

Bradenton, Florida When it comes to decision-making, ethical dilemmas require particular care. Because managers make many decisions, it should not be surprising that some of those decisions will have ethical implications. With multiple stakeholders to consider, sometimes what is best for one group of stakeholders is not what is best for others. I talked to Rob Ault about his experiences with ethical dilemmas over the course of his career. Rob has been in managerial roles for over 25 years, since he was 19 years old. He told me that he had experienced a number of ethical dilemmas in that time.

Rob has spent most of his career working for for-profit organizations, and for about half of that time he has worked in a union environment. What he has found most frustrating, regardless of environment, was when it was clear to him what was right, but what was right conflicted with what his boss was telling him to do. This included a situation in which he felt an employee should be fired for misbehavior (but wasn't), as well as situation in which he was asked to fire someone undeservedly. What we mostly talked about, though, was his process. How did he go about making decisions in these challenging situations?

Rob clearly stated that his approach to these situations has changed with experience. What he did early in his career is not necessarily what he would do now. He said that it takes experience and some maturity to recognize that, as a leader, the decisions you make affect other people's lives. He also explained that a starting point for the decision-making process is always a recognition of the fact that you have been hired to generate a benefit for your company. So a manager's decisions need to come from the perspective of what is going to be in the best long-term interest of the organization (in addition to what is morally right). This isn't always easy, because short-term consequences are much easier to observe and predict.

I asked Rob who he talked to prior to making decisions in situations with an ethical component. Rob told me that he felt one of the most important things you should do as a leader is to intentionally create and build relationships with people you trust in the organization. That way you have people you know you can talk to when difficult situations come up. He was very clear that you should always talk to your boss, who will tend to have a broader understanding of what is going on in the context of the larger organization. He also told me that he liked to talk to his father, who happened to work in human resource management for a large Fortune 500 organization. His father was always helpful in providing the perspective of how things were likely to play out long-term if one person was allowed to bend the rules. Rob realized eventually that the long-term consequences of this were almost always negative: once one person is allowed to misbehave, others find out about it and realize that they can do the same thing without repercussions. Rob also seeks out the opinions of other individuals in the organization before reaching decisions with an ethical component; he told me that when he worked in a union environment, he tried to make sure he had a good relationship with the union steward, because it was helpful to get the perspective of someone who was committed to the side of the employee.

The biggest ethical dilemma Rob faced was one that he actually couldn't talk to me about. He disagreed with what he was being asked to do, and when it was clear that he had no other choice in the matter, he quit his job rather than do something he felt wasn't right. He accepted a severance package in exchange for signing a nondisclosure agreement, which is why he can't share any details . . . but it was clear from our conversation that he feels he made the right choice. That particular ethical dilemma makes it clear how challenging managerial decision-making can sometimes be.

Discussion Questions

1. If you were faced with an ethical dilemma, from whom would you seek advice?
2. Describe some decisions that might be good for an organization's profitability in the short-term, but

bad for the organization in the long-term.
3. What factors would you take into consideration if you were thinking about leaving your job rather than do something unethical?

CONCEPT CHECK

1. Explain what satisficing is and when it may be a good strategy.
2. What are the six steps in the decision-making process?
3. What are the four steps involved in ethical decision-making?

2.6 Group Decision-Making

6. What are the advantages and disadvantages of group decision-making, and how can a manager improve the quality of group decision-making?

Involving more people in the decision-making process can greatly improve the quality of a manager's decisions and outcomes. However, involving more people can also increase conflict and generate other challenges. We turn now to the advantages and disadvantages of group decision-making.

Advantages of Group Decisions

An advantage to involving groups in decision-making is that you can incorporate different perspectives and ideas. For this advantage to be realized, however, you need a diverse group. In a diverse group, the different group members will each tend to have different preferences, opinions, biases, and stereotypes. Because a variety of viewpoints must be negotiated and worked through, group decision-making creates additional work for a manager, but (provided the group members reflect different perspectives) it also tends to reduce the effects of bias on the outcome. For example, a hiring committee made up of all men might end up hiring a larger proportion of male applicants (simply because they tend to prefer people who are more similar to themselves). But with a hiring committee made up of an equal number of men and women, the bias should be cancelled out, resulting in more applicants being hired based on their qualifications rather than their physical attributes.

Having more people involved in decision-making is also beneficial because each individual brings unique information or knowledge to the group, as well as different perspectives on the problem. Additionally, having the participation of multiple people will often lead to more options being generated and to greater intellectual stimulation as group members discuss the available options. **Brainstorming** is a process of generating as many solutions or options as possible and is a popular technique associated with group decision-making.

All of these factors can lead to superior outcomes when groups are involved in decision-making. Furthermore, involving people who will be affected by a decision in the decision-making process will allow those individuals to have a greater understanding of the issues or problems and a greater commitment to the solutions.

Disadvantages of Group Decisions

Group decision-making is not without challenges. Some groups get bogged down by conflict, while others go to the opposite extreme and push for agreement at the expense of quality discussions. **Groupthink** occurs when group members choose not to voice their concerns or objections because they would rather keep the peace and not annoy or antagonize others. Sometimes groupthink occurs because the group has a positive team spirit and camaraderie, and individual group members don't want that to change by introducing conflict.

It can also occur because past successes have made the team complacent.

Often, one individual in the group has more power or exerts more influence than others and discourages those with differing opinions from speaking up (**suppression of dissent**) to ensure that only their own ideas are implemented. If members of the group are not really contributing their ideas and perspectives, however, then the group is not getting the benefits of group decision-making.

How to Form a Quality Group

Effective managers will try to ensure quality group decision-making by forming groups with diverse members so that a variety of perspectives will contribute to the process. They will also encourage everyone to speak up and voice their opinions and thoughts prior to the group reaching a decision. Sometimes groups will also assign a member to play the **devil's advocate** in order to reduce groupthink. The devil's advocate intentionally takes on the role of critic. Their job is to point out flawed logic, to challenge the group's evaluations of various alternatives, and to identify weaknesses in proposed solutions. This pushes the other group members to think more deeply about the advantages and disadvantages of proposed solutions before reaching a decision and implementing it.



Exhibit 2.7 The Devils Advocate At a meeting of McDonald's franchise owners, attorney Brian Schnell was placed in the audience as a devil's advocate and often would strongly disagree with franchisee attorney Bob Zarco that the National Labor Relations Board (NLRB)'s joint-employer ruling on McDonald's is a boon for franchisees. He would raise his hand often and vehemently, which Zarco had asked him to do before the meeting. In that way, the franchisors' articulate arguments could be heard by all franchisee leaders in attendance, and rebutted. Credit (Mr. Blue MauMau/ flickr/ Attribution 2.0 Generic (CC BY 2.0))

The methods we've just described can all help ensure that groups reach good decisions, but what can a manager do when there is too much conflict within a group? In this situation, managers need to help group members reduce conflict by finding some common ground—areas in which they can agree, such as common interests, values, beliefs, experiences, or goals. Keeping a group focused on a common goal can be a very worthwhile tactic to keep group members working with rather than against one another. Table 2.3 summarizes the techniques to improve group decision-making.

Summary of Techniques That May Improve Group Decision-Making		
Type of Decision	**Technique**	**Benefit**
Group decisions	Have diverse members in the group.	Improves quality: generates more options, reduces bias
	Assign a devil's advocate.	Improves quality: reduces groupthink
	Encourage everyone to speak up and contribute.	Improves quality: generates more options, prevents suppression of dissent
	Help group members find common ground.	Improves quality: reduces personality conflict

Table 2.3 (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

Conclusion

Decision-making is a crucial daily activity for managers. Decisions range from small and simple, with straightforward answers, to big and complex, with little clarity about what the best choice will be. Being an effective manager requires learning how to successfully navigate all kinds of decisions. Expertise, which develops gradually through learning and experience, generally improves managerial decision-making, but managers rarely rely solely on their own expertise. They also conduct research and collect information from others; they pay attention to their own biases and to ethical implications; and they think critically about the information that they have received to make decisions that will benefit the organization and its stakeholders.

CONCEPT CHECK

1. Explain why group decision-making can be more effective than individual decision-making.
2. What are some things that can prevent groups from making good decisions?
3. As a manager, what can you do to enhance the quality of group decision-making?

Key Terms

Bounded rationality The concept that when we make decisions, we cannot be fully rational because we don't have all the possible information or the cognitive processing ability to make fully informed, completely rational decisions.

Brainstorming A process of generating as many ideas or alternatives as possible, often in groups.

Confirmation bias The tendency to pay attention to information that confirms our existing beliefs and to ignore or discount information that conflicts with our existing beliefs.

Creativity The generation of new or original ideas.

Critical thinking A disciplined process of evaluating the quality of information, especially by identifying logical fallacies in arguments.

Decision-making The action or process of thinking through possible options and selecting one.

Devil's advocate A group member who intentionally takes on the role of being critical of the group's ideas in order to discourage groupthink and encourage deep thought and discussion about issues prior to making decisions.

Emotional intelligence The ability to understand and manage emotions in oneself and in others.

Escalation of commitment The tendency of decision makers to remain committed to poor decision, even when doing so leads to increasingly negative outcomes.

Evidence-based decision-making A process of collecting the best available evidence prior to making a decision.

Groupthink The tendency of a group to reach agreement very quickly and without substantive discussion.

Heuristics Mental shortcuts that allow a decision maker to reach a good decision quickly. They are strategies that develop based on prior experience.

Nonprogrammed decisions Decisions that are novel and not based on well-defined or known criteria.

Process conflict Conflict about the best way to do something; conflict that is task-oriented and constructive, and not focused on the individuals involved.

Programmed decisions Decisions that are repeated over time and for which an existing set of rules can be developed.

Reactive system System of decision-making in the brain that is quick and intuitive.

Reflective system System of decision-making in the brain that is logical, analytical, and methodical.

Relationship conflict Conflict between individuals that is based on personal (or personality) differences; this type of conflict tends to be destructive rather than constructive.

Satisficing Choosing the first acceptable solution to minimize time spent on a decision.

Stakeholders Individuals or groups who are impacted by the organization. These include owners, employees, customers, suppliers, and members of the community in which the organization is located.

Suppression of dissent When a group member exerts his or her power to prevent others from voicing their thoughts or opinions.

Summary of Learning Outcomes

2.1 Overview of Managerial Decision-Making

1. What are the basic characteristics of managerial decision-making?

Managers are constantly making decisions, and those decisions often have significant impacts and implications for both the organization and its stakeholders. Managerial decision-making is often characterized by complexity, incomplete information, and time constraints, and there is rarely one right answer. Sometimes there are multiple good options (or multiple bad options), and the manager must try to decide which will generate the most positive outcomes (or the fewest negative outcomes). Managers must weigh the possible consequences of each decision and recognize that there are often multiple stakeholders with conflicting needs and preferences so that it often will be impossible to satisfy everyone. Finally, managerial decision-making can sometimes have ethical implications, and these should be contemplated before reaching a final decision.

2.2 How the Brain Processes Information to Make Decisions: Reflective and Reactive Systems

2. What are the two systems of decision-making in the brain?

The brain processes information to make decisions using one of two systems: either the logical, rational (reflective) system or the quick, reactive system. The reflective system is better for significant and important decisions; these generally should not be rushed. However, the reactive system can be lifesaving when time is of the essence, and it can be much more efficient when based on developed experience and expertise.

2.3 Programmed and Nonprogrammed Decisions

3. What is the difference between programmed and nonprogrammed decisions?

Programmed decisions are those that are based on criteria that are well understood, while nonprogrammed decisions are novel and lack clear guidelines for reaching a solution. Managers can establish rules and guidelines for programmed decisions based on known fact, which enables them to reach decisions quickly. Nonprogrammed decisions require more time to resolve; the decision maker may need to conduct research, collect additional information, gather opinions and ideas from other people, and so on.

2.4 Barriers to Effective Decision-Making

4. What barriers exist that make effective decision-making difficult?

There are numerous barriers to effective decision-making. Managers are limited in their ability to collect comprehensive information, and they are limited in their ability to cognitively process all the information that is available. Managers cannot always know all the possible outcomes of all the possible options, and they often face time constraints that limit their ability to collect all the information that they would like to have. In addition, managers, like all humans, have biases that influence their decision-making, and that can make it difficult for them to make good decisions. One of the most common biases that can confound decision-making is confirmation bias, the tendency for a person to pay attention to information that confirms her existing beliefs and ignore information that conflicts with these existing beliefs. Finally, conflict between individuals in organizations can make it challenging to reach a good decision.

2.5 Improving the Quality of Decision-Making

5. How can a manager improve the quality of her individual decision-making?

Managers tend to get better at decision-making with time and experience, which helps them build expertise. Heuristics and satisficing can also be useful techniques for making programmed decisions quickly. For nonprogrammed decisions, a manager can improve the quality of her decision-making by utilizing a variety of other techniques. Managers should also be careful to not skip steps in the decision-making process, to involve others in the process at various points, and to be creative in generating alternatives. They should also engage in evidence-based decision-making: doing research and collecting data and information on which to base the decision. Effective managers also think critically about the quality of the evidence that they collect, and they carefully consider long-term outcomes and ethical implications prior to making a decision.

2.6 Group Decision-Making

6. What are the advantages and disadvantages of group decision-making, and how can a manager improve the quality of group decision-making?

Groups can make better decisions than individuals because group members can contribute more knowledge and a diversity of perspectives. Groups will tend to generate more options as well, which can lead to better solutions. Also, having people involved in making decisions that will affect them can improve their attitudes about the decision that is made. However, groups sometimes fail to generate added value in the decision-making process as a result of groupthink, conflict, or suppression of dissent.

Managers can improve the quality of group decision-making in a number of ways. First, when forming the group, the manager should ensure that the individual group members are diverse in terms of knowledge and perspectives. The manager may also want to assign a devil's advocate to discourage groupthink. Managers should also encourage all group members to contribute their ideas and opinions, and they should not allow a single voice to dominate. Finally, they should not allow personality conflicts to derail group processes.

Chapter Review Questions

1. What are some of the factors that enabled Jen Rubio and Stephanie Korey to make good decisions when they established their luggage company, Away?
2. What are the two systems that the brain uses in decision-making? How are they related to programmed and nonprogrammed decisions?
3. What is a heuristic, and when would it be appropriate to use a heuristic for decision-making?
4. What is confirmation bias? Explain how it can be a barrier to effective decision-making.
5. What is a logical fallacy?
6. What are the two types of conflict? Which one is constructive, and which is destructive?
7. What are the steps in the decision-making process? Which ones do people tend to skip or spend insufficient time on?
8. What can individuals do to improve the quality of their decision-making?
9. What can groups or group leaders do to improve the quality of group decision-making?
10. What are the benefits of decision-making in a group, instead of individually?

Management Skills Application Exercises

1. If you wanted to buy a new car, what research would you do first to increase the likelihood of making a good decision? As a manager, do you think you would engage in more research or less research than that prior to making big decisions for the organization?
2. Think about a big decision that you have made. What impact did your emotions have on that decision? Did they help or hinder your decision-making? Would you make the same decision again?
3. If you were faced with an ethical dilemma at work, who would you want to talk to for advice prior to reaching a decision?
4. Which would be better to involve a group with, a programmed or a nonprogrammed decision? Why?
5. If you were manager of a group with a lot of personality conflict, what would you do?

Managerial Decision Exercises

1. Imagine that you are a manager and that two of your employees are blaming one another for a recent project not going well. What factors would you consider in deciding whom to believe? Who else would you talk to before making a decision? What would you do to try to reduce the likelihood of this happening again?
2. You have been asked whether your organization should expand from selling its products only in North America to selling its products in Europe as well. What information would you want to collect? Who would you want to discuss the idea with before making a decision?
3. You have a colleague who decided the organization should pursue a new technology. Nine months into the project of transitioning to the new technology, based on new information you are convinced that the new technology is not going to work out as anticipated. In fact, you expect it to be a colossal failure. However, when you try to talk to your colleague about the issue, she won't listen to your arguments. She is adamant that this new technology is the correct direction for your organization. Why do you think she is so resistant to seeing reason? Given what you learned in this chapter, what could you do to persuade her?
4. Your manager has asked you to take the lead on a new and creative project. She has encouraged you to create your own team (from existing employees) to work with you on the project. What factors would you want to consider in deciding who should join your project team? What would you want to do as the team

leader to increase the likelihood that the group will be successful?

5. Identify the logical flaw(s) in this argument:
   - We want to have effective leaders in this organization.
   - Taller individuals tend to be perceived as more leader-like.
   - Men are usually taller than women.
   - So, we should only hire men to be managers in our organization.



Critical Thinking Case

Vinyl Records Make a Comeback

The music industry has seen a series of innovations that have improved audio quality—vinyl records sales were eventually surpassed by compact discs in the 1980s, which were then eclipsed by digital music in the early 2000s. Both of the newer technologies boast superior sound quality to vinyl records. Vinyl should be dead . . . yet it's not. Some say this is simply a result of nostalgia—people love to harken back to older times. However, some audiophiles say that vinyl records produce a "warm" sound that can't be reproduced in any other format. In addition, a vinyl record is a tangible product (you can feel it, touch it, and see it when you own the physical record) and is more attractive, from an aesthetic perspective, than a CD. It is also a format that encourages listening to an entire album at once, rather than just listening to individual tracks, which can change the listening experience.

Whatever the reasons, vinyl is making an impressive comeback. Sales growth has been in the double digits for the last several years (over 50% in 2015 and again in 2016) and is expected to exceed $5 billion in 2017. Sony, which hasn't produced a vinyl record since 1989, recently announced that it is back in the vinyl business.

One of the biggest challenges to making vinyl records is that most of the presses are 40+ years old. In the record-making process, vinyl bits are heated to 170 degrees, and then a specialized machine exerts 150 tons of pressure to press the vinyl into the shape of the record. About a dozen new vinyl record manufacturers have sprung up in the last decade in the United States. Independent Record Pressing, a company based in New Jersey, began producing vinyl records in 2015 using old, existing presses. Their goal upon starting up was to produce over a million records a year. Even at that level of production, though, demand far outstrips the company's capacity to produce because of the limited number of presses available. They could run their machines nonstop, 24 hours a day, and not catch up with demand.

The big question is what the future holds for this industry. Will this just be a passing fad? Will the vinyl record industry remain a small niche market? Or is this the renaissance, the rebirth of a product that can withstand the test of time and alternative technologies? If it's a rebirth, then we should see demand continue to grow at its recent rapid pace . . . and if demand remains strong, then investing in new presses may well be worthwhile. If this is just a short-lived nostalgic return to an outdated media, however, then the large capital investment required to purchase new presses will never be recouped. Even with the recent growth, vinyl records still accounted for only 7% of overall music industry sales in 2015. That may be enough to get old presses running again, but so far it hasn't been enough to promote a lot of investment in new machines. The cost of a new press? Almost half a million dollars.

At least one manufacturer is optimistic about the future of vinyl. GZ Media, based in Czechoslovakia, is currently the world's largest producer of vinyl records. President and owner Zdenek Pelc kept his record factory going during the lean years when vinyl sales bottomed out. He admits that the decision was not wholly logical; he continued in part because of an emotional attachment to the media. After demand for vinyl records practically disappeared, Pelc kept just a few of the presses running to meet the demand that remained. His intention was to be the last remaining manufacturer of vinyl records. Pelc's emotional attachment to vinyl records seems to have served him well, and it's a great example of why basing decisions on pure logic doesn't always lead to the best results. Consumers make purchasing decisions in part based on the emotional appeal of the product, so it shouldn't be surprising that consumers also feel an emotional attachment to vinyl records,

as Pelc did.

When demand for vinyl records was low, Pelc stored the company's presses that were no longer in use so that they could be cannibalized for parts as needed. When sales began to grow again in 2005, he started pulling old machines out of storage and even invested in a few new ones. This has made GZ Media not only the largest vinyl record producer in the world, but also one of the only ones with new factory equipment. GZ Media produces over 20 million vinyl records a year, and Pelc is excited to continue that trend and to remain a major manufacturer in what is currently still considered a niche market.

Critical Thinking Questions

1. Why do you think vinyl records are appealing to customers?
2. Do you think the sales growth will continue to be strong for vinyl sales? Why or why not?
3. What research would you want to conduct prior to making a decision to invest in new presses?

Sources: Lee Barron, "Back on record – the reasons behind vinyl's unlikely comeback," *The Conversation*, April 17, 2015, https://theconversation.com/back-on-record-the-reasons-behind-vinyls-unlikely-comeback-39964. Hannah Ellis-Peterson, "Record sales: vinyl hits 25-year high," The Guardian, January 3, 2017, https://www.theguardian.com/music/2017/jan/03/record-sales-vinyl-hits-25-year-high-and-outstrips-streaming. Allan Kozinn, "Weaned on CDs, They're Reaching for Vinyl," *The New York Times*, June 9, 2013. Rick Lyman, "Czech company, pressing hits for years on vinyl, finds it has become one," The New York Times, August 6, 2015. Alec Macfarlane and Chie Kobayashi, "Vinyl comeback: Sony to produce records again after 28-year break," *CNN Money*, June 30, 2017, http://money.cnn.com/2017/06/30/news/sony-music-brings-back-vinyl-records/index.html. Kate Rogers, "Why millennials are buying more vinyl records," CNBC.com, November 6, 2015. https://www.cnbc.com/2015/11/06/why-millennials-are-buying-more-vinyl-records.html. Robert Tait, "In the groove: Czech firm tops list of world's vinyl record producers," *The Guardian*, August 18, 2016.



3

The History of Management

Exhibit 3.1 (Gawler History/ Attribution 2.0 Generic (CC BY 2.0))

Introduction

Learning Outcomes

After reading this chapter, you should be able to answer these questions:

1. Describe management in the ancient world.
2. How did the Italian Renaissance affect the progression of management theory?
3. How did the Industrial Revolution affect the progression of management theory?
4. How did Frederick Winslow Taylor influence management theory, and how did efficiency in management affect current management theory?
5. How do bureaucratic and administrative management complement scientific management?
6. How did Elton Mayo influence management theory, and how did the human relations movement affect current management theory?
7. How did contingency and systems management transform management thought?

EXPLORING MANAGERIAL CAREERS

Michael Porter: Harvard Professor and Management Consultant, The Monitor Group

Michael Porter is the Bishop William Lawrence University Professor at Harvard Business School and one of the foremost scholars and consultants in business strategy. Dubbed the first "Lord of Strategy," he is one of the most influential management thinkers of all time. Porter's primary contribution is in the field of competition, specifically the question of why some companies profit while others do not. Porter first became interested in competition due to his enthusiasm competing in youth sports (baseball, football, and basketball).

Porter was born in 1947 and graduated from Princeton in 1969 with a degree in aerospace and mechanical engineering. He went on to receive his MBA from Harvard Business School in 1971 and his PhD in business economics from Harvard University in 1973. His book *Competitive Strategy: Techniques for Analyzing*

Industries and Competitors (published in 1980) was deemed the ninth most influential work of the 20th century by the Fellows of the Academy of Management. Porter, writing during a period of great economic competition between the United States and Japan, was able to gain a wide and vast audience for his work.



Exhibit 3.2 Michael Porter Michael E. Porter leads a conversation with three leading public and private investors, Jin-Yong Cai, Tony O. Elumelu, and Arif Naqvi, on the panel "Investing in Prosperity: A Conversation with Global Leaders" at the Shared Value Leadership Summit. (Shared Value Initiative/ flickr/ Attribution 2.0 Generic (CC BY 2.0))

In his 1979 *Harvard Business Review* article "How Competitive Forces Shape Strategy," Porter presented his game management idea that five forces help determine the level of profitability. The five forces are competition in the industry, potential of new entrants into the industry, power of suppliers, power of customers, and threat of substitute products. An unattractive industry is one in which the five forces align themselves to produce a purely competitive industry. In this type of industry, normal profit levels are the highest a firm can expect, which means that the firm can cover its costs and make the owner a profit but cannot make excess profits. Once a firm identifies the five forces in its industry, it can choose between one of three generic strategies for success focus, differentiation, or cost leadership. Depending on where a firm is positioned within the market, the marketplace will determine what strategy it can take. This "five forces, three strategies" framework explains how McDonald's, Morton's Steakhouse, Subway, Wendy's, and TGIF can all be in the same industry and still be profitable. They offer different types of products to different types of customers. These products compete on price, differentiation, focus, or a combination of these. In addition to the five forces model, Porter developed the value-chain model, which describes the unique activities that a corporation performs to make its products valuable to its customers. Porter has also contributed to health-care management, environmental regulation, international competition, and industry-level profits.

Porter's five forces framework is intuitive and has provided managers with an approach to develop actual strategies. His ideas became popular because business leaders wanted to know how their companies could compete. Prior to Porter, management scholars stressed the idiosyncratic nature of business, stressing how each situation faced by each business was different. Other scholars offered business strategy models, but they were not as useful or practical as Porter's. Through his use of industrial-organizational economics and his training in the case method, Porter bridged the gap between theoretical frameworks and the reality of the competitive business world and became one of the most important thinkers on business in the world.

Sources: Bedeian, Arthur G and Wren, Daniel A. (Winter 2001). "Most Influential Management Books of the 20th Century" (PDF). *Organizational Dynamics*. 29 (3): 221–225; Kiechel, Walter (2010). The Lords of Strategy: The Secret Intellectual History of the New Corporate World. *Harvard Business Review Press*; Magretta, Joan (2011). Understanding Michael Porter: The Essential Guide to Competition and Strategy. *Harvard Business Review Press*; and Mathews, J.(2013-02-01). The Competitive Advantage of Michael Porter.

In The Oxford Handbook of Management Theorists: *Oxford University Press*.

While you may think that management is a relatively new field, it actually has its roots in the ancient world. In fact, whenever and wherever there has been commerce, there has been management and those thinking about how to do it better. For example, the Seven Wonders of the Ancient World, including the Colossus of Rhodes, the Hanging Gardens of Babylon, and the Great Pyramid, could only have been constructed through the work of a great many people. The size and complexity of these structures suggest that there must have been people (managers) who coordinated the labor and resources needed to execute the construction plans. Similarly, the Romans and the ancient Chinese could not have managed their vast empires without management, nor could the Phoenicians and the Greeks have dominated oceangoing trade without management.

Because management has been around for a while, it makes sense that the study of management is old. This idea is supported by the many managerial insights we can find in political, diplomatic, and military history and in philosophy, poetry, economics, and literature. Anyone familiar with Shakespeare's *King Lear* would recognize the present-day management problem of succession planning! Modern managers have been influenced by the works of Chinese military strategist and philosopher Sun Tzu, Roman general and politician Julius Caesar, and even Genghis Kahn, Mongolian conqueror and ruler of what became the largest land empire in all of history.[1] Mark Zuckerberg[2] of Facebook is a modern admirer of the Caesars and has said that he bases some of his management style on his classical education.

Despite its ancient roots, modern management is less than 150 years old. In fact, a comparison of management before and after the Industrial Revolution shows that the former is only a shadowy comparison to the latter. Prior to the Industrial Revolution, work was performed, with exceptions, mostly in home and on farms by forced labor (slaves or indentured servants) or family members, and the output they produced was often for employers', local, or family consumption. Over the centuries, economics and morality shifted, and laborers could choose where and for whom to work. These changes, in turn, would bring about many changes in how labor and other resources were employed in production.

The two developments that transformed management were the revolutions in how and where goods were sold and the Industrial Revolution. The events combined led to the selling of a wider variety of goods to a wider variety of customers in more distant locations. These events also led to the establishment of vast companies. Competition required the development of economies of scale (i.e., increased production lowering costs) and required coordination and specialization in the use of resources. The combination of coordination and specialization problems encouraged the development of management study as a distinct field.

In this chapter, we trace the evaluation of management from its origins in the ancient world to its form as a modern profession. Understanding how management came to be helps us to understand its principles in a richer, more thorough context and to understand how each concept we discuss is based on evidence produced by a wide range of scholars over many years in the fields of engineering, economics, psychology, sociology, and anthropology.

3.1 The Early Origins of Management

1. Describe management in the ancient world.

Table 3.1 traces the development of management thought from the ancient world until the 19th century's Industrial Revolution.

Sumer, located in what is today southern Iraq and the first urban-based civilization, contained the genesis of management. Sumer had a flourishing merchant culture in which goods such as grains, livestock, perfumes, and pottery were sold to customers. Rather than bartering (using one good or service, not money, to pay for

another good or service), the ancient Sumerians used ancient clay coins to pay. The sizes and shapes of coins represented different amounts of currency and signaled the types of goods for which they could be exchanged.[3]

What made this level of trade and economic activity possible? The introduction of writing made it possible for merchants to keep track of various trades. And the development of a basic form of coins allowed for increased trade because a person wanting to obtain a good or service no longer had to find another person who wanted exactly the good or service he produced. Coordinating the activities of those who provided goods and those who wanted to purchase them often required coordination, one of the main functions of a manager.

Early Contributor	Outcome
Sumerians	Writing and trade
Hammurabi	Written commands and controls
Nebuchadnezzar	Incentives
Ancient Egyptians	Division of labor, coordination and span of control
Sun Tzu	Division of labor, communication and coordination
Han dynasty (206 BC–220 AD)	Development of bureaucracy
Ancient Greeks	Division of labor
Romans	Standardization
Italians	Accounting, corporations, multinational corporations
John Florio	Management to English language

Source: Adapted from George (1972) and Wren & Bedeian (2009)

Table 3.1 (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

Two additional contributions to the early development of management came from the Middle East. The idea of written laws and commands comes from the Babylonian king **Hammurabi** (1810 BC–1750 BC).[4] The Code of Hammurabi was a listing of 282 laws that regulated a wide variety of behaviors, including business dealings, personal behavior, interpersonal relations, and punishments. Law 104 was one of the first instances of accounting and of the need for formal rules for managers and owners. The code also set wages for doctors, bricklayers, stonemasons, boatmen, herdsmen, and other labors. The code did not, however, include the concept of incentive wages because it set wages at a fixed amount. The idea of incentives would come from another, much later, Babylonian king, **Nebuchadnezzar** (605 BC–c. 562 BC),[5] who gave incentives to cloth weavers for production. Weavers were paid in food, and the more cloth they produced, the more food they were given.

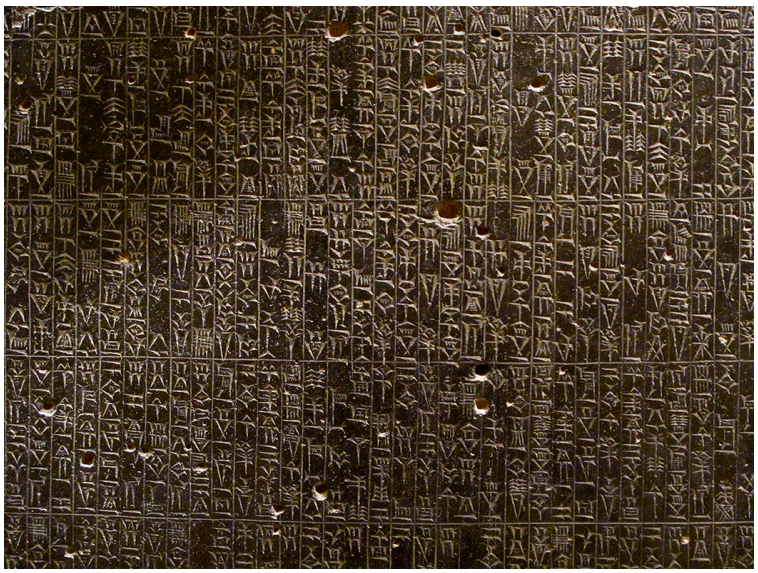

Exhibit 3.3 Hammurabi The Code of Hammurabi is a well-preserved ancient law code, created between 1810 BC and 1750 BC in ancient Babylon. It's a listing of 282 laws that regulated conduct on a wide variety of behaviors, including business dealings, personal behavior, interpersonal relations, and punishments. Law 104 was one of the first instances of accounting and the need for formal rules for owners and managers. (Gabrielle Barni / flickr/ Attribution 2.0 Generic (CC BY 2.0))

The ancient Egyptians made great strides in the building of the great pyramids. The ancient Egyptians were exceptional builders of canals, irrigation projects, and the pyramids, royal tombs whose size and complexity exceeded what the Greeks and Romans[6] were able to build in later centuries. Although we are still uncertain about exactly how the pyramids were constructed, we have some idea that the process required a great number and wide range of slave laborers to construct them. Each laborer would have a different task. Some of the laborers were stonecutters; others were required to push and pull gigantic blocks of stone; still others were required to grease the stones to reduce friction. In this process, we see the management principals of division of labor, coordination, and specialization. These groups of workers were supervised by one individual. In figuring out how best to handle the huge numbers of workers engaged in pyramid building, the ancient Egyptians also pioneered the concept of span of control, that is, the number of workers that a manager controls directly. Anticipating research on this issue in the far, far distant future, Egyptians found the ideal number of workers per supervisor to be ten. In addition, there were various overseers, who had the responsibility to compel workers to produce.

In Asia, the Chinese began to develop the idea of bureaucracy. Bureaucracy has roots in the early dynasties but only became fully developed during the Han dynasty (206 BC–220 AD).[7] The idea was to train scholars in Confucian teachings and use those teachings to make decisions. Unlike modern bureaucracies, this system was not formal but relied upon the discretion of the scholars themselves. Another important development was the idea of meritocracy because selection for and then promotion within a bureaucracy was based on a test of Confucian teaching.

The Greeks (800 BC–400 BC) and Romans (500 BC–476 AD) added a number of important steps in the development of management. Although neither empire was commercially oriented, both Greeks and the Romans undertook a wide range of industrial projects, such as roads and aqueducts, and established various guilds and societies that encouraged trade. The Greeks continued to develop the idea of division of labor based on Plato’s recognition of human diversity. The great Greek philosopher Socrates stressed the development of managerial skills such as creating an atmosphere of information sharing and analysis. The Romans’ contribution to management was standardization. Because the Romans needed to administer a vast empire, they needed standardization of measures, weights, and coins. Romans also saw the birth of the corporation, in that many Roman companies sold stocks to the public.

Both Greece and Rome saw the continued pestilence of slavery, but due to economic changes that made

slavery financially unfeasible, workers were gaining some degree of freedom. They still had masters who determined at what jobs they could work and how those jobs should be done. After the collapse of the Roman Empire, there was a decline in European trade. Scholars refer to this time as the Dark or Middle Ages (500 AD–1000 AD), due its location between the classical world of the Greeks and Romans and the world of the Renaissance. While there was little trade or economic development in Europe during this period, trade flourished in the Muslim and Chinese worlds. Various travelers, such as 13th-century Italian merchant and explorer Marco Polo, provided readers with tales and goods from those booming societies.

CONCEPT CHECK

1. What were the contributions of the following groups to modern management: Sumerians, Babylonians, Egyptians, Chinese, Greeks, and Romans?

3.2 The Italian Renaissance

2. How did the Italian Renaissance affect the progression of management theory?

In the 11th, 12th, and 13th centuries, Europeans went on a series of military expeditions to recover the Holy Land from the Muslims. These expeditions, called the Crusades, brought wealth and technological advances into Europe from the Muslim world.[8]

In the 14th century, a movement of cultural change and astounding achievements in all spheres of life began in northern Italy. The **Italian Renaissance** saw the reintroduction of classical knowledge and the emergence of new knowledge and learning, much of which had economic and business implications. The emergence of the basic printing press allowed for these ideas and knowledge to spread throughout Europe. The combination of these factors led to the creation of new wealth as a new emphasis on trade and wealth creation developed. In Italy, we see the emergence of modern enterprise and the emergence of the need for people to run these new enterprises. As Muldoon and Marin[9] write:

> Their industrious countrymen were improving mining operations and developing the shipping and banking industries, which created the underlying conditions for the migration of the Italian Renaissance's commercial and intellectual culture from its native Italian soil (Haynes, 1991). The increasing scope and complexity of these commercial activities may well have prompted such inventions as double-entry bookkeeping and motivated companies to hire business managers to coordinate and direct their operations (Witzel, 2002).

Organizations called corporations developed to carry out these commercial activities, not only within a country, but among many countries. The first multinational corporations were located in Italy but had branches across Europe. The Florence Company of Bardi was a multinational bank that provided loans to various kings, including Edward III of England.[10] As their commercial enterprises flourished, the Italians provided manuals for merchants, which spread the ideas of commerce throughout Europe.

CONCEPT CHECK

1. What was the Italian Renaissance?
2. What managerial legacy did it leave?

3.3 The Industrial Revolution

3. How did the Industrial Revolution affect the progression of management theory?

The Renaissance and its ideals came to England, a backwater power at the time, during the reign of the Tudors (1485–1603).[11] It was during this time that the word *management* came into the English language from Italy through translations by John Florio,[12] an Anglo-Italian member of Queen Elizabeth's court.

The emergence of British power would spawn the third major advance in management, the **Industrial Revolution**. As the British Empire's power grew, so did opportunities for trade. The 18th century saw the emergence of various international corporations, such as the Hudson's Bay Company[13] and the East India Company,[14] which conducted business globally. The Hudson's Bay Company orchestrated fur trade in Canada where pelts were produced and then shipped to England for trade in any part of the globe.

This further development of trade led to the establishment of the marketplace as a dominant means of organizing the exchange of goods. The market would coordinate the actions and activities of various participants, thus allowing resources to flow to their most efficient uses. One of the major intellectual leaders of this period was the economist and moral philosopher **Adam Smith**.[15] In his masterpiece, *The Wealth of Nations*,[16] Smith proposed the idea of specialization and coordination within corporations as a source of economic growth. Specialization and division of labor were Smith's major contributions to management thought. The division of labor meant that a worker specialized in performing one task that was part of a larger series of tasks, at the end of which a product would be produced. The idea of specialization of labor had several important outcomes. Firstly, specialization drastically reduced the cost of goods. Secondly, it drastically reduced the need for training. Instead of learning every aspect of a task, workers needed to learn one portion of it. Thirdly, the need to coordinate all these different tasks required a greater emphasis on management.

Another significant part of the Industrial Revolution involved the development of the steam engine, which played a major role in improving the transportation of goods and raw materials. The steam engine lowered production and transportation costs, thus lowering prices and allowing products to reach more distant markets.[17] All of these factors played a role in the Industrial Revolution, which occurred between 1760 and 1900.[18] The Industrial Revolution saw the emergence of the modern corporation, in which work, usually in a factory setting, was specialized and coordinated by managers.

Prior to the Industrial Revolution, goods and services lacked standardization and were produced at home in small batches.[19] The Industrial Revolution saw work shift from family-led home production to factory production. These factories could employ hundreds and even thousands of workers who produced mass batches of standardized goods more cheaply than they could be produced in homes.

Factory sizes ranged from sections of cities and towns to whole cities, such as Lowell, Massachusetts, which consisted primarily of textile mills. As the Industrial Revolution progressed, small factories transformed into larger ones. In 1849, Harvester in Chicago employed 123 workers and was the largest factory in the United States. McCormick plant by the mid-1850s had 250 workers who made 2,500 reapers per year. After the Great Chicago Fire, McCormick built a new plant with 800 workers and sales well above $1 million. In 1913, Henry Ford's plant in Dearborn employed up to 12,000 workers.[20] As factories grew in size, they provided chances for personnel fulfillment. Not only was the Hawthorne plant in Cicero, Illinois, a place of business, but it also featured sports teams and other social outlets.[21]

The Industrial Revolution shifted from England across the globe and eventually found its way into the United States. The United States starting seeing several notable industrial revolutions from the 1820s until the 1860s. The transportation revolution included the construction of canals and, later, railroads that connected the different parts of the continent. The emergence of a telegraph system allowed for faster communication between various parts of the United States. Previously, it would take weeks to get information from New York to Boston; with the telegraph, it took minutes.[22] The United States also saw the emergence of the Market

Revolution. Previously to the Market Revolution, the U.S. economy had been based on small, self-subsistent yeoman farmers who would produce mostly homemade batches. Around 1830, the existence of easy credit and improved transportation established a broad Market Revolution. This spawned a wide variety of corporations that needed managers to coordinate various company offices.[23]

After the period of the American Civil War, which ended in 1865, society witnessed the emergence of gigantic corporations that spanned the continent and factories that were like small cities.[24] Various problems emerged due to the change of production (similar to some of the issues we face today with the change from a manufacturing economy to an information economy). For example, how do you motivate workers? When families controlled labor, it was very easy to motivate workers due to the fact that if family members did not produce, the family may not survive.[25] Yet in the factory, it was possible for workers to avoid work or even destroy machines if they disliked management's ideas. Each worker did the job in a different fashion, workers seemed to be selected without regard to whether they were suited for a particular job, management seemed to be whimsical, and there was little standardization of equipment.

Because production quantity remained an unknown to both management and the worker, management did not explain how they determined what should be produced. Workers believed that management determined what should be produced in haphazard ways.[26] Workers believed that if too much were produced, management would eliminate workers because they believed that there was a finite amount of work in the world. Workers would control production by punishing those workers who produced too much. For example, if a worker produced too much, his equipment would be damaged, or he would be brutalized by his coworkers. Methods of production were similarly haphazard. For example, if you learned how to shovel coal or cut iron, you learned multiple ways to perform the job, which did little for efficiency. Due to managerial inefficiency, various reformers in engineering urged for the establishment of management as a distinct field of study so that some order and logic could be brought to bear on how work was performed. Although this period witnessed enormous changes in technology, management was still lagging behind.[27]

CONCEPT CHECK

1. Why was Adam Smith's specialization of labor so important?
2. What was the economic and managerial legacy of the Industrial Revolution? What were the challenges?

3.4 Taylor-Made Management

4. How did Frederick Winslow Taylor influence management theory, and how did efficiency in management affect current management theory?

The economic upheaval of the Industrial Revolution also witnessed tremendous social upheavals. The U.S. professional classes (lawyers, administrators, doctors) had numerous concerns.[28] Because more and more people were now working in factories, there was the potential for creating a permanent underclass of poorly educated workers struggling to make a living. Many reformers felt that workers could be radicalized and actively try to better their working conditions, pay, and so on, thus disrupting the status quo of the labor markets, leading to strikes, riots, violence. There were also concerns that money, influence, and pressure from big business were corrupting politics and overriding the will of the people.

The working class had many concerns about their work life. As mentioned earlier, there was a deep fear that work would disappear because of overproduction. There were also concerns over wages, job tenure, and workplace justice. And there was little in the way of standardization when it came to how tasks were to be accomplished.[29] When Frank Gilbreth, a pioneer in scientific management, was apprenticed as a bricklayer in 1885, he noted that he was taught three ways to lay bricks even though there was no need for more than one

method.

In the factories, there was little concern for the workers' physical or mental health, and there were no breaks.[30] Management and the workforce were in vicious contention with each other. Management would set the rate of work expected for the day, and in response, workers would band together to limit production. This action, called "soldiering," was a deliberate reduction of productivity on the part of the worker. Those workers who either over- or underproduced could expect that their equipment would be destroyed or that they themselves would be physically harmed. There were very few, if any, incentives provided by management. When managers sought to motivate workers, they did so through physical beatings and other punishments.[31] Neither side had a reason to trust or cooperate with the other.

Compounding management problems, there was now a demand for managers, but there were very few of them to fill this demand, as there was little training provided. Prior to the Industrial Revolution, companies were largely in the hands of a family or a single owner/manager. As companies were getting larger and more complex and the exchange of goods was taking place across more and more regions, most business owners no longer had the expertise to run such vast geographic and financial enterprises.[32] Yet there was little in the way of management training or education. There were no established scholarly journals, such as the *Academy of Management Journal*, or practitioner journals, such as the *Harvard Business Review*. Nor were there business schools until 1881, when the Wharton School of Business at the University of Pennsylvania was established. Business education at this time consisted mostly of classes that taught secretarial work. Allied fields, such as psychology and sociology, were in their infancy. Any management education that did exist was mostly learned from lessons of history and literature. Although there were numerous examples of both excellent and terrible management, this education was anecdotal and not systematic.

The second phase of the Industrial Revolution commenced with the establishment of management as a distinct discipline of knowledge. Management's birth was not in Great Britain, but in the United States.[33] According to management consultant and educator Peter Drucker, the development of management was one of the United States' primary contributions to the world, along with the Declaration of Independence.[34] At the same time management was getting established, sociology and psychology were developing, and the studies of history and economics were becoming more scientific and formal. Management also became formalized as a field of study using the scientific method. Drucker stated that the development of management was one of the factors that held off the development of radicalism in the United States because it increased productivity, lowered prices, and increased wages for workers. The success of scientific management lifted workers into the middle class. This crucial development has been attributed to one person in particular: **Frederick Winslow Taylor**.

Frederick Winslow Taylor (1856–1915) is known as the father of scientific management. He was born to the Quaker aristocracy of Pennsylvania, and initially he planned to go to Harvard and become a lawyer or an executive until he suffered an eye injury that prevented him from reading,[35] With Harvard no longer an option, Taylor went to work at a family friend's factory, the Midvale Steel Company. Taylor took to the work and was promoted quickly from pattern maker to foreman and then to chief engineer. During this time, he witnessed many acts aimed at limiting or reducing production—including having his tools destroyed—and it was he who coined the term *soldiering* to describe this deliberate act.[36] Rather than stand by and see such senseless acts affect the business he worked for, Taylor decided to take action. First, he went to Stevens Institute of Technology to gain a background in engineering. Then he took this knowledge and applied it to his work.

It is important to note that Taylor was not an original thinker. Many of his ideas came from other thinkers, especially the Englishman Charles Babbage (1791–1871).[37] Taylor's contribution was that he advanced a total system of management by uniting the ideas and philosophies of many others. While he may not have invented the scientific study of management, Taylor contributed to the use and synthesis of management by pioneering the use of time studies, division of labor based on function, cost-control systems, written instruction for workers, planning, and standardized equipment. Taylorism is still the basis of modern management, including

the use of incentives. For example, Taylor stressed piecework production, meaning that workers were paid for how much they produced. Taylor also stressed the idea of differential piecework, meaning that if workers produced more than a certain amount, they would be paid more. Some compensation systems, such as sales commissions (i.e., being paid for how much you sell), have their bases in Taylor's work.

Taylor's major contribution was that he prized knowledge and science over tradition and rules of thumb. He broke down each act of production into its smallest parts and watched the best workers perform their jobs. Using a stopwatch to time the workers' actions, Taylor determined the most effective and efficient way to accomplish a given task. After breaking down each job into its component parts, Taylor then reconstructed them as they *should* be done. Taylor also developed time management studies to break down a person's workday into a series of activities. He then timed the execution of each activity to see which way was the quickest. He would rebuild the job using only the most efficient ways possible and then train workers to perform the task. And by allowing workers to have rest periods throughout the day, he was able to get workers to work faster and better without making them tired.[38]

Another one of Taylor's significant contributions to the practice and profession of management was the concept of first-class work. When Taylor developed the notion of first-class work, he did so with the idea that workers should do as much work as they are physically and mentally capable of doing. Those who were not physically or mentally capable of keeping up with production and job demands were sent to different areas in the plant where they could work most effectively. First-class work was based not on physical strain or bursts of activity, but on what a worker could realistically be expected to do.

Taylor also developed a task management system that allowed work to occur more efficiently and allowed for breaking up a supervisor's work so that he could function within a discrete area of activities. This focus allowed supervisors to better plan and control the activities for which their workers were responsible. Taylor believed that managers would become better at and more suited to analyzing their specific area of expertise, with authority that came from knowledge and skill and not simply from position or power. He also developed a cost-accounting method that became an integral part of daily planning and control, not something that was applied only to long-term analysis.

Taylorism was based on **four principles of management** illustrated in **Table 3.2**.

Principle 1: A manager should develop a rule of science for each aspect of a job. Following this principal ensures that work is based on objective data gathered through research rather than rules of thumb. For example, many people believed that allowing workers to take breaks would limit how much work could be done. After all, how could a worker produce if he was not working? Taylor changed this attitude through research that demonstrated the benefits of breaks during the workday. Due to Taylor's research, we now enjoy coffee breaks.

Principle 2. Scientifically select and train each worker. When you get to the chapter on human resource management, you will see that Taylor's ideas still hold. Prior to Taylor's work, the selection of workers was made based on favoritism, nepotism, or random choice. Taylor got his job at Midvale because the owner was his father's friend. Likewise, workers were usually selected for a particular job with little consideration of whether they were physically or mentally fit to perform it. Taylor changed this viewpoint by using research to find the best worker for the job.

Principle 3. Management and the workforce should work together to ensure that work is performed according to the principles of management. Taylor's observation went against the long-established principles of both management and the worker who believed that each was the other's enemy. Rather than enmity, Taylor stressed cooperation and the need for the work relationship to be mutually beneficial.

Principle 4. Work and responsibility should be equally divided between management and workers. Previously, management set the directives, and workers obeyed or blocked them. Taylor believed that management and workers had joint responsibilities to each other. Management's responsibility was to scientifically select the

quantity of output for the day and provide a fair wage. In return, workers were to provide a fair day's work.

Principles of Scientific Management
First. They develop a science for each element of a man's work, which replaces the old rule-of-thumb method.
Second. They scientifically select and then train, teach, and develop the workman, whereas in the past he chose his own work and trained himself as best he could.
Third. They heartily cooperate with the men so as to ensure all of the work being done in accordance with the principles of the science which has been developed.
Fourth. There is an almost equal division of the work and the responsibility between the management and the workmen. The management take over all work for which they are better fitted than the workmen, while in the past almost all of the work and the greater part of the responsibility were thrown upon the men.

Table 3.2 (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

Taylor's Acolytes

In addition to his groundbreaking work on scientific management, Taylor attracted a wide variety of talented individuals who aided him in his research. The first important individual was the mathematician **Carl G. Barth** (1860–1939). Barth made two notable contributions. The first was his work on employee fatigue. He attempted to find what aspects made a worker tired. The second was his use of the slide rule for calculating how much steel to cut. A slide rule is a ruler with a sliding central strip. It makes it possible to perform calculations rapidly and accurately. Barth developed one for cutting steel. Before Barth's work, workers were required to make difficult calculations to determine how much steel to cut. Usually, they guessed, which led to a lot of errors and waste. With the slide rule, however, the number of errors decreased, as did the costs associated with them.

Another notable contributor to Taylor's methods was **Henry Gantt** (1861–1919), who developed the Gantt chart, which allowed for greater and more precise control over the production process. The Gantt chart, illustrated in **Exhibit 3.4**, tracked what was supposed to be done versus what was actually done. Gantt gives two principles for his charts: First, measure the amount of time needed to complete an activity. Second, use the space on the chart to visually represent how much of an activity should have been completed in that given time. Today, the closest thing to a Gantt chart is a scheduling system. These charts allowed management to see how projects were progressing, take steps to see if they were on schedule, and monitor budget concerns.[39] Gantt also pioneered the employee bonus system, in which employees were given a bonus if they completed the task they were assigned.

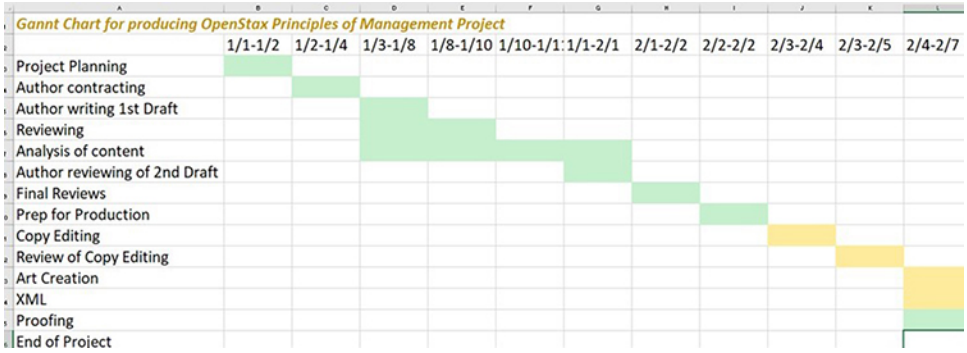

Exhibit 3.4 Gantt Chart Attribution: Copyright Rice University, OpenStax, under CC BY NC-SA-NC-SA 4.0 license

The next key contributors to Taylor's system of scientific management were **Frank** (1868–1924) and **Lillian Gilbreth** (1878–1972),[40] a couple that sometimes competed with and sometimes worked with Taylor. Frank Gilbreth was a bricklayer who, before who he heard of Taylor, began to find ways to limit his fatigue and more efficiently lay down more bricks. Unlike Taylor, Gilbreth was concerned with **motion studies**, in which he would film various motions while someone worked on the job. To determine the most efficient way to perform a task, for example, Gilbreth reduced all motions of the hand into some combination of 17 basic motions. Gilbreth would then calculate the most efficient way of carrying out a job. Gilbreth filmed workers performing a wide variety of jobs, including bricklaying, secretarial duties, and even a baseball game.

When working in construction, Gilbreth developed a management system that included rules about no smoking on the job, a ten-dollar prize for the best suggestion in how to improve labor, and a new system of training so that workers were taught only the best way to perform a task. He developed a rule that all accident sites be photographed for use in future lawsuits. Gilbreth also prepared employees for their present and future positions by introducing a plan for promotion, training, and development. This system required charting promotion paths and record keeping for performance appraisals. He wanted to impress upon both workers and managers an understanding of fatigue and of how to improve pay. In his research, Gilbreth realized that monotony came not from the job itself, but from a worker's lack of interest in the job.

Lillian Gilbreth may not have been the originator of the industrial psychology movement, but she brought a human element into the study and practice of management with her training and insight. She stated that to understand how to work better, we must understand the worker. Under scientific management, for example, understanding the worker became a fundamental principle in selecting workers for particular tasks and providing workers with incentives. The object was to develop each person to his fullest potential by strengthening his personal traits, special abilities, and skills. After Frank Gilbreth died, Lillian Gilbreth shifted her focus to increasing domestic efficiency and, in the process, designed the modern kitchen.

Taylor's Shortcomings

Taylor was a monomaniac on a mission to convert as many people to scientific management as possible. Yet despite his conviction and zealousness, Taylor's ideas were poorly understood, and he attracted more enemies than followers.[41] Taylor attracted enmity from unions because he was against them; he believed that unions separated workers from management. Taylor attracted enmity from the workers because he compared them to apes and other beasts of burden. And Taylor gained the distrust and enmity of management because he criticized them for their previous management failures. Taylor had a difficult personality and angered just about everyone.

Additionally, Taylor made several mistakes. Taylorism, despite its claims, was not an overall theory of management, but a management system designed for frontline managers, those immediately supervising. He generally ignored strategy and implementation and thought of workers as machine tools to be manipulated rather than as human beings. Although he was aware of group pressures, he believed that monetary incentives could overcome group pressures. This oversight made him ignore the human aspects of handling workers, those that involved emotions, personality, and attitudes.

While Taylor was certainly a flawed individual, these criticisms do not diminish his great contributions. Taylor dramatically changed management practices and created the modern management world. Future researchers did not replace Taylor, but complemented him. What is remarkable about Taylor was not that he was right in his time and place, but that his vision continues to have meaning and consequence even today.[42] Management was truly Taylor-made.

CONCEPT CHECK

1. List the contributions from Taylor and his associates.
2. How did Taylor change management?

3.5 Administrative and Bureaucratic Management

5. How do bureaucratic and administrative management complement scientific management?

Writing at the same time as Taylor, **Henri Fayol** (1841–1925) and **Max Weber** (1864–1920) wrote complementary contributions to Taylor's four principles of scientific management framework. Whereas Taylor focused on frontline managers, those who handle workers, Fayol focused on top managers, who set strategy, and Weber focused on middle managers, who implement strategy. Although Taylor, Fayol, and Weber viewed management from different perspectives, each stressed the need for logical, rational systems to coordinate and control various types of enterprises.

Henri Fayol was a French mining executive who did the majority of his scholarly work after the Franco-Prussian War of 1870–1871.[43] Fayol sought to develop a theory of administrative theory in order to increase efficiency in order to make the French economy stronger. Like Taylor, Fayol prized knowledge and experience over tradition. Unlike Taylor, however, Fayol focused on overall management of the corporation rather than on individual tasks involved in carrying out a firm's business. Fayol focused on the overall social interactions of the company. An explanation for this difference is that Taylor was concerned with worker behavior and performance, the domain of the frontline manager. Fayol's focus was on the direction and coordination of the whole organization, which is the domain of the top manager.[44] Another notable difference between the two men was that Taylor emphasized monetary compensation while Fayol recognized that people work for things other than money. Fayol's greatest contribution was that he sought to develop an approach that would aid top managers in setting the direction of their company.

Fayol presented three principal ideas about management.[45] First, Fayol stressed the need for **unity of command**, that is, that a company's management should speak with only one voice. Too often under the Taylor system, a worker could have up to eight managers telling him how to perform a single task. Fayol stressed flexibility and recognized that authority must have responsibility attached to it. Accordingly, he stressed that management should maintain a unity of command, which ensured that each supervisor would explain to each of the employees in his group or division what aspect of his job to focus on. Each supervisor receives direction and information from the managers above him and passes that information down the chain of command.

Fayol's second notable contribution was his recognition that workers focused on the social aspects of their jobs as well as on the monetary compensation they received for doing the job. Taylor was well aware of the social aspects and pressures of work, but he sought to limit them. Fayol sought to use them for the business's benefit by stressing the development of an esprit de corps among workers. *Esprit de corps* refers to the cohesion of workers in a given unit or department, to their commitment to their individual goals and to their coworkers even in the face of adversity, and to the pride that one feels by being a member of the organization. Fayol stressed communication as a means of creating esprit de corps and building commitment between personal goals and organizational goals.

A third important aspect of Fayol's work was his emphasis on the notion of justice within an organization and on the idea that an organization must decide issues fairly and equitably. In this way, managers could limit the ways in which their biases and personal feelings could influence their decisions.

Taken as a whole, Fayol's ideas became what we call today Fayolism, or administrative theory. Fayolism consists of the **14 principles of management**. The 14 principles articulate the types of tasks that managers are supposed to do. These 14 principles are still used today, but how they are used varies with a firm's use of technology and its culture. For example, a society that stresses individual outcomes will have different compensation systems than those that are focused on collective or group outcomes.

Fayol's 14 Principles of Management are:

1. Division of Work
2. Authority
3. Discipline
4. Unity of Command
5. Unity of Direction
6. Subordination of Individual Interest
7. Remuneration
8. Centralization
9. Scalar Chain
10. Order
11. Equity
12. Stability of Tenure of Personnel
13. Initiative—Employees should be given the necessary level of freedom to create and carry out plans.
14. Esprit de Corps

In addition to the 14 principles, Fayol identified the **five functions of management**:

1. Planning
2. Organizing
3. Staffing
4. Controlling
5. Directing

Each of these functions describes what managers should do on a day-to-day basis. The functions of management have changed over the years but have built upon Fayol's structure. Fayol fully described what a manager does and how each activity builds off of the others.

Max Weber was a German sociologist who made significant complementary contributions to Taylor's management system as well as to the disciplines of economics and sociology. Weber did the majority of his work in the early 1890s and then after 1904 when he started writing again. Sociologists hold Weber in such esteem that they regard him as a father of the field.

Weber[46] stressed that social scientists could only understand collectives by understanding the actions of individuals. One of the individual behaviors that Weber did research was the types of leadership, identifying three types of leadership: charismatic domination (familial and religious) traditional domination (patriarchs, patrimonialism, and feudalism) and legal domination (modern law, state, and bureaucracy). Weber's contribution to management is the development and understanding of the legal rationalism model of leadership, which stressed the idea that leaders should make decisions based on law, precedent, and rule, rather than whim. Weber went further than previous scholars and described why we saw the emergence of bureaucracies and other responses to industrialization.

According to Weber, both the industrialization and transportation revolutions allowed for the expanse of territories to be managed. The demands placed on managing larger and larger amounts of territory as well as people facilitated the need for bureaucracy, which is a system of fixed rules that are impartially administered. The expanding market economy required administration that is more efficient. At the same time, the emergence of communication and transportation improvements made improved administration possible.

The most notable contribution Weber provided to modern management was the creation of the **modern bureaucracy**. Weber's principles of the ideal bureaucracy are shown. Although the ancient Chinese had the first bureaucracy, the notable difference of Weber's bureaucracy is that decisions were made on a formal basis, rather than what a manager felt was correct. Weber stressed that knowledge, not birth circumstances, should be the basis of hiring and promotion within a bureaucracy. This attitude stood in sharp contrast to the policies and practices of the time in both Europe and the United States, which stressed birth circumstances. Weber also stressed that bureaucrats need to make decisions based on rules rather than whims. The word *bureaucracy* has negative connotations in the mind of the modern reader, but it was a vast improvement over what had occurred previously. Prior to Weber, management did not have to provide justification for why they made particular decisions, nor did they have to make decisions based on rules. Hiring and promotion were based on nepotism, very different from the modern meritocracy of today.

Principles of the Ideal Bureaucracy:

- Specialized roles
- Recruitment based on merit
- Uniform principles of placement, promotion, and transfer
- Careerism with systematic salary structure
- Hierarchy, responsibility, and accountability
- Subjection of official conduct to strict rules of discipline and control
- Supremacy of abstract rules
- Impersonal authority (i.e., office bearer does not bring the office with him)

There was, however, a downside to this new managerial approach. A bureaucracy could shield bureaucrats from personal responsibility and initiative. Even worse, it could make them willing participants in criminal activities. American sociologist Robert K. Merton noted that in a bureaucracy, rules could become more important than actual goals. Merton wrote:

> An effective bureaucracy demands reliability of response and strict devotion to regulations. (2) Such devotion to the rules leads to their transformation into absolutes; they are no longer conceived as relative to a set of purposes. (3) This interferes with ready adaptation under special conditions not clearly envisaged by those who drew up the general rules. (4) Thus, the very elements which conduce toward efficiency in general produce inefficiency in specific instances. Full realization of the inadequacy is seldom attained by members of the group who have not divorced themselves from the meanings which the rules have for them. These rules in time become symbolic in cast, rather than strictly utilitarian.[47]

Another particular issue was that bureaucracy placed so much emphasis on legal authority that it ignored several important factors. The first factor is that bureaucratic laws are often incomplete due to problems in communication and understanding. Contracts tend to be abandoned rather than completed. No contract or law can consider every outcome or event. The second issue is that bureaucratic organizations ignored interpersonal authority and often relied only on reason and logic for decision-making. Often people followed their managers because they personally liked them rather than the legal aspect of authority. Managers that only use legal authority to gain performance are going to be really limited in the performance they will be able to garner (please see the chapter on leadership).

Both Fayol and Weber made significant contributions to management. Fayol's ideas are the basis of modern strategy, as he attempted to understand what activities managers should do. His ideas inform management thoughts in terms of the various roles that managers need to undertake to ensure the cooperation of workers. Likewise, Weber's ideas can be seen very clearly in human resource management in that managers should make decisions based on policy rather than whim. We can see that both men's ideas about structure and the line of authority continue to have great influence in management today.

CONCEPT CHECK

1. What were the contributions of Fayol and Weber?
2. How did their work compare to Taylor's?
3. What is the idea of line of authority and structure?

3.6 Human Relations Movement

6. How did Elton Mayo influence management theory, and how did the human relations movement affect current management theory?

The human relations movement was a natural response to some of the issues related to scientific management and the under-socialized view of the worker that ignored social aspects of work. The key uniting characteristics of Taylor, Weber, and Fayol were the ideas of efficiency produced through either operational, legal, or administrative improvements. One of the principal assumptions was an emphasis on rationality.[48] According to scientific management, there was a logic to actions, and formal and knowledge authority were the principal catalysts of workplace motivation. Scientific management tended to downplay the effects of social pressures on human interactions.[49] The human relations movement enhanced scientific management because it acknowledged that peoples' attitudes, perceptions, and desires play a role in their workplace performance. With this acknowledgement, for example, managers began to realize that settling disputes was more difficult than the scientific management approach described.

The major difference between scientific management and human relations theory was that human relations theory recognized that social factors were a source of power in the workplace. While Taylor recognized the existence of social pressures in an organization, he sought to diminish them through pay, that is, compensating workers for production even though social pressure forced workers to reduce production. Fayol recognized the existence of social issues as well, but he emphasized commitment to the organization as a management technique rather than commitment of workers to each other or to their supervisor. Weber placed emphasis on the rule of law and believed that laws and regulations would guide society and corporations. Yet he did not spend enough energy recognizing the outcomes that happen when rules break down. Fayol and Weber did not recognize the role of corporate culture in an organization and did not examine more closely why workers do not follow orders. The human relations movement added more of the social element to the study and theory of work.[50]

Perhaps no research studies have been as misunderstood as the Hawthorne studies. The Hawthorne studies are the most influential, misunderstood, and criticized research experiment in all of the social sciences. The legend goes that **Elton Mayo** (1880–1949) researched, theorized, and developed human relations theory based on a 1924–1932 experiment he conducted at the Hawthorne plant of the Western Electric Company in Cicero Illinois. However, there is very little of the legend that is true. The truth is more complicated and difficult to understand. Most textbooks claim that Mayo researched and conducted the studies. Yet this is fiction. The studies were commenced by scholars from the Massachusetts Institute of Technology. Mayo did not become involved until 1927. Nevertheless, it is Mayo's vision of Hawthorne that has come to dominate the literature.

The first phase of the Hawthorne studies was called the illumination study, and it sought to measure the impact of light upon productivity. The study was inconclusive because there were too many variables other than light that could have affected worker productivity. The researchers had difficulty understanding why productivity increased. The second phase of the study was called the relay-assembly-test-room, and these experiments were carried out in a room where researchers tested the effect that working conditions such as breaks, length of the workday, company-provided lunches, and payment method had on productivity. They

selected six young female workers to be part of a team that produced a phone relay switch. Each woman was young and unlikely to be married any time soon. One woman was assigned to gather the parts to make the switch, and each of the other five women was assigned to assemble one component of the phone relay. The researchers found that production increased regardless of what variable was manipulated. Nevertheless, soldiering still occurred during the experiment. After two workers were fired for a health issue and getting married, production increased even more. The results were surprising to the researchers: they had expected to see a reduction but instead saw a consistent increase.

The Hawthorne executives turned to Elton Mayo, an Australian psychologist from Harvard University, to explain the puzzling results. Most of the controversy regarding the Hawthorne studies stems from Mayo's involvement. Mayo observed that production could be increased if management understood the role of individual workers' attitudes toward work and also took into account how group attitudes affected behavior. Mayo theorized that social issues and attention paid by the supervisor to these issues played a role in increasing production. The Hawthorne women were granted freedoms at work, including the ability to make suggestions regarding their work conditions. Many of the Hawthorne women felt that they were special and that if they performed well on the relay assembly task, they would be treated better by the company's management. Additionally, the Hawthorne women became very friendly with each other. Their connection as a team and increased satisfaction in their work appeared to drive the women to greater performance. Yet the study found that financial incentives were a clear driver of performance as well.

A third study, called the bank wiring room study, was conducted between 1931 and 1932. Rather than being selected to form a new group, participants in the bank wiring room study consisted of an already existing group, one that had a number of bad behaviors. Regardless of financial incentives, group members decided that they would only produce 6,000 to 6,600 connections a day. Workers who produced more were ostracized or hit on the arm to lower production. George Homans summarized the difference in the results of the relay assembly and the bank wiring room experiments:

"Both groups developed an informal social organization, but while the Bank Wiremen were organized in opposition to management, the Relay Assemblers were organized in cooperation with management in the pursuit of a common purpose. Finally, the responses of the two groups to their industrial situation were, on the one hand, restriction of output and, on the other, steady and welcome increase of output. These contrasts carry their own lesson."

Researchers found that cliques were formed that placed informal rules on the workers within a group. According to Homans, the workers also made a connection with one of the managers to control production. The discovery that management could ally themselves with the workforce to limit production was a notable contribution to management thought at the time. It suggests that managerial authority can break down if the manager disagrees with management's policy toward the workers.



Exhibit 3.5 The Hawthorne Electric Plant The Hawthorne studies examined the effects that differences in working conditions (such as the timing and frequency of breaks) had on productivity. The term got its name from the experiments conducted at the Western Electric Hawthorne plant, illustrated here, located in Cicero, Illinois. These studies made popular the idea that attitudes affect performance. Credit: (public domain / flickr / This work is in the public domain in the United States because it was published in the United States between 1923 and 1977 without a copyright notice.)

What did the studies mean? On some level, they were meaningless because they proved little. Indeed, they have been called scientifically worthless. There were too many variables being manipulated; the sample size was too small; observations were collected at random; the Hawthorne researchers viewed the experiments through their own ideological lenses. They made mistakes in assuming that that the wage was insignificant to the workers, when in reality the wage was a significant driving force. Yet these criticisms ignore two major facts about the Hawthorne studies. The first is that the Hawthorne studies were the first to focus on the actual work life of the workers. This was a notable change in sociological research. The second fact is that the studies were intended to generate future research, and future research did discover that attitudes play a major role in determining workplace outcomes. Another important finding concerned the role of the supervisor. Many worker behaviors, attitudes, and emotions have their genesis in their supervisor's actions. Stress and fatigue can be the result of interactions with supervisors and coworkers; they are not just a response to less-than-ideal physical conditions. Finally, the Hawthorne studies showed that work motivation is a function of a wide variety of factors, including pay, social relationships, meaning, interests, and attitudes.

Barnard and the "Zone of Indifference"

Chester Barnard (1886–1961) was president of the New Jersey Bell Telephone Company.[51] As president, he was given an unusual amount of time to conduct research. Barnard had been a student at Harvard, and through his connections there, he found out about some of the industrial research going on. His notable contribution was a book called *The Functions of the Executive*.[52] Barnard argued that an executive's purpose is to gain resources from members within the organization by ensuring that they perform their jobs and that cooperation exists between various groups within the organization. The other notable function of an executive is to hire and retain talented employees. Barnard defined a formal organization as consciously coordinated activities between two or more people but noted that such coordination is not likely to last for very long, a factor that may explain why many companies do not survive for long periods of time.

Barnard believed that executives best exerted authority through communication and the use of incentives. Communication within an organization should include definite channels of communication, and workers should have access to knowledge and information. Communication should be clear, direct, and honest so that members of an organization understand what is expected of them.

Barnard stressed several important outcomes regarding incentives. Some of his incentives reflected the human relations movement's occupation with social outcomes but tempered that movement's emphasis with an understanding that workers labored for pay. The first incentive was that there should be monetary and other material inducements to encourage better performance and production. The second incentive was that there should be nonmaterial incentives, such as recognition. The third incentive was that working conditions should be desirable. The fourth and final incentive was that workers should find pride and meaning in the work they do. Barnard believed that a combination of these elements would ensure cooperation and contributions from organizational members.

While his findings on executive functions, communication, and incentives were significant, Barnard's largest contribution to the study of management involved what he called the "**zone of indifference**." The idea behind the zone of indifference is that workers will comply with orders if they are indifferent to them. This does not mean they have to agree with or support the orders. Rather the zone of indifference suggests that workers need merely to be indifferent to an order to follow it and that workers will follow orders due to an individual's natural tendency to follow authority. The zone of indifference must be reached through the following factors. First, the workers must have the ability to comply with the order. Second, workers must understand the order. Third, the order must be consistent with organizational goals. For both management and the worker to cooperate, their interests must be aligned. Fourth, the order must not violate an individual's personal beliefs. Barnard provided an explanation for why workers do not always obey orders.

Follett and Conflict Resolution

Mary Parker Follett (1868–1933) found a way to use the tenets of the human relations movement to solve some of the problems with the scientific management framework. Follett was a political scientist from Harvard. (Her work on the Speaker of the House remains the classic in the field.) After graduating from Harvard, given the limited opportunities for women, she wound up in the field of social work. She continued to publish works on philosophy and political science, but, based on her social work connections, she soon found herself drifting over to the Taylor Society, a group dedicated to the principles of scientific management. Later in her career, she turned toward business. As Wren and Bedeian note, chronologically she belonged to the scientific management era, but intellectually she belonged to the human relations movement era.[53]

Follett's work was largely ignored for years either because it was too original or because she was a woman; it is likely both factors played a role.[54] Her ideas found little acceptance during the period because in her time, management saw workers only as tools. Her focus was on how to reduce conflict. Follett's contribution was that she pointed out that management should take social concerns into account when dealing with workers. She asked questions of management: How do we create unity of action? How do we help workers live fuller, richer lives? How do we contribute to group success? Her argument was that individual behavior is affected by and affects others in the group.[55] Accordingly, she argued for the need of the principle of coordination to have a continuous interaction of all factors. What she meant was that both management and the worker should be able to understand the other's viewpoint. She sought to have both management and the worker share power with each other, rather than have power over one another. In addition, unlike Weber and more in line with Taylor, she believed that power should be based on knowledge and expertise.

Follett also argued that there are several ways to resolve conflicts. The first is to have one party dominate the other. In **dominance**, one party dictates the terms of the arrangement. Follett recognized that very few situations in life allow this to be possible and that, for many companies, this approach is impossible without incurring social costs in terms of a disaffected workforce. The second solution is **compromise**. In a compromise, neither side gets exactly everything it wants, and the best each side can do is obtain a result that each can agree too. The problem with this approach is that both sides give up what they really want and settle on what they can agree on. In a compromise, neither side is happy. The third way to solve conflict is **integration**, which occurs when each party states its preferences and attempts to reach an agreement. Follett provided an example of integration:

> In the Harvard Library one day, in one of the smaller rooms, someone wanted the window open. I wanted it shut. We opened the window in the next room where no one was sitting.[56]

It would appear that this situation is a compromise. But closely look at it; Follett wanted the window closed, and her study partner wanted a window open. It just did not have to be in that room. Because they rearranged the problem, they came up with a solution that was satisfactory to both of them.

CONCEPT CHECK

1. What did the Hawthorne studies, Barnard, and Fayol contribute to management thought?
2. What did the works of Follett and Mayo contribute to management thought?

3.7 Contingency and System Management

7. How did contingency and systems management transform management thought?

The 1950s and 1960s saw the establishment of two schools that competed with and complemented the scientific management and human relations approaches. The first school of thought was the systems school.

Some of the leaders of the systems school were Kenneth Boulding, Daniel Katz, Robert Kahn, and Ludwig von Bertalanffy. These men came from diverse disciplines (psychology, economics, sociology, and even biology) and attempted to explain how external factors determine managerial outcomes.[57] The major purpose behind systems school research was to understand the external conditions that organizations face and how to handle these conditions. The major overview of the systems theorists was that firms were an **open system**, that is, a system that interacts with its environment. In this case, the environment interacts with the firm in that it provides and accepts valued resources from the firm. For instance, the raw components of an iPhone are gathered by Apple. Through knowledge, procedures, tools, and resources, Apple takes these components and creates something of value for its customers, after which the consumer purchases the final product. In addition to providing financial resources to the firm, customers provide the firm with information—namely whether they like the product enough to purchase it.

The issue that systems management raises is that the managers' actions are the products of outside factors. For example, if you are a human resource manager, the actions you take are determined by employment law. The law requires corporations to have tests that are both consistent and reliable. When a manager violates this law, the firm can expect a lawsuit. Likewise, the laws of supply and demand determine the salary range that a firm will offer to job applicants. If the firm pays above market, they can expect their pick of the best candidates; below market, they may have a difficult time finding quality workers. From a strategic perspective, how firms compete against each other will be determined, in part, by the general external environment. For example, Apple's ability to sell iPhones is constricted by outside factors, including technology, suppliers, customers, and competitors. Every Android phone sold limits how many iPhones Apple can sell.

The other school that made a contribution to management thought during this time was the **contingency school**. Prior to the development of the contingency school, management scholars sought the one best way of managing. The contingency school changed this by proposing that there are no universal rules in management. External and internal factors create unique situations, and each situation requires a different response. What is the most appropriate response in one situation may not work in another. The key statement of the contingency school is "it depends." One of the major theorists in this school is **Joan Woodward**, a British scholar who did her work in the 1950s and 1960s.[58] She argued that contingencies, such as technology, play a role in how much training workers should receive. For instance, one of the major themes in management today is that workers should be well-trained. Woodward would argue that for low-tech jobs, this might not be the case but that for jobs requiring quite bit of technology, training would be a necessity.

Modern Management

From the 1970s to the present, we have seen the various management schools of thought interwoven. One of the major approaches in modern management is the development of managerial theories. When people hear the word *theory*, they usually assume that it refers to something impractical and disconnected from real life. The reality is that theory is a prediction and an explanation. Since the 1970s, the concept of theory has entered into the management literature and has led to more rigorous research.[59] The body of knowledge explored in this book about concepts such as strategy, organizational behavior, human resource management, and organizational theory has many roots from the 1970s. Management has been enriched over the last 40 years by the contributions from researchers in allied fields such as economics, psychology, and sociology.

Based on the theoretical research of the last 40 or so years, scholars such as Stanford University's Jeffrey Pfeffer have now proposed the idea for evidence-based management.[60] The idea is to recommend managerial practices that have been tested. In many ways, this brings us back to Taylor and the need for science-based management. Once again, management thinkers are seeking to use formalized research to eliminate bad management techniques that have been recommended over the last several years.

Exhibit 3.6 indicates how each of the thinkers we discussed in this chapter relates to the others. From Taylor and others, we learned about the basic outcomes of human resource management, control, and some aspects of motivation. From Fayol and Barnard, we began to develop concepts related to strategic management and

authority. Mary Parker Follett provided insights into leadership. Elton Mayo and his colleagues launched the field of organizational behavior, and their work continues to have an impact on the fields of motivation, stress, and job design. Weber gave us the start of organizational design and the importance of authority.

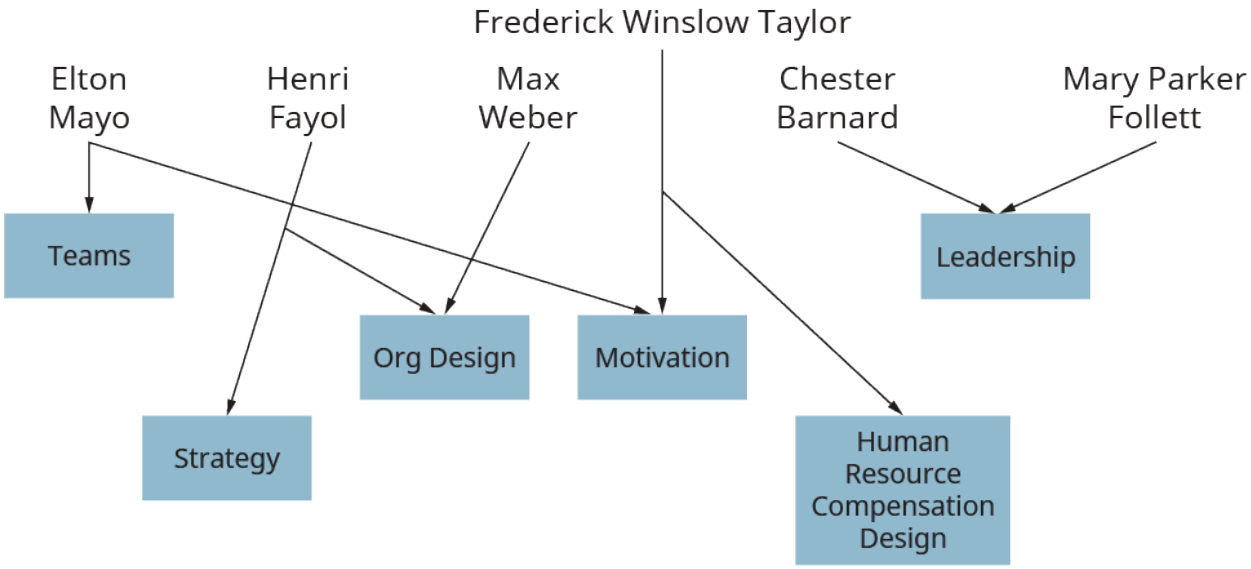

Exhibit 3.6 The Development of Management Thought (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

CONCEPT CHECK

1. What is the going contribution of systems and contingency management thought?
2. What is the idea of evidence-based management?

Key Terms

14 principles of management Created by Henri Fayol.

Adam Smith Adam Smith proposed the ideas of division of labor, specialization, and coordination within a corporation.

Carl G. Barth Carl G. Barth (1860–1939), mathematician, developed a slide rule for calculating how much steel to cut.

Chester Barnard Chester Barnard (1886–1961) argued that the executive purpose was to gain resources from members within the organization by ensuring that they perform their jobs and that cooperation exists between various groups within the organization.

Compromise In a compromise, neither side gets what it wants. The best each side could get is what each can agree too.

Contingency school The contingency school explained that there were no universal laws in management, due to a wide variety of variables that influence relationships and create unique situations, and that each situation required a different response.

Dominance In dominance, one dictates the terms of the arrangement.

Elton Mayo Elton Mayo (1880–1949) researched, theorized, and developed human relations theory based on an experiment at the Hawthorne plant on how to manage workers and to improve production.

Five functions of management Created by Henri Fayol: planning, organizing, staffing, controlling, and directing.

Frank and Lillian Gilbreth Their major contribution was **motion studies**.

Frederick Winslow Taylor Taylor is known as the father of scientific management.

Hammurabi The Code of Hammurabi was a listing of 282 laws that regulated conduct on a wide variety of behaviors, including business dealings, personnel behavior, interpersonal relations, punishments and a wide variety of other outcomes.

Henri Fayol Fayol's administrative theory was the first general statement on management theory.

Henry Gantt Henry Gantt (1861–1919) developed the Gantt chart, which allowed for the process of control to occur.

Industrial Revolution The Industrial Revolution occurred between roughly 1760 and 1900 and saw the emergence of the modern factory.

Integration In integration, both parties state their preferences and attempt to reach an agreement.

Italian Renaissance The Italian Renaissance was a major leap of knowledge and learning that had economic and business implications.

Joan Woodward A British scholar who did her work in the 1950s and 1960s. She argued that contingencies, such as technology, play a role in how much training workers should receive.

Mary Parker Follett Mary Parker Follett (1868–1933) found a way to utilize the tenets of the human relations movement to solve some of the issues with scientific management.

Max Weber Weber developed the idea that organizations should be formalized and legalistic in their operations.

Modern bureaucracy Decisions should be made on a formal basis, rather than what a bureaucrat felt was correct. Weber stressed that knowledge, not birth circumstances, should be the basis of hiring and promotion within a bureaucracy.

Motion studies Film studies of work.

Nebuchadnezzar Nebuchadnezzar (605 BC–c. 562 BC) was a pioneer in the development of incentives in that he gave greater rewards to workers who were productive.

Open system An open system interacts with the environment to gain resources.

Sun Tzu Sun Tzu developed subdivisions, various rankings of authority, and the use of colors as coordination between units.

Unity of command Unity of command stresses that each worker should have only one supervisor.

Zone of indifference Workers would comply with orders if they were indifferent to them. This does not mean

they have to agree with the orders. Rather the zone of indifference suggests that workers need merely to be indifferent to an order to follow it.

Summary of Learning Outcomes

3.1 The Early Origins of Management

1. Describe management in the ancient world.

We can track the concept of management from its development under the Sumerians. The Sumerians provided the concepts of writing and record keeping that allowed for an urban economy to develop, which in turn led to the establishment of small businesses. The Egyptians helped to pioneer the ideas of specialization of labor, span of control, and hierarchy of command. Sun Tzu developed subdivisions, various rankings of authority, and coordination. The Greeks and Romans built forerunners of the modern corporation and guilds.

3.2 The Italian Renaissance

2. How did the Italian Renaissance affect the progression of management theory?

The Crusades and various travelers brought new knowledge from both the Muslim and Chinese societies. In addition, there was a rediscovery of trade throughout Europe. These factors led to the establishment of the Renaissance that took place initially in Italy. The development of the printing press saw a distribution of these ideas across Europe. The Renaissance saw a reemergence of trade. The Renaissance also saw the development of the idea of the corporation and double-entry accounting. In fact, some of the first multinational corporations have their genesis in the Italian Renaissance.

3.3 The Industrial Revolution

3. How did the Industrial Revolution affect the progression of management theory?

The Industrial Revolution was a product of a combination of factors, including the spread of learning from the Italian Renaissance, the improvement of transportation, the Market Revolution, and technology. In addition, scholars such as Adam Smith provided support for the ideas of division of labor, specialization, and coordination within a corporation, allowing for the development of factories. This economic shifted created the need for managers.

3.4 Taylor-Made Management

4. How did Frederick Winslow Taylor influence management theory, and how did efficiency in management affect current management theory?

Taylor was the man that added the scientific method to management. He developed the four principles of scientific management and the notion of time study. Henry Gantt developed his famous chart, which allowed managers to track what was done versus supposed to be done. Frank and Lillian Gilbreth added motion study to Taylor's time management.

3.5 Administrative and Bureaucratic Management

5. How do bureaucratic and administrative management complement scientific management?

Henri Fayol and Max Weber made notable contributions to the development of management thought. Fayol focused on top managers, and Weber focused on middle managers. Fayol's administrative theory was the first general statement on management theory. He stressed the need for collective action and vision from top management. Weber developed the idea that organizations should be formalized and legalistic in their operations.

3.6 Human Relations Movement

6. How did Elton Mayo influence management theory, and how did the human relations movement affect

current management theory?

Elton Mayo noted the role of nonmonetary motivators and attitudes in terms of the workplace. Barnard developed the idea of the zone of indifference. Follett developed ways to resolve conflict without the use of compromise or domination.

3.7 Contingency and System Management

7. How did contingency and systems management transform management thought?

Systems management developed the concept that management is an open system in that organizations interact with the environment to gain resources. Since organizations require resources from the environment, this constrains what managers can do. The contingency school explained that there were no universal laws in management, due to a wide variety of variables that influence relationships. Modern management is based on theory.

Chapter Review Questions

1. What contributions did ancient civilizations make to management thought?
2. Describe the role of the Renaissance in shaping management thought.
3. How did the Industrial Revolution change business and the economy?
4. Describe scientific management. How was scientific management different from management techniques that came before it?
5. Who were the key contributors to scientific management?
6. Describe the Hawthorne studies. Was Elton Mayo a humanist?
7. What is the zone of indifference?
8. Describe Follett's concept of conflict resolution.
9. What does open systems say about management?
10. What is contingency management?

Managerial Decision Exercises

1. Which management scholar do you find to be the most influential and important, and how would you incorporate their approach into your managerial approach?
2. Based on the reading in this chapter, defend or attack this statement that would be stated by a direct report:

   Management is unethical because it is about manipulating workers.
3. Which management scholar matches your viewpoints on the role of management?



4

External and Internal Organizational Environments and Corporate Culture

Exhibit 4.1 (Credit: Free-Photos/ Pixabay/ (CC BY 0)), modified from an original image by Ivan Mlinaric)

Introduction

Learning Outcomes

After reading this chapter, you should be able to understand these statements:

1. Define the external environment of organizations.
2. Identify contemporary external forces pressuring organizations.
3. Identify different types of organizational structures and their strengths and weaknesses.
4. Explain how organizations organize to meet external market threats and opportunities.
5. Identify the fit between organizational cultures and the external environment.
6. Identify environmental trends, demands, and opportunities facing organizations.

EXPLORING MANAGERIAL CAREERS

Jeff Bezos of Amazon

Amazon's market value was estimated at $1 trillion USD dollars in 2018. The company was recognized as the most innovative company in Fast Company's 2017 list, accounting for 44 percent of all U.S. e-commerce that year—approximately 4 percent of the U.S.'s total retail sales. Amazon market value is greater than the sum of the market capitalizations of Walmart, Target, Best Buy, Nordstrom, Kohl's, JCPenney, Sears, and Macy's. Jeff Bezos, founder and leader, has creatively accomplished what most large companies fail at: meshing size, scale, and external opportunities with agility. Sales figures reached $100 billion in 2015 while the stock price climbed over 300% in the past five years. The company plans on creating over 50,000 new jobs starting in 2018. Bezos has blended his strategy of virtually reaching unlimited numbers of online customers while maintaining land-based distribution centers using Prime's $99-per-year—$119 in 2018—membership. Stephenie Landry, an Amazon vice president, stated that Prime has reached 49 cities in seven countries. Over 100 million people in 2018 subscribe to the Prime service. She noted that the business has only to answer two questions from customers: "Do you have what I want, and can you get it to

me when I need it?" The answer seems to be yes, especially with Bezos's strategy of having high-tech robots already working side by side with human employees—resembling a "factory of the future."

Bezos's digital commerce strategy has led the firm to become the leader of retail commerce. Amazon's digital strategy uses Prime memberships that are supplied and supported by land-based distribution centers; Prime takes in reaching about 60% of the total dollar value of all merchandise sold on the site. That accounts for 60 million customers in the United States who use Prime and who spend $2,500 on Amazon annually. A study of 3,000 independent businesses, half of whom were retailers, listed competition from Amazon as their primary concern. Industry after industry is being disrupted, some replaced, by Bezos's strategy. He has said, "Everybody wants fast delivery. Low prices. I'm serious about this. Our job is to provide a great customer experience, and that is something that is universally desired all over the world".

Still, Amazon faces such challenges as high shipping cost (over $11 billion annually), pressures on employees (especially those working in warehouses that have been criticized for poor working conditions), shipping contractors who go on strike demanding higher wages and reduced workloads, and the possibilities of more governmental regulation (especially with regard to adding drones as a delivery method), as well as pressures to pay more taxes. Bezos has countered these arguments by adding more full-time jobs in different cities, promising to improve working conditions, supporting public spaces for the public, and most importantly, contributing to the U.S. economy.

Sources: https://www.bloomberg.com/news/articles/2018-04-26/amazon-eyes-second-biggest-market-cap-surging-past-microsoft. Noah Robischon, (2017). Why Amazon Is The World's Most Innovative Company Of 2017, https://www.fastcompany.com/3067455/why-amazon-is-the-worlds-most-innovative-company-of-2017; L. Thomas, (2018). Amazon grabbed 4 percent of all US retail sales in 2017, new study says, https://www.cnbc.com/2018/01/03/amazon-grabbed-4-percent-of-all-us-retail-sales-in-2017-new-study.html

Organizations and industries are again at a crossroads when confronting new and challenging external environmental demands. Exceptional companies such as Amazon, in the opening case, Apple, Netflix, and Google/Alphabet Inc. exemplify evolving business models that combine strategic innovation, technological prowess, and organizational cultural agility that not only meet external environmental demands, but also shape them.

Many businesses with traditional business models, however, have failed or are not succeeding strategically, operationally, and organizationally by not realizing and/or adapting to changing external environments. Such firms that were once successful but did not anticipate and then adapt to such changes include Blockbuster, Toys R Us, Borders, Sun Microsystems, Motorola, Digital Equipment Corporation, Polaroid, and Kodak, to name only a few. A sample of contemporary external environmental trends and forces that currently challenge organizations' survival and effectiveness includes:

- *Digital technologies and artificial intelligence (AI)*: Extensions of AI help automate a firm's value chain, thus speeding up and increasing efficient operations and service to customers—as Amazon exemplifies. A current survey showed that 59% of organizations are collecting information to develop AI strategies, while others are moving forward in piloting and/or adopting AI solutions to compete faster and at less cost.[1] However, there are also risks that accompany firms that incorporate new digital and online technologies without adequate security measures. For example, some newer online technologies can expose operational systems to cyberattacks and large-scale manipulation. Hacking is now both an illegal and ongoing "profession" for those who are able to paralyze organizations from accessing their data unless they pay a ransom. While hacking is not new, it is more widespread and lethal, to the point of even threatening national security. Evidence from the U.S. presidential election between Donald Trump and Hillary Clinton indicates that international hackers affected online U.S. election processes. In 2020, a major cyberattack penetrated multiple portions of the U.S. federal government, including the Departments of

Homeland Security, Justice, Treasury, Energy, and Defense. Still, the future of most businesses is using some type of digital and AI technologies.

- The advent of *blockchain* technologies that are interrupting new industry practices. Blockchain is not a single technology; it is "an architecture that allows disparate users to make transactions and then creates an unchangeable record of those transactions." It is "a public electronic ledger—similar to a relational database—that can be openly shared among disparate users and that creates an unchangeable record of their transactions, each one time-stamped and linked to the previous one."[2] These technological inventions will continue to affect almost every business process from procurement to legal management. The banking industry is already using it. It increases speed, security, and accuracy of transactions.
- *Sharing-economy cultural and economic value-added business models* that use information technologies to gain competitive advantage. Companies such as Airbnb and Uber have ushered in new business models that have already disrupted real estate, hotel, taxi, and other industries. Taking out the middle layer of management in transactions to increase efficiencies and customer satisfaction while cutting costs through the use of information and social media technologies will continue. This trend has already had both positive and disruptive effects on companies. Many customers are likely benefitted; businesses with outdated and ineffective business models have either failed or struggle to adapt.
- *Shifts in learning and learning credentials*. Identifying, recruiting, and retaining talent is crucial to organizations. An evolving crisis for the current generation—future talent—is the continued rise in higher educational institutions' tuitions, student debt, and the changing nature of jobs. With the advent of online resources, prospective students' inability to pay creates both a crisis and opportunity for traditional higher educational institutions. While bachelor's degrees remain a requirement for many companies hiring needed higher-level talent, online resources such as Khan Academy, Udacity, and Coursera are gaining recognition and legitimacy toward providing financially challenged students opportunities for entry-level jobs. While many higher-skilled students and professionals may not presently be included in this trend, companies seeking to pay lower wages while offering flexible working conditions are attracting students.[3] Again, how higher educational private, not-for-profit, and even for-profit educational institutions adapt, innovate, and manage their external environments is yet to be seen.
- *Ethics, corporate social responsibility (CSR), and sustainability.* Corruption, lying, and fraud have been and continue to be part of the landscape of governments and public- and private-sector corporations. However, public awareness through social and online media has awakened consumers and corporations to the impending dangers and drawbacks of illegal and unethical activities of certain large corporations. And external environmental problems, created in part by humans, such as pollution and climate change pressure companies to be responsible for their share of the costs associated with these problems.

This small sample of powerful external forces illustrates the continuing pressure companies encounter to innovate in their industries. Basic theories, concepts, and principles are presented in this chapter to help explain elements of external environments and how organizations and corporations can organize and are organizing to survive and thrive in the 21st century.

4.1 The Organization's External Environment

1. Define the external environment of organizations.

To succeed and thrive, organizations must adapt, exploit, and fit with the forces in their external environments. Organizations are groups of people deliberately formed together to serve a purpose through structured and coordinated goals and plans. As such, organizations operate in different external environments and are organized and structured internally to meet both external and internal demands and opportunities. Different types of organizations include not-for-profit, for-profit, public, private, government, voluntary, family owned and operated, and publicly traded on stock exchanges. Organizations are commonly referred to as companies, firms, corporations, institutions, agencies, associations, groups, consortiums, and conglomerates.

While the type, size, scope, location, purpose, and mission of an organization all help determine the external environment in which it operates, it still must meet the requirements and contingencies of that environment to survive and prosper. This chapter is primarily concerned with how organizations fit with their external environments and how organizations are structured to meet challenges and opportunities of these environments. Major takeaways for readers of this chapter include the following: 1) Be able to identify elements in any organization's external—and internal—environment that may interest or affect you as an employee, shareholder, family member, or observer. 2) Gain insights into how to develop strategies and tactics that would help you (and your organization) navigate ways to cope with or try to dominate or appeal to elements (e.g., market segments, stakeholders, political/social/economic/technological issues) in the environment.

The big picture of an organization's **external environment**, also referred to as the *general environment*, is an inclusive concept that involves all outside factors and influences that impact the operation of a business that an organization must respond or react to in order to maintain its flow of operations.[4] Exhibit 4.2 illustrates types of general macro environments and forces that are interrelated and affect organizations: sociocultural, technological, economic, government and political, natural disasters, and human-induced problems that affect industries and organizations. For example, economic environmental forces generally include such elements in the economy as exchange rates and wages, employment statistics, and related factors such as inflation, recessions, and other shocks—negative and positive. Hiring and unemployment, employee benefits, factors affecting organizational operating costs, revenues, and profits are affected by global, national, regional, and local economies. Other factors discussed here that interact with economic forces include politics and governmental policies, international wars, natural disasters, technological inventions, and sociocultural forces. It is important to keep these dimensions in mind when studying organizations since many if not most or all changes that affect organizations originate from one or more of these sources—many of which are interrelated.

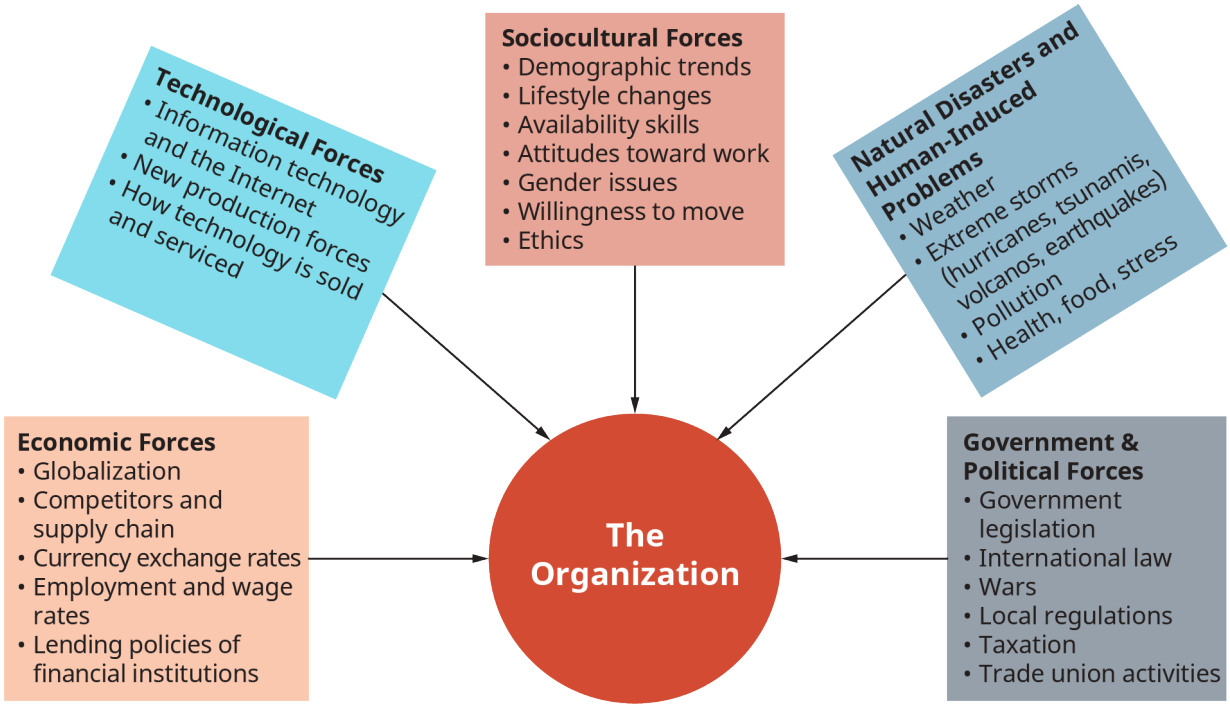

Exhibit 4.2 Macro Forces and Environments (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

Globalization is a combination of external forces shaping environments of organizations. Defined as the development of an integrated global economy and characterized by free trade, capital flows, communications, and cheaper foreign labor markets, the processes of globalization underlie the forces in the general international economic environment. This dimension continues to present opportunities and pressures to

companies operating locally as well as globally. Globalization continues to affect industries and companies in ways that benefit some and not others. Amazon, for example, is thriving. The firm sells low-end products through its brand AmazonBasics. The company has individual retail websites for the United States, the United Kingdom and Ireland, France, Canada, Germany, Italy, Spain, the Netherlands, Australia, Brazil, Japan, China, India, and Mexico. Uber and Airbnb represent some of the larger sharing-economy companies that operate internationally and have to date prospered in the so-called new but fragmenting global economy.



Exhibit 4.3 Bezos Jeff Bezos' digital commerce strategy has led the firm to become the leader of retail commerce, and forced traditional retailers like Toys R Us to close their operations, and retailers like Walmart, Target, and Sears to reassess their business environment. Amazon's digital strategy uses Prime memberships that are supplied and supported by land-based distribution centers; Prime takes in reaching about 60% of the total dollar value of all merchandise sold on the site. (Credit: Sam Churchill/flickr/ Attribution 2.0 Generic (CC BY 2.0))

In general, countries that have gained from globalization include Japan, South Korea, Taiwan, Malaysia, Singapore, Hong Kong, Thailand, and China. China's markets and growing economic prowess have particularly been noticed. China's GDP (gross domestic product) is estimated at $13.2 trillion in 2018, outpacing the $12.8 trillion combined total of the 19 countries that use the euro.[5] Corporations worldwide, large and small, online and land-based, strive to gain access to sell in China's vast markets. Moreover, China at the beginning of 2018 owns $1.168 trillion of the United States' debt.[6] Japan, in second place, owes $1.07 trillion of this debt. Any instability politically and economically with China could result in increasing inflation and interest rates in the U.S. economy that could, in turn, negatively affect U.S. businesses.

Economic forces

Economically, "The strategic challenge of the next decade is navigating a world that is simultaneously integrating and fragmenting. Stock markets have set new records and economic volatility has fallen to historic lows, while political shocks on a scale unseen for generations have taken place. Seemingly contradictory realities do co-exist."[7] Overall, while economic data indicates that globalization has had a positive effect on the world economy, a dark side also shows that two-thirds of all households in 25 advanced-economy countries had incomes stagnate and/or decline between 2005 and 2014. Moreover, the U.K. and U.S. witnessed falling wages. Wealth distribution in these countries continues to decline. Income inequality globally is also rising. Other trends that also affect the global, regional, and local economies are discussed in this chapter as well as below.

Technological forces

Technological forces are another ubiquitous environmental influence on organizations. Speed, price, service,

and quality of products and services are dimensions of organizations' competitive advantage in this era. Information technologies and social media powered by the Internet and used by sharing-economy companies such as Airbnb and Uber have democratized and increased, if not leveled, competition across several industries, such as taxis, real estate rentals, and hospitality services. Companies across industry sectors cannot survive without using the Internet, social media, and sophisticated software in R&D (research and development), operations, marketing, finance, and sales. To manage and use big data in all these functional areas, organizations rely on technology.

Government and political forces

Government and political forces also affect industries and organizations. Recent events that have jarred the global economy—and are too early to predict the long-term outcomes of—are the United Kingdom's exit from the European Union, wars in the Middle East, policies that question and disrupt free trade, health-care reform, and immigration—all of which increase uncertainty for businesses while creating opportunities for some industries and instability in others.

Sociocultural forces

Sociocultural environmental forces include different generations' values, beliefs, attitudes, customs and traditions, habits, and lifestyles. More specifically, other aspects of societal cultures are education, language, religion, law, politics, and social organizations. The millennial (ages 20 to 35) workforce, for example, generally seeks work that engages and interests them. Members of this generation are also health conscious and eager to learn. Since this and the newer generation (Generation Z) are adept and accustomed to using technology—social media in particular—organizations must be ready and equipped to provide wellness, interesting, and a variety of learning and work experiences to attract and retain new talent. Millennials are also estimated to be the United States' largest living adult generation in 2019. This generation numbered about 71 million compared with 74 million baby boomers (ages 52 to 70) in 2016. By 2019, an estimated 73 million millennials and 72 million boomers are projected. Because of immigration, millennials are estimated to increase until 2036.[8]

Other general sociocultural trends occurring in the United States and internationally that affect organizations include the following: (1) Sexual harassment at work in the era of #MeToo has pressured organizations to be more transparent about relationships between owners, bosses, and employees. Related to this trend, some surveys show new difficulties for men in workplace interactions and little effect on women's career opportunities taking place in the short term.[9] (2) While fewer immigrants have been entering the United States in recent years, diversity in the U.S. workplace continues. For example, 20 million Asian Americans trace their roots to over 20 countries in East and Southeast Asia and the Indian subcontinent—"each with unique histories, cultures, languages and other characteristics. The 19 largest origin groups together account for 94% of the total Asian population in the U.S."[10] (3) Young adults in the United States are living at home longer. "In 2016, 15% of 25- to 35-year-old Millennials were living in their parents' home. This is 5 percentage points higher than the share of Generation Xers who lived in their parents' home in 2000 when they were the same age (10%), and nearly double the share of the Silent Generation who lived at home in 1964 (8%)."[11] (4) While women have made gains in the workplace, they still comprise a small share of top leadership jobs—across politics and government, academia, the nonprofit sector, and business. Women comprised only about 10% of CEOs (chief executive officers), CFOs (chief financial officers), and the next three highest-paid executives in U.S. companies in 2016–17.[12] A 2018 study by McKinsey & Company "reaffirms the global relevance of the link between diversity—defined as a greater proportion of women and a more mixed ethnic and cultural composition in the leadership of large companies—and company financial outperformance."[13] These and other related sociocultural trends impact organizational cultures and other dimensions involving human talent and diverse workforces.

Natural disasters and human-related problems

Natural disaster and human induced environmental problems are events such as high-impact hurricanes, extreme temperatures and the rise in CO2 emissions as well as 'man-made' environmental disasters such as water and food crises; biodiversity loss and ecosystem collapse; large-scale involuntary migration are a force that affects organizations. The 2018 Global Risks Report identified risks in the environmental category that also affect industries and companies—as well as continents and countries. These risks were ranked higher than average for both likelihood and impact over a 10-year horizon. The report showed that 2017 was characterized by high-impact hurricanes, extreme temperatures, and the first rise in carbon dioxide emissions in four years; "man-made" environmental disasters; water and food crises; biodiversity loss and ecosystem collapse; and large-scale involuntary migration to name a few. Authors of this study noted that "Biodiversity is being lost at mass-extinction rates, agricultural systems are under strain and pollution of the air and sea has become an increasingly pressing threat to human health."[14] Most vulnerable to rising seas are low-lying islands in the Indian and Pacific Oceans. The Republic of the Marshall Islands has more over 1,100 low-lying islands on 29 atolls that include island nations with hundreds of thousands of people. Predictions indicate that rising sea levels could reach 3 feet worldwide by 2300 or sooner. One report stated that in your child's lifetime, Miami, Florida, could be underwater.[15] Large sections of Louisiana's marshes separating the ocean from the coastline are submerging. Oil producers and other related corporations are being sued by that state, claiming that fossil fuel emissions have contributed to natural disasters such as climate change. Many new companies in the United States are already constructing buildings to withstand increasing flooding and predicted rising water levels.

CONCEPT CHECK

1. Define the components of the internal and the external business environments.
2. What factors within the economic environment affect businesses?
3. Why do demographic shifts and technological developments create both challenges and new opportunities for business?

4.2 External Environments and Industries

2. Identify contemporary external forces pressuring organizations.

Industry and organizational leaders monitor environments to identify, predict, and manage trends, issues, and opportunities that their organizations and industries face. Some corporations, such as Amazon, anticipate and even create trends in their environments. Most, however, must adapt. External environments, as identified in the previous section, can be understood by identifying the uncertainty of the environmental forces. **Exhibit 4.4** illustrates a classic and relevant depiction of how scholars portray environment-industry-organization "fit," that is, how well industries and organizations align with and perform in different types of environments.

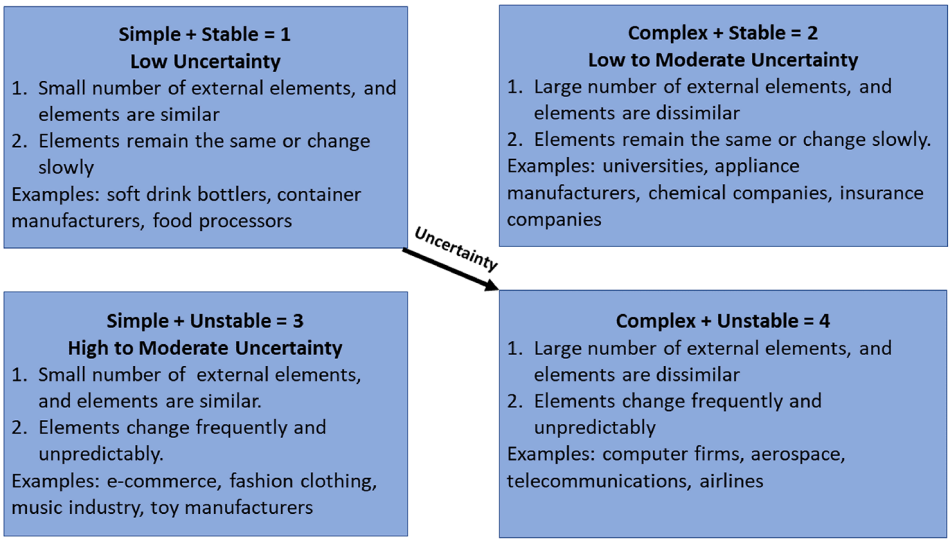

Exhibit 4.4 Company Industry Fit Adapted from: Duncan, R. (1972). *Characteristics of organizational environments of uncertainty.* American Science Quarterly, 17 *(September), 313-327; Daft, R.* Organizational Theory and Design, 12th edition, p. 151, *Mason, OH, Cengage Learning.*

The two dimensions of this figure represent "environmental complexity" (i.e., the number of elements in the environment, such a competitors, suppliers, and customers), which is characterized as either simple or complex, and "environmental change," described as stable or unstable. How available monetary and financial resources are to support an organization's growth is also an important element in this framework.[16] Certain industries—soft drink bottlers, beer distributors, food processors, and container manufacturers—would, hypothetically, fit and align more effectively in a stable (i.e., relative unchanging), simple, and low-uncertainty (i.e., has mostly similar elements) external environment—cell 1 in **Exhibit 4.4**. This is referred to when organizations are in a **simple-stable environment**. Of course unpredicted conditions, such as global and international turmoil, economic downturns, and so on, could affect these industries, but generally, these alignments have served as an ideal type and starting point for understanding the "fit" between environment and industries. In a stable but complex, low- to moderate-uncertainty environment, cell 2 in **Exhibit 4.4**, universities, appliance manufacturers, chemical companies, and insurances companies would generally prosper. This is referred to when organizations are in a **complex-stable environment**. When the external environment has simple but high to moderate uncertainty, cell 3 of **Exhibit 4.4**, e-commerce, music, and fashion clothing industries would operate effectively. This is referred to when organizations are in a **simple-unstable environment**. Whereas in cell 4 of **Exhibit 4.4**, an environment characterized by a high degree of uncertainty with complex and unstable elements, industries and firms such as computer, aerospace, airlines, and telecommunications firms would operate more effectively. This is referred to when organizations are in a **complex-unstable environment**.

Exhibit 4.4 is a starting point for diagnosing the "fit" between types of external environments and industries. As conditions change, industries and organizations must adapt or face consequences. For example, educational institutions that traditionally have been seen to operate best in low- to moderate-uncertainty environments, cell 2 of **Exhibit 4.4**, have during this past decade experienced more high to moderate uncertainty (cell 3)—and even high uncertainty (cell 4). For example, for-profit educational institutions such the University of Phoenix and others—as compared to not-for-profit universities and colleges, such as public state institutions, community colleges, and private nonprofit ones—have undergone more unstable and complex forces in the external environment over the past decade. Under the Obama administration, for-profit universities faced greater scrutiny regarding questionable advertising, graduation rates, and accreditation issues; lawsuits and claims against several of these institutions went forward, and a few of the colleges had to close. The Trump administration showed signs of alleviating aggressive governmental control and monitoring in this sector. Still, higher educational institutions in general currently face increasingly complex and unstable

environments given higher tuition rates, increased competition from less-expensive and online programs, fewer student enrollments, and an overabundance of such institutions. Several private, not-for-profit higher educational institutions have merged and also ceased to exist. Adapting to increasingly rapid external change has become a rallying call for most industries and organizations as the 21st century evolves.

Organizational Complexity

It is important to point out here that external (and internal) organizational complexity is not often as simple as it may seem. It has been defined as "...the amount of complexity derived from the environment where the organisation operates, such as the country, the markets, suppliers, customers and stakeholders; while internal complexity is the amount of complexity that is internal to the organisation itself, i.e. products, technologies, human resources, processes and organisational structure. Therefore, different aspects compose internal and external complexities."[17]

The dilemma that organizational leaders and managers sometimes face is how to deal with external, and internal, complexity? Do you grow and nurture it or reduce it? Some strategies call for reducing and managing it at the local level while nurturing it at the global level—depending on the organization's size, business model, and the nature of the environments. Without going into complicated detail, it is fair to say at the beginning of the chapter that you may want to read through the chapter first, then return here afterward.

In the meantime, here are some simple rules from organizational practitioners De Toni and De Zan to keep in mind for managing high levels of complexity from the external environment, internally, after you have diagnosed the nature of the external complexity—as we discuss throughout in this chapter: first, assemble "...a set of self-managing teams or autonomous business units,[known as modularized units] with an entrepreneurial responsibility to the larger organization." These focused self-organizing teams use creative methods to deal with the diversity to the advantage of the organization. A second method when facing high external environmental complexity when you want to gain value from it is to find and develop "...simple rules to drive out creativity and innovation ... to keep the infrastructure and processes simple, while permitting complex outputs and behaviours." An example offered is found in the rules of the Legos company: "(1) does the proposed product have the Lego look? (2) Will children learn while having fun? (3) Will parents approve? (4) Does the product maintain high quality standards? (5) Does it stimulate creativity?"[18]

A third strategy for dealing with external complexity involves companies' building on their own capabilities. If companies attempt to manage too much complexity it would lead to chaos. Some strategies to combat external complexity and improve a company's capabilities include: (1) creating open networks internal and outside the organization to promote cooperation and integration, and (2) to develop and advance their brand and reputation. Some of those strategies include creating open networks internal and outside the organization to promote cooperation and integration and to develop brand and reputation. Also, sharing "...values, vision, strategy, organizational processes and knowledge, through the development of trust and incorporation and promotion of leaders at all levels" can help internal teams exploit external complexity to the organization's advantage. Keep these ideas in mind as you read through the chapter and think about how leaders, managers, employees, and you can learn to read external environmental clues that organizations can use to creatively and proactively use organizational resources to be more competitive, effective, and successful.

CONCEPT CHECK



1. What factors within the economic environment affect businesses?
2. Why do change and shifts and technological developments create both challenges and new opportunities for business?

4.3 Organizational Designs and Structures

3. Identify different types of organizational structures and their strengths and weaknesses.

A 2017 Deloitte source asked, before answering, "Why has organizational design zoomed to the top of the list as the most important trend in the Global Human Capital Trends survey for two years in a row**?"**[19] The source continued, "The answer is simple: The way high-performing organizations operate today is radically different from how they operated 10 years ago. Yet many other organizations continue to operate according to industrial-age models that are 100 years old or more."[20]

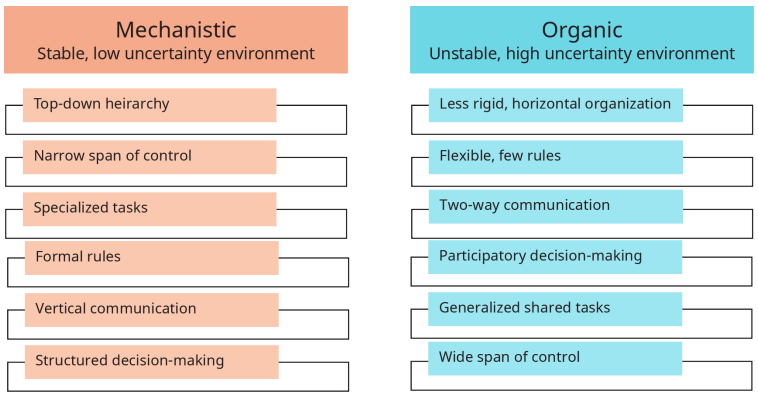

Exhibit 4.5 Mechanistic and Organic Organizations (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

Early organizational theorists broadly categorized **organizational structures** and systems as either mechanistic or organic.[21] This broad, generalized characterization of organizations remains relevant. **Mechanistic organizational structures** (Exhibit 4.5) are best suited for environments that range from stable and simple to low-moderate uncertainty (Exhibit 4.4) and are characterized by top-down hierarchies of control that are rule-based. The chain of command is highly centralized and uses formal authority; tasks are clearly defined and differentiated to be executed by specific specialized experts. Bosses and supervisors have fewer people working directly under them (i.e., a narrow span of control), and the organization is governed by rigid departmentalization (i.e., an organization is divided into different departments that perform specialized tasks according to the departments' expertise). This form of organization represents a traditional type of structure that evolved in environments that were, as noted above, stable with low complexity. Historically, the U.S. Postal Service and other manufacturing types of industries (Exhibit 4.4) were mechanistic. Again, this type of organizational design may still be relevant, as Exhibit 4.4 suggests, in simple, stable, low-uncertainty environments.

Organic organizational structures and systems, however, have opposite characteristics from mechanistic ones. As Exhibit 4.4 shows, these organizational forms work best in unstable, complex, changing environments. Their structures are flatter, with participatory communication and decision-making flowing in different directions. There is more fluidity and less-rigid ways of performing tasks; there may also be fewer rules. Tasks are more generalized and shared; there is a wider span of control (i.e., more people reporting to managers). Exhibit 4.5 offers examples of organically structured industries, such as high tech, computer, aerospace, and telecommunications industries, that must deal with change and uncertainty. Contemporary corporations and firms engaged in fast-paced, highly competitive, rapidly changing, and turbulent environments are becoming more organic in different ways, as we will discuss in this chapter. However, not every organization or every part of most organizations may require an organic type of structure. Understanding different organizational designs and structures is important to discern when, where, and under what circumstances a type of mechanistic system or part of an organization would be needed. The following section discusses five types of structures with variations.

Types of Organizational Structures

Within the context of mechanistic versus organic structures, specific types of organizational structures in the United States historically evolved over at least three eras, as we discuss here before explaining types of organizational designs. During the first era, the mid-1800s to the late 1970s, organizations were mechanistic self-contained, top-down pyramids.[22] Emphasis was placed on internal organizational processes of taking in raw materials, transforming those into products, and turning them out to customers.

Early organizational structures were focused on internal hierarchical control and separate functional specializations in order to adapt to external environments. Structures during this era grouped people into functions or departments, specified reporting relationships among those people and departments, and developed systems to coordinate and integrate work horizontally and vertically. As will be explained, the **functional structure** evolved first, followed by the divisional structure and then the matrix structured.

The second era started in the 1980s and extended through the mid-1990s. More-complex environments, markets, and technologies strained mechanistic organizational structures. Competition from Japan in the auto industry and complex transactions in the banking, insurance, and other industries that emphasized customer value, demand and faster interactions, quality, and results issued the need for more organic organizational designs and structures.

Communication and coordination between and among internal organizational units and external customers, suppliers, and other stakeholders required higher levels of integration and speed of informational processing. Personal computers and networks had also entered the scene. In effect, the so-called "horizontal organization" was born, which emphasized "reengineering along workflow processes that link organizational capabilities to customers and suppliers."[23] Ford, Xerox Corp., Lexmark, and Eastman Kodak Company are examples of early adopters of the **horizontal organizational design**, which, unlike the top-down pyramid structures in the first era, brought flattened hierarchical, hybrid structures and cross-functional teams.

The third era started in the mid-1990s and extends to the present. Several factors contributed to the rise of this era: the Internet; global competition—particularly from China and India with low-cost labor; automation of supply chains; and outsourcing of expertise to speed up production and delivery of products and services. The so-called silos and walls of organizations opened up; everything could not be or did not have to be produced within the confines of an organization, especially if corporations were cutting costs and outsourcing different functions of products to save costs. During this period, further extensions of the horizontal and organic types of structures evolved: the divisional, matrix, global geographic, modular, team-based, and virtual structures were created.

In the following discussion, we identify major types of structures mentioned above and discuss the advantages and disadvantages of each, referenced in **Exhibit 4.6**. Note that in many larger national and international corporations, there is a mix and match among different structures used. There are also advantages and disadvantages of each structure. Again, organizational structures are designed to fit with external environments. Depending on the type of environments from our earlier discussion in which a company operates, the structure should facilitate that organization's capability to achieve its vision, mission, and goals.

Exhibit 4.6 offers a profile of different structures that evolved in our discussion above.

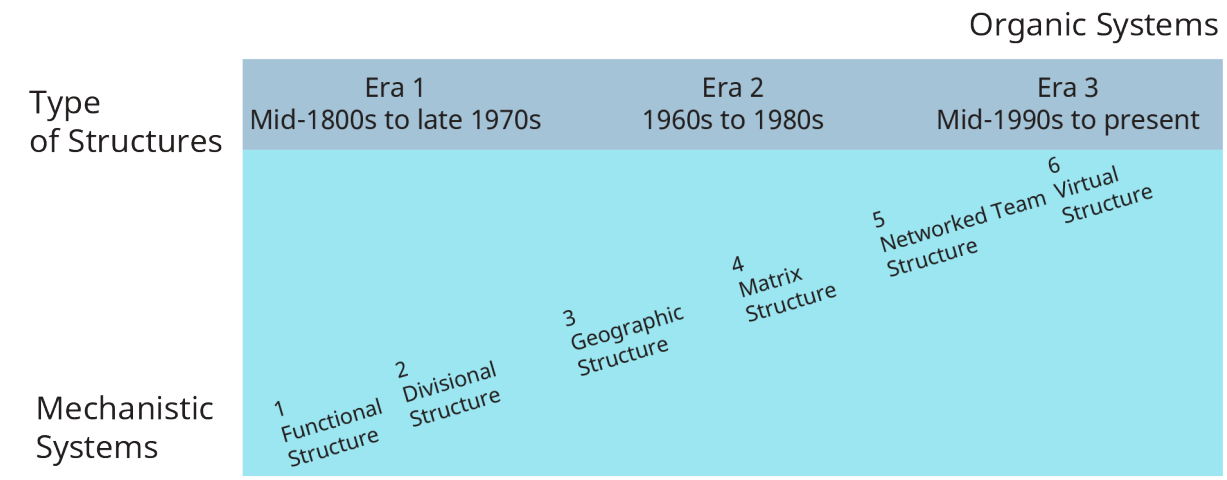

Exhibit 4.6 Evolution of Organizational Structure Adapted from: Daft, R., 2016, Organization Theory and Design, 12th edition, Cengage learning, Chapter 3; Warren, N., "Hitting the Sweet Spot Between Specialization and Integration in Organizational Design", People and Strategy, 34, No. 1, 2012, pp. 24-30.

Note the continuum in **Exhibit 4.6**, showing the earliest form of organizational structure, functional, evolving with more complex environments to divisional, matrix, team-based, and then virtual. This evolution, as discussed above, is presented as a continuum from mechanistic to organic structures—moving from more simple, stable environments to complex, changing ones, as illustrated in **Exhibit 4.6**. The six types of organizational structures discussed here include functional, divisional, geographic, matrix, networked/team, and virtual.[24]

The functional structure, shown in **Exhibit 4.7**, is among the earliest and most used organizational designs. This structure is organized by departments and expertise areas, such as R&D (research & development), production, accounting, and human resources. Functional organizations are referred to as pyramid structures since they are governed as a hierarchical, top-down control system.

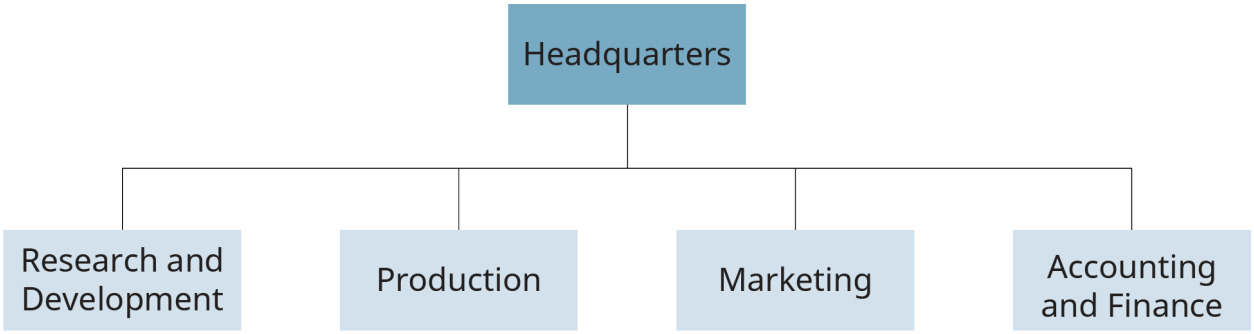

Exhibit 4.7 Functional Structure (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

Small companies, start-ups, and organizations working in simple, stable environments use this structure, as do many large government organizations and divisions of large companies for certain tasks.

The functional structure excels in providing for a high degree of specialization and a simple and straightforward reporting system within departments, offers economies of scale, and is not difficult to scale if and when the organization grows. Disadvantages of this structure include isolation of departments from each other since they tend to form "silos," which are characterized by closed mindsets that are not open to communicating across departments, lack of quick decision-making and coordination of tasks across departments, and competition for power and resources.

Divisional structures, see **Exhibit 4.8**, are, in effect, many functional departments grouped under a division head. Each functional group in a division has its own marketing, sales, accounting, manufacturing, and production team. This structure resembles a product structure that also has profit centers. These smaller

functional areas or departments can also be grouped by different markets, geographies, products, services, or other whatever is required by the company's business. The market-based structure is ideal for an organization that has products or services that are unique to specific market segments and is particularly effective if that organization has advanced knowledge of those segments.

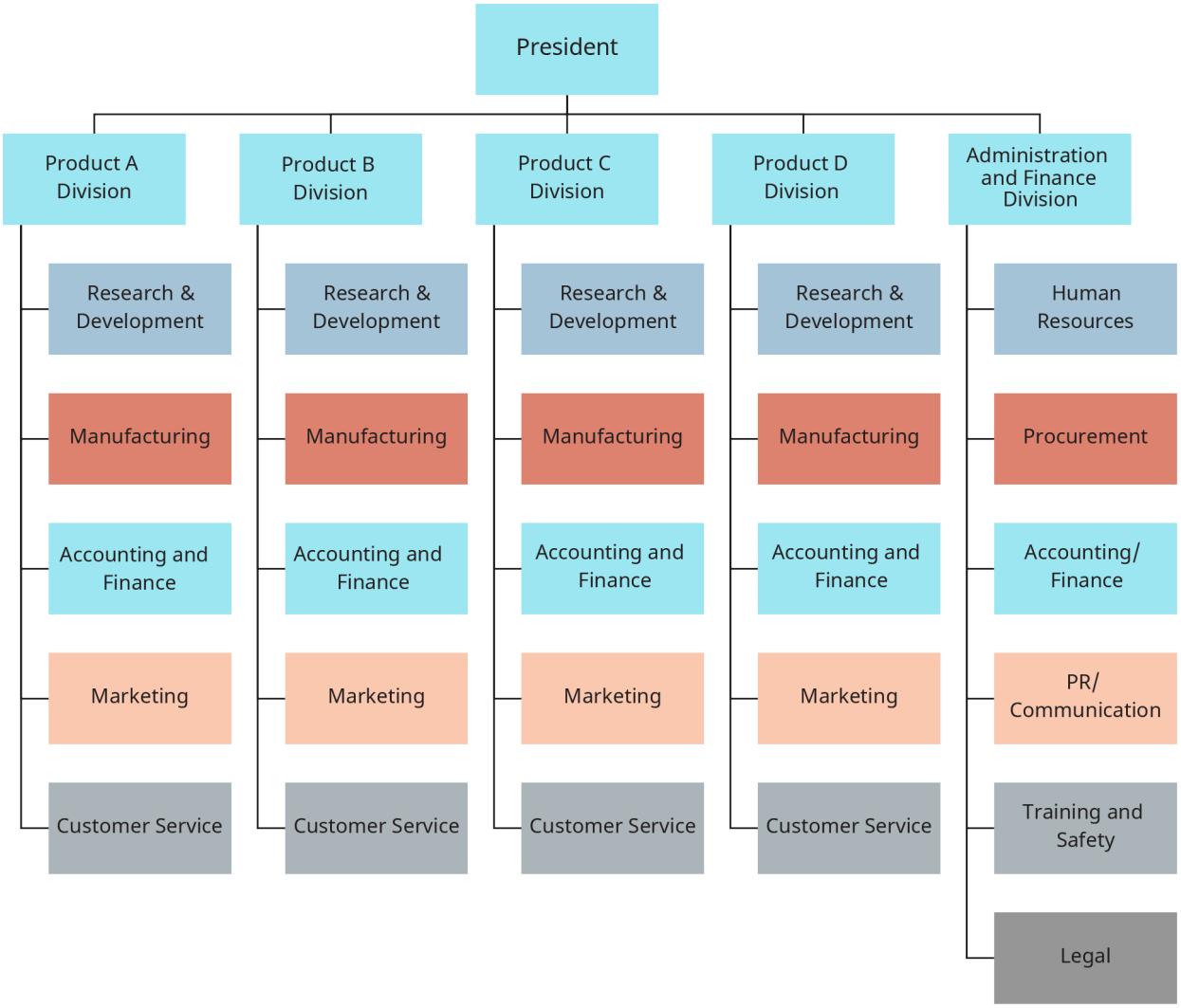

Exhibit 4.8 Divisional Organization Structure (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

The advantages of a divisional structure include the following: each specialty area can be more focused on the business segment and budget that it manages; everyone can more easily know their responsibilities and accountability expectations; customer contact and service can be quicker; and coordination within a divisional grouping is easier, since all the functions are accessible. The divisional structure is also helpful for large companies since decentralized decision-making means that headquarters does not have to micromanage all the divisions. The disadvantages of this structure from a headquarters perspective are that divisions can easily become isolated and insular from one another and that different systems, such as accounting, finance, sales, and so on, may suffer from poor and infrequent communication and coordination of enterprise mission, direction, and values. Moreover, incompatibility of systems (technology, accounting, advertising, budgets) can occur, which creates a strain on company strategic goals and objectives.

A **geographic structure**, Exhibit 4.9, is another option aimed at moving from a mechanistic to more organic design to serve customers faster and with relevant products and services; as such, this structure is organized by locations of customers that a company serves. This structure evolved as companies became more national, international, and global. Geographic structures resemble and are extensions of the divisional structure.

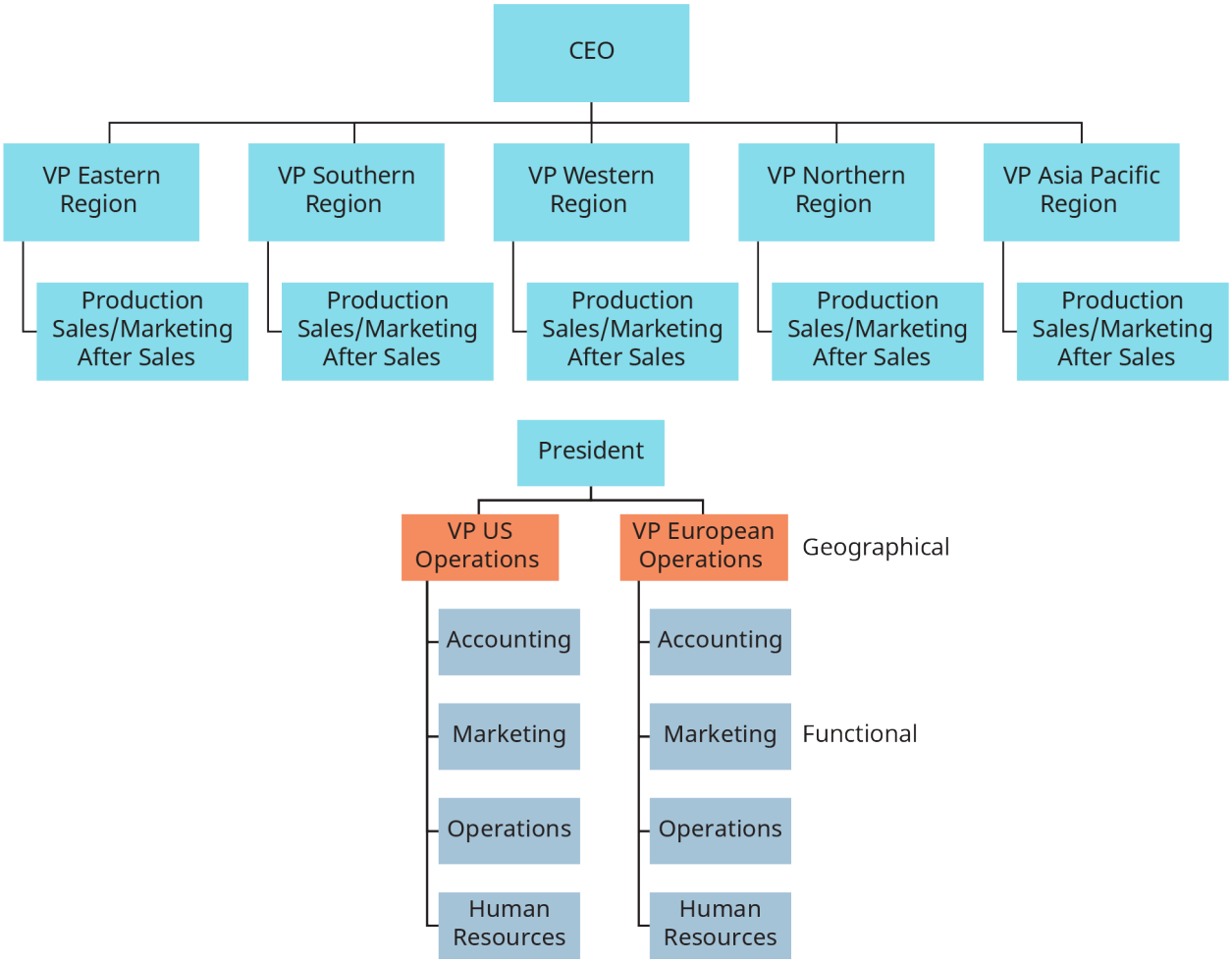

Exhibit 4.9 Geographic Structure (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

Organizing geographically enables each geographic organizational unit (like a division) the ability to understand, research, and design products and/or services with the knowledge of customer needs, tastes, and cultural differences. The advantages and disadvantages of the geographic structure are similar to those of the divisional structure. Headquarters must ensure effective coordination and control over each somewhat autonomous geographically self-contained structure.

The main downside of a geographical organizational structure is that it can be easy for decision-making to become decentralized, as geographic divisions (which can be hundreds if not thousands of miles away from corporate headquarters) often have a great deal of autonomy.



Exhibit 4.10 IBM China IBM has chosen a geographic structure which is aimed at moving from a mechanistic to more organic

design to serve customers faster and with relevant products and services; as such, this structure is organized by locations of customers that a company serves. This structure evolved as companies became more national, international, and global. Geographic structures resemble and are extensions of the divisional structure. (Credit: Cory Denton/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))

Matrix structures, illustrated in Exhibit 4.6 and depicted in Exhibit 4.11, move closer to organic systems in an attempt to respond to environmental uncertainty, complexity, and instability. The matrix structure actually originated at a time in the 1960s when U.S. aerospace firms contracted with the government. Aerospace firms were required to "develop charts showing the structure of the project management team that would be executing the contract and how this team was related to the overall management structure of the organization." As such, employees would be required to have dual reporting relationships—with the government and the aerospace company.[25] Since that time, this structure has been imitated and used by other industries and companies since it provides flexibility and helps integrate decision-making in functionally organized companies.

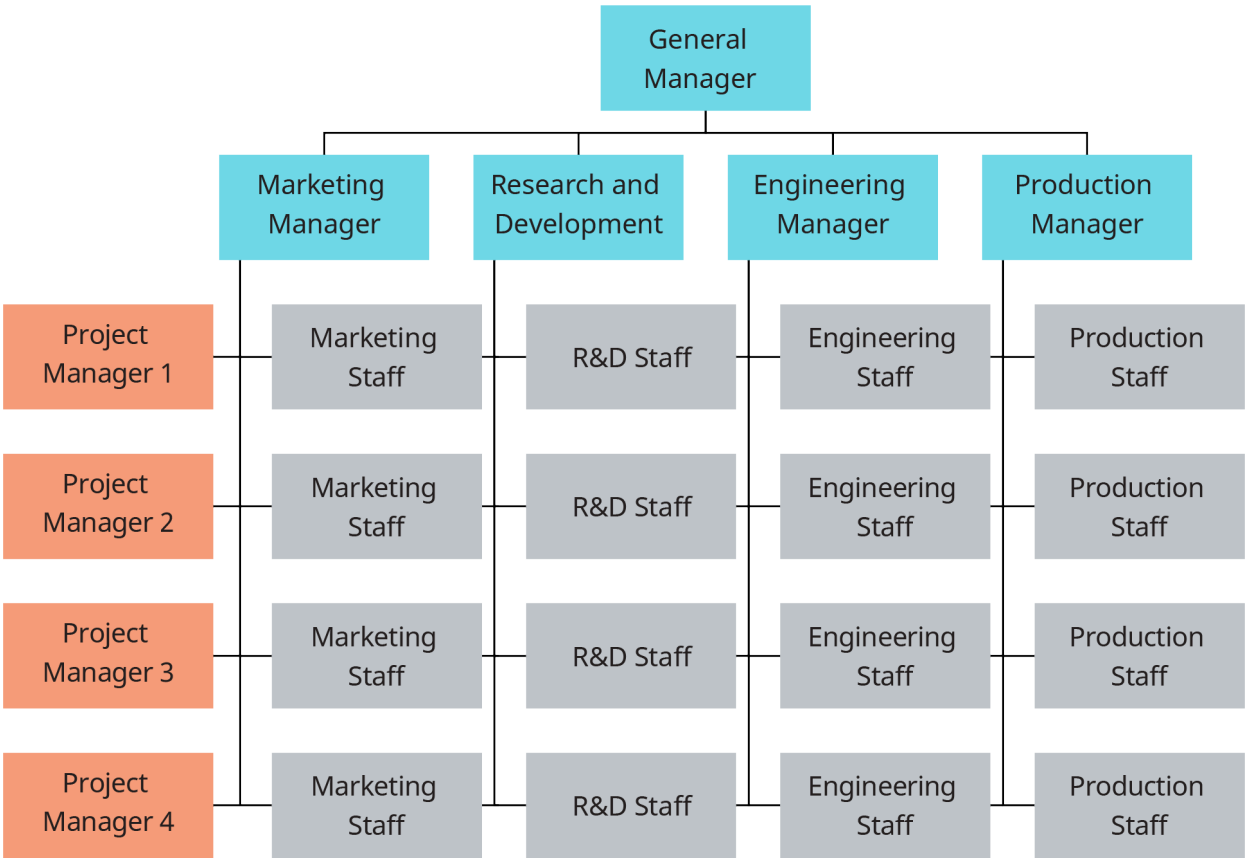

Exhibit 4.11 Matrix Structure (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

Matrix designs use teams to combine vertical with horizontal structures. The traditional functional or vertical structure and chain of command maintains control over employees who work on teams that cut across functional areas, creating horizontal coordination that focuses projects that have deadlines and goals to meet within and often times in addition to those of departments. In effect, matrix structures initiated horizontal team-based structures that provided faster information sharing, coordination, and integration between the formal organization and profit-oriented projects and programs.

As Exhibit 4.11 illustrates, this structure has lines of formal authority along two dimensions: employees report to a functional, departmental boss and simultaneously to a product or project team boss. One of the weaknesses of matrix structures is the confusion and conflicts employees experience in reporting to two bosses. To work effectively, employees (including their bosses and project leaders) who work in dual-authority matrix structures require good interpersonal communication, conflict management, and political skills to manage up and down the organization.

Different types of matrix structures, some resembling virtual team designs, are used in more complex environments.[26] For example, there are cross-functional matrix teams in which team members from other organizational departments report to an "activity leader" who is not their formal supervisor or boss. There are also functional matrix teams where employees from the same department coordinate across another internal matrix team consisting of, for example, HR or other functional area specialists, who come together to develop a limited but focused common short-term goal. There are also global matrix teams consisting of employees from different regions, countries, time zones, and cultures who are assembled to achieve a short-term project goal of a particular customer. Matrix team members have been and are a growing part of horizontal organizations that cut across geographies, time zones, skills, and traditional authority structures to solve customer and even enterprise organizational needs and demands.

As part of the next discussed organizational type of structure, networked teams, organizational members in matrix structures must "learn how to collaborate with colleagues across distance, cultures and other barriers. Matrix team members often suffer from the problem of divided loyalties where they have both team and functional goals that compete for their time and attention, they have multiple bosses and often work on multiple teams at the same time. For some matrix team members this may be the first time they have been given accountability for results that are broader than delivery of their functional goals. Some individuals relish the breath and development that the matrix team offers and others feel exposed and out of control." To succeed in these types of horizontal organizational structures, organizational members "should focus less on the structure and more on behaviors."[27]

Networked team structures are another form of the horizontal organization. Moving beyond the matrix structure, networked teams are more informal and flexible. "[N]etworks have two salient characteristics: clustering and path length. Clustering refers to the degree to which a network is made up of tightly knit groups while path lengths is a measure of distance—the average number of links separating any two nodes in the network."[28] A more technical explanation can be found in this footnote source.[29] For our purposes here, a networked organizational structure is one that naturally forms after being initially assigned. Based on the vision, mission, and needs of a problem or opportunity, team members will find others who can help—if the larger organization and leaders do not prevent or obstruct that process.

There is not one classical depiction of this structure, since different companies initially design teams to solve problems, find opportunities, and discover resources to do so. Stated another way, "The networked organization is one that is connected together by informal networks and the demands of the task, rather than a formal organizational structure. The network organization prioritizes its 'soft structure' of relationships, networks, teams, groups and communities rather than reporting lines."[30] **Exhibit 4.12** is a suggested illustration of this structure.

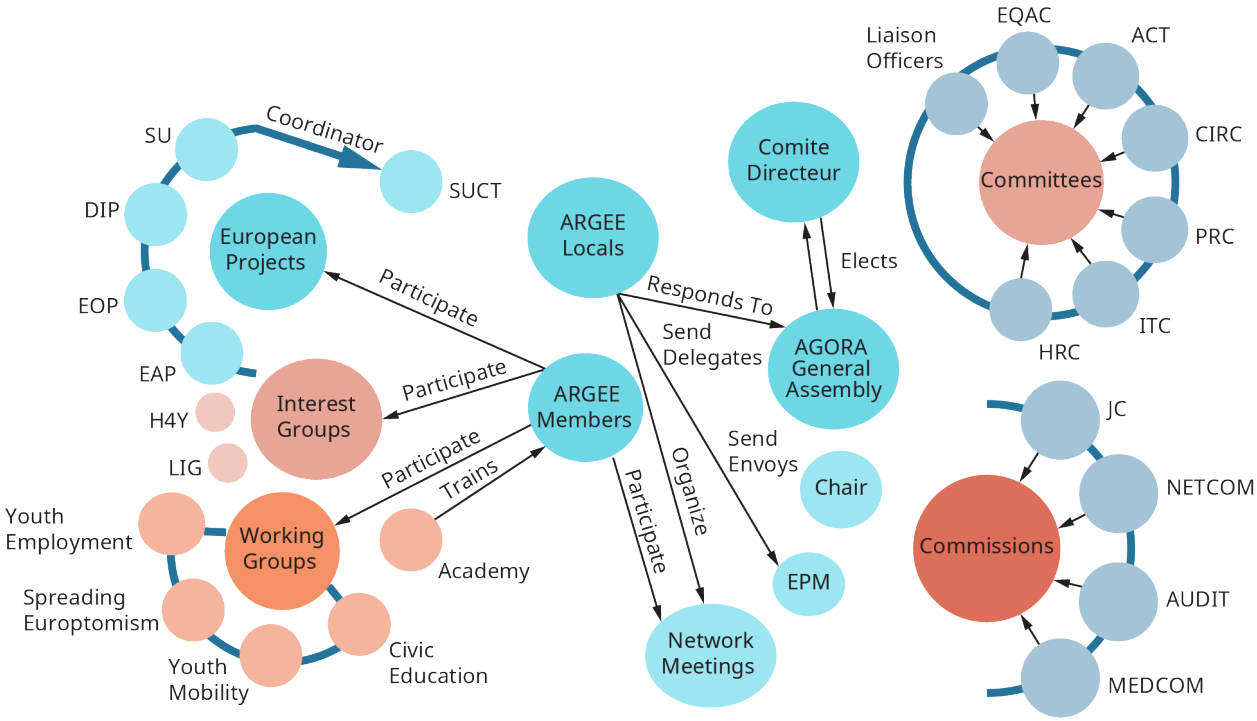

Exhibit 4.12 Networked Team Structure (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

A Deloitte source based on the 2017 Global Human Capital Trend study stated that as organizations continue to transition from vertical structures to more organic ones, networked global designs are being adapted to larger companies that require more reach and scope and quicker response time with customers: "Research shows that we spend two orders of magnitude more time with people near our desk than with those more than 50 meters away. Whatever a hierarchical organization chart says, real, day-to-day work gets done in networks. This is why the organization of the future is a 'network of teams.'"[31]

Advantages of networked organizations are similar to those stated earlier with regard to organic, horizontal, and matrix structures. Weaknesses of the networked structure include the following: (1) Establishing clear lines of communication to produce project assignments and due dates to employees is needed. (2) Dependence on technology—Internet connections and phone lines in particular—is necessary. Delays in communication result from computer crashes, network traffic errors and problems; electronic information sharing across country borders can also be difficult. (3) Not having a central physical location where all employees work, or can assemble occasionally to have face-to-face meetings and check results, can result in errors, strained relationships, and lack of on-time project deliverables.[32]

Virtual structures and organizations emerged in the 1990s as a response to requiring more flexibility, solution-based tasks on demand, fewer geographical constraints, and accessibility to dispersed expertise.[33] Virtual structures are depicted in **Exhibit 4.13**. Related to so-called modular and digital organizations, virtual structures are dependent on information communication technologies (ICTs).

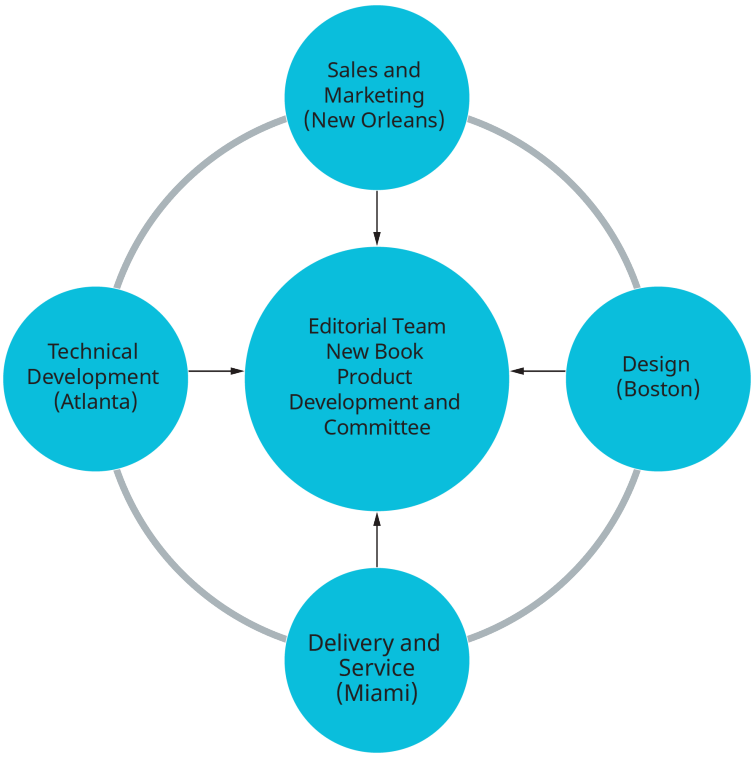

Exhibit 4.13 Virtual Structure (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

These organizations move beyond network team structures in that the headquarters or home base may be the only or part of part of a stable organizational base. Otherwise, this is a "boundaryless organization." Examples of organizations that use virtual teams are Uber, Airbnb, Amazon, Reebok, Nike, Puma, and Dell. Increasingly, organizations are using different variations of virtual structures with call centers and other outsourced tasks, positions, and even projects.



Exhibit 4.14 Using Technological Disruption Information technologies and social media powered by the internet and used by sharing economy companies such as Airbnb and Uber have democratized and increased, if not leveled, competition across several industries such taxis, real estate rentals, and hospitality services. (Credit: Grid Engine/ flickr/ Attribution 2.0 Generic (CC BY 2.0))

Advantages of virtual teams and organizations include cost savings, decreased response time to customers, greater access to a diverse labor force not encumbered by 8-hour workdays, and less harmful effects on the environment. "The telecommuting policies of Dell, Aetna, and Xerox cumulatively saved 95,294 metric tons of greenhouse gas emissions last year, which is the equivalent of taking 20,000 passenger vehicles off of the road."[34] Disadvantages are social isolation of employees who work virtually, potential for lack of trust among

employees and between the company and employees when communication is limited, and reduced collaboration among separated employees and the organization's officers due to lack of social interaction.

In the following section, we turn to internal organizational dimensions that complement structure and are affected by and affect external environments.

CONCEPT CHECK

1. Why does the matrix structure have a dual chain of command?
2. How does a matrix structure increase power struggles or reduce accountability?
3. What are the advantages of committees?

4.4 The Internal Organization and External Environments

4. Explain how organizations organize to meet external market threats and opportunities.

At a basic level of understanding how internal organizations respond to environments, consider the theory of Open Systems, which the organizational theorists Katz and Kahn[35] and Bertalanffy introduced.[36]

Exhibit 4.15 illustrates this theory's view of organizations as open systems that take in resources and raw materials at the "input" phase from the environment in a number of forms, depending on the nature of the organization, industry, and its business. Whatever the input resource, (information, raw materials, students entering a university), those resources will be transformed by the internal processes of the organization. The internal organizational systems then process and transform the input material, which is called "through-put" phase, and move the changed material (resources) to the "outputs" and back into the environment as products, services, graduates, etc.

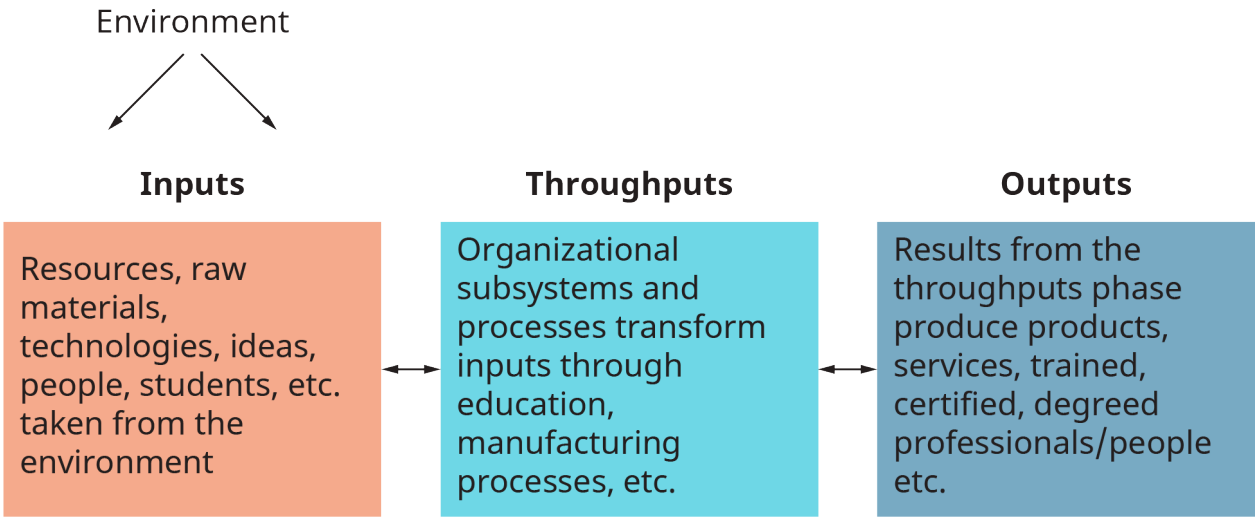

Exhibit 4.15 Open System Model of an Organization (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

The open systems model serves as a feedback loop continually taking in resources from the environment, processing and transforming them into outputs that are returned to the environment. This model explains organizational survival that emphasizes long-term goals.

Organizations according to this theory are considered as either Open or Closed systems, (or relatively opened or closed) depending on the organization's sensitivity to the environment. Closed systems are less sensitive to environmental resources and possibilities, and open systems are more responsive and adaptive to

environmental changes. For example, during the 1980's the then Big 3 U.S. auto manufacturers (Ford, General Motors and Chrysler) were pressured by Japanese auto manufacturers' successful 4-cylinder car sales that hit the U.S. like a shock wave. The Detroit producers experienced slumping sales, plant closures, and employee lay-offs in response to the Japanese wave of competition. It seemed that the U.S. auto makers had become closed or at least insensitive to changing trends in cars during that time and were unwilling to change manufacturing processes. Similarly, Amazon's business model, discussed earlier, has and continues to pressure retailers to innovate and change processes and practices to compete in this digital era.

Organizations respond to external environments not only through their structures, but also by the domains they choose and the internal dimensions and capabilities they select. An organization defines itself and its niche in an environment by the choice of its **domain**, i.e., what sector or field of the environment it will use its technology, products, and services to compete in and serve. Some of the major sectors of a task environment include marketing, technology, government, financial resources, and human resources.

Presently, several environmental domains that once were considered stable have become more complex and unstable—e.g., toys, public utilities, the U.S. Postal Service, and higher education. And even domains are changing. For example, as referred to earlier, the traditionally stable and somewhat unchanging domain of higher education has become more complex with the entry of for-profit educational institutions, MOOCs (massive open online courses), internal company "universities," and other certification and degree programs outside traditional private institutions. Sharing-economy companies such as Uber and Airbnb have redefined the transportation domain in which taxis operate and the hospitality domain in which hotels and bed and breakfasts serve. New business models that use mobile phones, ICTs (information communication technologies), and apps remove middle management layers in traditional organizations and structures.

With a chosen domain in which to operate, owners and leaders must organize internal dimensions to compete in and serve their markets. For example, hierarchies of authority and chain of command are used by owners and top-level leaders to develop and implement strategic and enterprise decisions; managers are required to provide technologies, training, accounting, legal, and other infrastructure resources; and cultures still count to establish and maintain norms, relationships, legal and ethical practices, and the reputation of organizations.



Exhibit 4.16 Internal Organization (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

Exhibit 4.16 shows internal organizational dimensions. These dimensions and systems include leadership, strategy, culture, management, goals, marketing, operations, and structure. Relationships, norms, and politics are also included in the informal organization. There are other internal functions not listed here, such as research and development, accounting and finance, production, and human resources. Another popular depiction of internal organizational dimensions is the **McKinsey 7-S model**, shown in Exhibit 4.17. Similarly, *strategy, structure, systems, skills, staff*, and style all revolve around and are interconnected with *shared values* (or culture) in an organization.

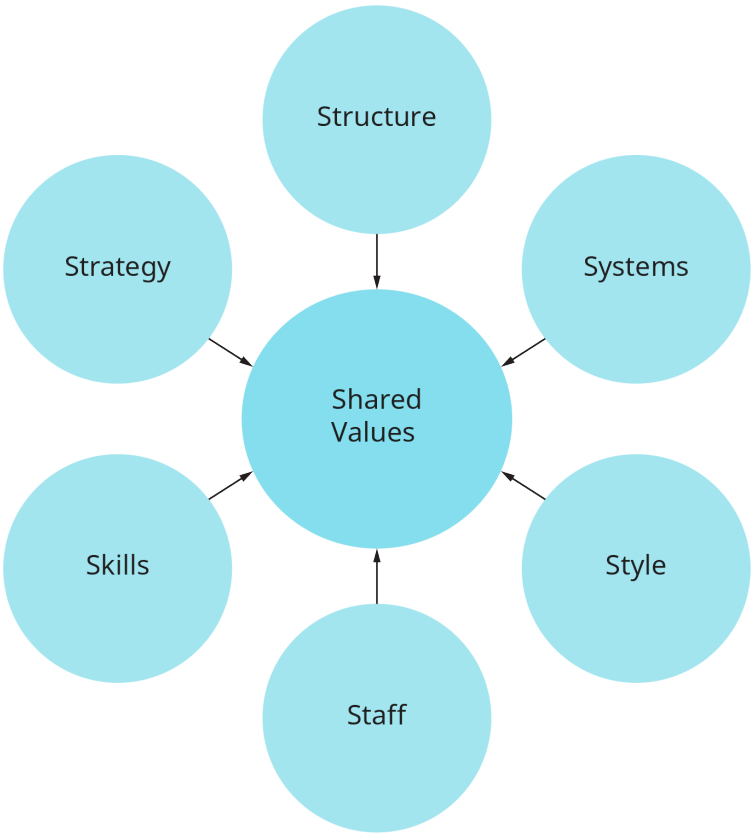

Exhibit 4.17 The McKinsey 7-S Model (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

A unifying framework shown in **Exhibit 4.18**, developed by Arie Lewin and Carroll Stephens,[37] illustrates the integration of internal organizational dimensions and how these work in practice to align with the external environment. Note that it is the CEO and other top-level leaders who scan the external environment to identify uncertainties and resources before using a SWOT analysis (identifying strengths, weaknesses, opportunities, and threats) to confirm and update the domain of an organization and then to define the vision, mission, goals, and strategies. Once the enterprise goals and strategies are developed, the organizational culture, structure, and other systems and policies can be established (human resources, technologies, accounting and finance, and so on).

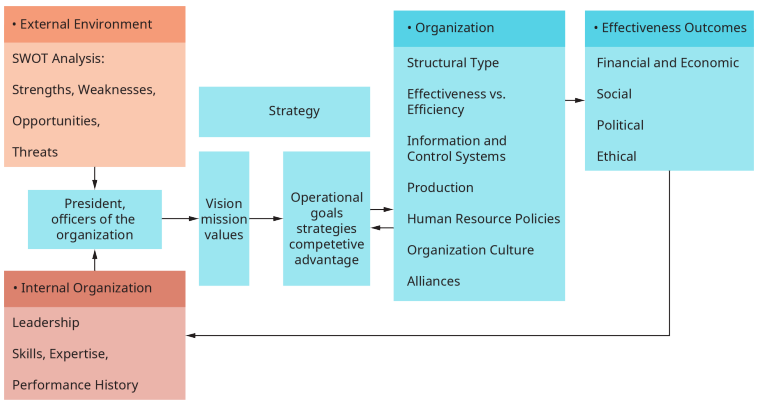

Exhibit 4.18 The Internal Organization and External Environment (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

As **Exhibit 4.18** shows, after a CEO and the top-level team identify opportunities and threats in the environment, they then determine the domain and purpose of the organization from which strategies, organizational capabilities, resources, and management systems must be mobilized to support the enterprise's purpose.[38] The company McDonald's has, for example, successfully aligned its enterprise with the

global environments it serves, which is "1% of the world's population—more than 70 million customers—every day and in virtually every country across the world." The major operating goal of the firm driving its internal alignment is a "fanatical attention to the design and management of scalable processes, routines, and a working culture by which simple, stand-alone, and standardized products are sold globally at a predictable, and therefore manageable, volume, quality, and cost."[39] A more detailed SWOT analysis of McDonald's operations can be found in endnote.



Exhibit 4.19 McDonald's Processes McDonalds, major operating goal of the firm driving its internal alignment is a "Fanatical attention to the design and management of scalable processes, routines, and a working culture by which simple, stand-alone, and standardized products are sold globally at a predictable, and therefore manageable, volume, quality, and cost." Here employees are reminded of the time that the ingredients should stay on a secondary shelf. (Credit: Walter Lim/ flickr/ Attribution 2.0 Generic (CC BY 2.0))

In practice, no internal organizational alignment with its external environment is perfect or permanent. Quite the opposite. Companies and organizations change leadership and strategies and make structural and systems changes to meet changing competition, market forces, and customers and end users' needs and demands. Even Amazon continues to develop, expand, and change. With a mission statement as bold and broad as Amazon's, change is a constant: "Our vision is to be earth's most customer-centric company; to build a place where people can come to find and discover anything they might want to buy online" (Amazon.com, Apr 15, 2018).

Amazon has a functional organizational structure that focuses on business functions for determining the interactions among the different parts of the company. Amazon's corporate structure is best characterized as global function-based groups (most significant feature), a global hierarchy, and geographic divisions, as **Exhibit 4.20** shows. This structure seems to fit with the size of Amazon's business—43% of 2016 retail sales were in the United States.[40] Seven segments, including information technology, human resources and legal operations, and heads of segments, report to Amazon's CEO. "Senior management team include two CEOs, three Senior Vice Presidents and one Worldwide Controller, who are responsible for various vital aspects of the business reporting directly to Amazon CEO Jeff Bezos." [41] The strategic goal underlying this structure is to facilitate Amazon.com to successfully implement e-commerce operations management throughout the entire organization.[42]

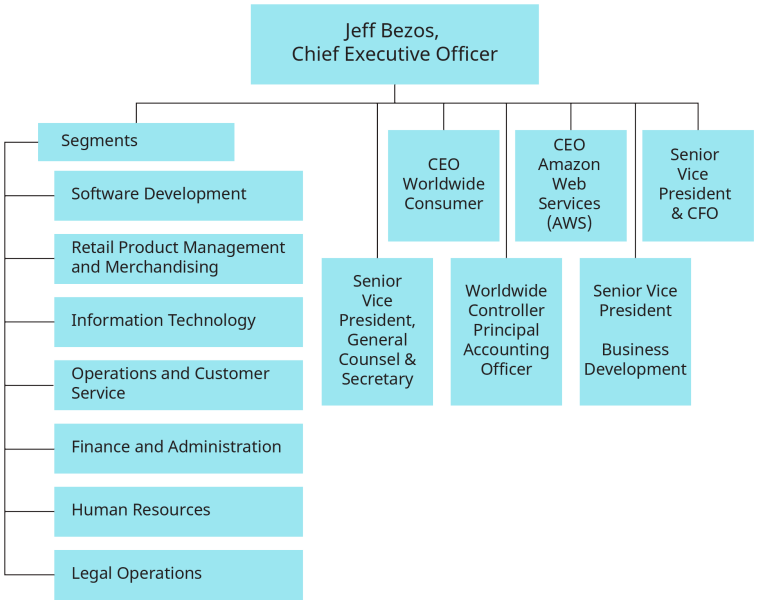

Exhibit 4.20 Amazon's Corporate Structure (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

Despite the company's exponential growth and success to date, as noted earlier in the section on organizational structures, a disadvantage of structures such as Amazon's, and in this case Amazon's, is that it has limited flexibility and responsiveness even with its current growth. "The dominance of the global function-based groups and global hierarchy characteristics reduces the capacity of Amazon to rapidly respond to new issues and problems encountered in the e-commerce business."[43] Still, Amazon's most outstanding success factor remains its CEO, Jeff Bezos—his ingenuity, vision and foresight, and ability to sustain and even extend the company's competitive advantages. Amazon customers value these factors—customer purchase criteria (CPC) that include price, fast delivery, and reliable service. "Consumers choose Amazon because it does better than its competition on these CPC."[44]

CONCEPT CHECK

1. Identify the six major organizational structures.
2. Explain the McKinsey 7-S model.

4.5 Corporate Cultures

5. Identify the fit between organizational cultures and the external environment

Organizational culture is considered one of the most important **internal dimensions of an organization**'s effectiveness criteria. Peter Drucker, an influential management guru, once stated, "Culture eats strategy for breakfast."[45] He meant that **corporate culture** is more influential than strategy in terms of motivating employees' beliefs, behaviors, relationships, and ways they work since culture is based on values. Strategy and other **internal dimensions of organization** are also very important, but organizational culture serves two crucial purposes: first, culture helps an organization adapt to and integrate with its external environment by adopting the right values to respond to external threats and opportunities; and secondly, culture creates internal unity by bringing members together so they work more cohesively to achieve common goals.[46]Culture is both the personality and glue that binds an organization. It is also important to note that organizational cultures are generally framed and influenced by the top-level leader or founder. This individual's vision, values, and mission set the "tone at the top," which influences both the ethics and legal foundations,

modeling how other officers and employees work and behave. A framework used to study how an organization and its culture fit with the environment is offered in the Competing Values Framework.

The **Competing Values Framework** (CVF) is one of the most cited and tested models for diagnosing an organization's cultural effectiveness and examining its fit with its environment. The CVF, shown in **Exhibit 4.21**, has been tested for over 30 years; the effectiveness criteria offered in the framework were discovered to have made a difference in identifying organizational cultures that fit with particular characteristics of external environments.[47]

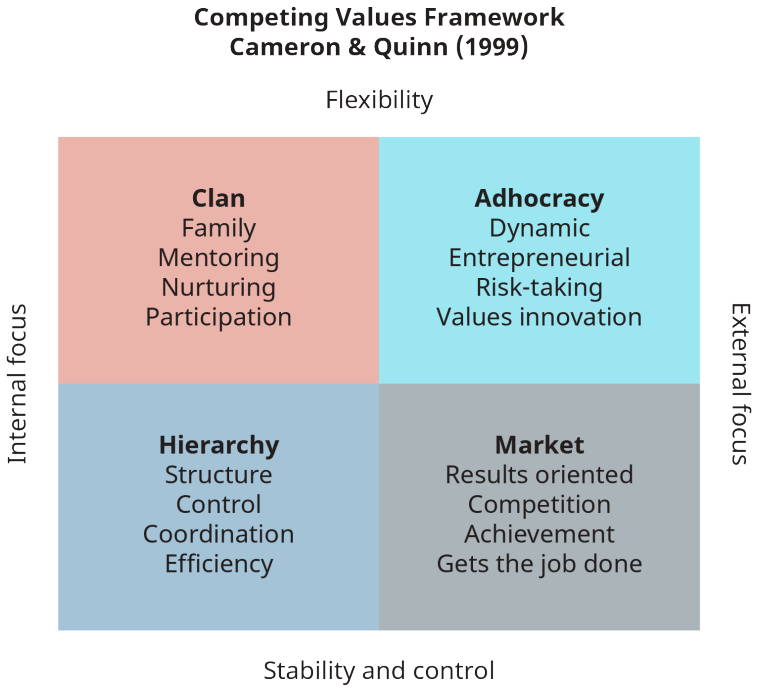

Exhibit 4.21 The Competing Values Framework Source: Adapted from K. Cameron and R. Quinn, 1999. Diagnosing and Changing Organizational Culture, Addison-Wesley, p. 32.

The two axes in the framework, external focus versus internal focus, indicate whether or not the organization's culture is externally or internally oriented. The other two axes, flexibility versus stability and control, determine whether a culture functions better in a stable, controlled environment or a flexible, fast-paced environment. Combining the axes offers four cultural types: (1) the dynamic, entrepreneurial **Adhocracy Culture**—an external focus with a flexibility orientation; (2) the people-oriented, friendly **Clan Culture**—an internal focus with a flexibility orientation; (3) the process-oriented, structured **Hierarchy Culture**—an internal focus with a stability/control orientation; and (4) the results-oriented, competitive **Market Culture**—an external focus with a stability/control orientation.

The orientation of each of these cultural types is summarized as follows. The **Adhocracy Culture** profile of an organization emphasizes creating, innovating, visioning the future, managing change, risk-taking, rule-breaking, experimentation, entrepreneurship, and uncertainty. This profile culture is often found in such fast-paced industries as filming, consulting, space flight, and software development. Facebook and Google's cultures also match these characteristics.[48] It should be noted, however, that larger organizations may have different cultures for different groupings of professionals, even though the larger culture is still dominant. For example, a different subculture may evolve for hourly workers as compared to PhD research scientists in an organization.

The **Clan Culture** type focuses on relationships, team building, commitment, empowering human development, engagement, mentoring, and coaching. Organizations that focus on human development, human resources, team building, and mentoring would fit this profile. This type of culture fits Tom's of Maine, which has strived to form respectful relationships with employees, customers, suppliers, and the physical

environment.

The **Hierarchy Culture** emphasizes efficiency, process and cost control, organizational improvement, technical expertise, precision, problem solving, elimination of errors, logical, cautious and conservative, management and operational analysis, and careful decision-making. This profile would suit a company that is bureaucratic and structured, such as the U.S. Postal Service, the military, and other similar types of government agencies.

The **Market Culture** focuses on delivering value, competing, delivering shareholder value, goal achievement, driving and delivering results, speedy decisions, hard driving through barriers, directive, commanding, and getting things done. This profile suits a marketing-and-sales-oriented company that works on planning and forecasting but also getting products and services to market and sold. Oracle under the dominating, hard-charging executive chairman Larry Ellison characterized this cultural fit.

Amazon illustrates a company that can have a mix of cultures and be effective. For example, Amazon blends a high-performance Adhocracy Culture with regard to its external expansion and Bezos's leadership style; at the same time, Amazon resembles a Hierarchy Culture internally with regard to its tight control over employees at lower levels. The company propelled its domain from an "online bookstore" "to selling everything online to being the pioneering in adopting cloud computing with AWS . . . to adopting the latest robotics in its warehouses to improve productivity . . . to thinking and testing disruptive technologies like drones and so on."[49] It has been criticized, at the same time, for its "toxic cut-throat work environment," asserting that Jeff Bezos is overly demanding and sets very high standards for Amazon employees, as well as for himself. This type of culture extends down to the warehouse employees. Amazon employees have complained that "Work came first, life came second, and trying to find the balance came last." This criticism peaked with an alleged suicide attempt in 2017 of a disgruntled employee who requested a transfer to a different department within in the company but was placed on an employee improvement plan—"a step that could result in his termination from Amazon if his performance didn't improve."[50] Amazon has since changed many of its working rules and regulations for warehouse employees.

CONCEPT CHECK

1. How can employee diversity give a company a competitive advantage?
2. Explain the concept of hiring for fit as it relates to corporate culture.
3. What are some organizational issues that must be addressed when two large firms merge or grow rapidly like Amazon?

4.6 Organizing for Change in the 21st Century

6. Identify environmental trends, demands, and opportunities facing organizations.

The 2018 annual Global Risks Perception Survey (GRPS) predicts the following trends in the external environment: (1) persistent inequality and unfairness, (2) domestic and international political tensions, (3) environmental dangers, and (4) cyber vulnerabilities. With this context, authors in this report suggest that complex organizations approach their futures with the "nine resilience lens"—i.e., the capacity of a company or other organization to adapt and prosper in the face of high-impact, low-probability risks.[51] The nine lenses are grouped into three categories. First, structural resilience considers the systemic dynamics within the organization itself. The author calls for "system modularity," i.e., structures and designs that are "loosely coupled," which is another way of saying that rigid, mechanistic hierarchies will not function as well in these high-impact environments. Secondly, integrative resilience underlines complex interconnections with the external context. Here the author suggests that organizations must be part of and aware of their contexts: geographically and the health of "individuals, families, neighborhoods, cities, provinces, and countries" that

are affected. Relatedly, the author notes that organizations must rely on their social cohesion—such as the social capital an organization has to fall back on in times of crisis—which is a strong source of resilience. Third, transformative resilience requires that mitigating some risks requires transformation. Important to organizations here is the need "to proactively change or it will end up being changed by external circumstances." This process requires organizational foresight, not forecasting. Organizations need to apply different search, environmental scanning, and new discovery techniques "to engage with the uncertainty of multiple futures." They do this through innovation and experimentation. In practice, Google, Amazon, Facebook, SpaceX, Tesla, Airbnb, Uber, and the resilience of other industry and organizational pioneering will be required.

Another trend on the horizon is that "[o]rganizations are no longer judged only for their financial performance, or even the quality of their products or services. Rather, they are being evaluated on the basis of their impact on society at large—transforming them from business enterprises into social enterprises."[52] A recent survey showed that 65 percent of CEOs rated "inclusive growth" as a "top-three strategic concern, more than three times greater than the proportion citing 'shareholder value.'"[53] Deloitte researchers noted that "[a] social enterprise is an organization whose mission combines revenue growth and profit-making with the need to respect and support its environment and stakeholder network. This includes listening to, investing in, and actively managing the trends that are shaping today's world. It is an organization that shoulders its responsibility to be a good citizen (both inside and outside the organization), serving as a role model for its peers and promoting a high degree of collaboration at every level of the organization."[54]

Key Terms

Adhocracy culture Creates an environment of innovating, visioning the future, accepting of managing change, and risk taking, rule-breaking, experimentation, entrepreneurship, and uncertainty.

Clan culture Focuses on relationships, team building, commitment, empowering human development, engagement, mentoring, and coaching.

Competing Values Framework Developed by Kim Cameron and Robert Quinn this model is used for diagnosing an organization's cultural effectiveness and examining its fit with its environment.

Complex-Stable environments Environments that have a large number of external elements, and elements are dissimilar and where elements remain the same or change slowly.

Complex-Unstable environments Environments that have a large number of external elements, and elements are dissimilar and where elements change frequently and unpredictably

Corporate culture Defines how motivating employees' beliefs, behaviors, relationships, and ways they work creates a culture that is based on the values the organization believes in.

Divisional structure An organizational structure characterized by functional departments grouped under a division head.

Domain The purpose of the organization from which its strategies, organizational capabilities, resources, and management systems are mobilized to support the enterprise's purpose.

Functional structure The earliest and most used organizational designs.

Geographic structure An Organizational option aimed at moving from a mechanistic to more organic design to serve customers faster and with relevant products and services; as such, this structure is organized by locations of customers that a company serves.

Government and political environment forces The global economy and changing political actions increase uncertainty for businesses, while creating opportunities for some industries and instability in others.

Hierarchy culture Emphasizes efficiency, process and cost control, organizational improvement, technical expertise, precision, problem solving, elimination of errors, logical, cautious and conservative, management and operational analysis, careful decision making.

Horizontal organizational structures A "flatter" organizational structure often found in matrix organizations where individuals relish the breath and development that their team offers.

Internal dimensions of organizations How an organization's culture affects and influences its strategy.

Market culture Focuses on delivering value, competing, delivering shareholder value, goal achievement, driving and delivering results, speedy decisions, hard driving through barriers, directive, commanding, competing and getting things done.

Matrix structure An organizational structure close in approach to organic systems that attempt to respond to environmental uncertainty, complexity, and instability.

McKinsey 7-S model A popular depiction of internal organizational dimensions.

Mechanistic organizational structures Best suited for environments that range from stable and simple to low-moderate uncertainty and have a formal "pyramid' structure.

Natural disaster and human induced environmental problems Events such as high-impact hurricanes, extreme temperatures and the rise in CO2 emissions as well as 'man-made' environmental disasters such as water and food crises; biodiversity loss and ecosystem collapse; large-scale involuntary migration are a force that affects organizations.

Networked-team structure A form of the horizontal organization.

Organic organizational structures The opposite of a functional organizational form that works best in unstable, complex changing environments.

Organizational structures A broad term that covers both mechanistic and organic organizational structures.

Simple-Stable environments Environments that have a small number of external elements, and elements are similar, and the elements remain the same or change slowly.

Simple-Unstable environments Environments that have a small number of external elements, and elements are similar and where elements change frequently and unpredictably.

Socio-cultural environment forces Include different generations' values, beliefs, attitudes and habits, customs and traditions, habits and lifestyles.

Technological forces Environmental influence on organizations where speed, price, service, and quality of products and services are dimensions of organizations' competitive advantage in this era.

Virtual structure A recent organizational structure that has emerged in the 1990's and early 2000's as a response to requiring more flexibility, solution based tasks on demand, less geographical constraints, and accessibility to dispersed expertise.

Summary of Learning Outcomes

4.1 The Organization's External Environment

1. Define the external environment of organizations

Organizations must react and adapt to many forces in their internal and external environments. The context of the firms such as size and geographic location impact how environmental forces affect each organization differently. An understanding of the forces and they currently affecting organizations and pressuring structural change is crucial.

4.2 External Environments and Industries

2. Identify contemporary external forces pressuring organizations

An understanding of the various industries and organizations 'fit' with different types of environment in crucial. There are small and large organizations that face environments that are either stable of unstable and managing the organization by recognizing their environment is a crucial skill.

4.3 Organizational Designs and Structures

3. Identify different types of organizational structures, and their strengths and weaknesses

An understanding of Mechanistic vs Organic Structures and Systems and how they differ and how these major concepts help classify different organizational structures is crucial to recognizing organizational structures. Finally, the issue of organizational complexity and its impact on organizational structure needs to be understood.

You should be able to discuss the evolution of different types of Organizational Structures. You should understand and identify the six types of organizational structures, and the advantages and disadvantages of each: Functional, Divisional, Matrix, Geographic, Networked Team, and Virtual.

4.4 The Internal Organization and External Environments

4. Explain how organizations organize to meet external market threats and opportunities

You should understand and identify the six types of organizational structures, and the advantages and disadvantages of each structure:

- Functional
- Divisional
- Matrix
- Geographic
- Networked Team
- Virtual

You should also understand why the internal dimensions of an organization matter with regard to how it fits with its external environment.

4.5 Corporate Cultures

5. Identify the fit between organizational cultures and the external environment

You should be able to identify and differentiate between the four types of organizational cultures and the fit of each with the external environment and describe the CVF framework. Finally, you can identify the internal dimensions of organizations, the interconnection among the dimensions, and how these affect the 'fit' with external environments.

4.6 Organizing for Change in the 21st Century

6. Identify environmental trends, demands, and opportunities facing organizations.

Among the trends in the external environment: (1) persistent inequality and unfairness, (2) domestic and international political tensions, (3) environmental dangers, and (4) cyber vulnerabilities. Another trend is that organizations will no longer solely be judged only for their financial performance, or even the quality of their products or services. Rather, they will be evaluated on the basis of their impact on society at large—transforming them from business enterprises into social enterprises.

Chapter Review Questions

1. Explain how several current environmental forces are affecting and will affect organizations and organizational structures' effectiveness and efficiency in the near future?
2. What are ways to classify and describe how industries and organizations fit and do not fit with their external environments?
3. What are a few industries and/or organizations that are fitting well with their current environments? What are a few that are not? Why?
4. What are some major differences between organic and mechanistic organizational structures and systems?
5. Which organization would you work best in, an organically or mechanistically structured one, and why?
6. What are some advantages and disadvantages of functional structures?
7. Do you think it's true that every organization has a hidden functional structure in it? Explain your answer.
8. Why have functional structures been criticized for not accommodating new changes in the environment?
9. What are some advantages and disadvantages of divisional structures?
10. How is a product structure one type of a divisional structure? Explain.
11. What are some disadvantages in working in a matrix structure and why?
12. What advantages do matrix structures have compared to functional structures?
13. What advantages do geographic structures have compared to a functional structure?
14. What are issues that working in a networked team structure present?
15. In what ways is a virtual organization and structure different from the other ones discussed in the chapter?
16. What major trends discussed at the end of this chapter are different from previous external environments and the ways organizations were organized?
17. What purposes does an organization's culture serve when considering the external environment?
18. How does **Exhibit 4.16** facilitate an understanding of how the internal organization functions with external environments?

Management Skills Application Exercises

1. You have just been assigned to lead a functionally structured organization. Explain what types of skills you would need to best perform this function.
2. What types of problems would you expect to have managing a divisionally structured organization? What skills would you need to excel in this undertaking?
3. If you were assigned to work in a matrix team structure, explain the issues and benefits you might expect

to experience and why. What skills would help you in this function?

4. .You have just been assigned to work with a strategy team in an organization to predict issues and opportunities that might be expected for the next 2 years. Using this chapter, explain what information you would provide to this team?
5. Use **Exhibit 4.21**, "The Competing Values Framework," to identify the type of organizational culture at IKEA, Home Depot, and Best Buy.

Managerial Decision Exercises

1. You are a manager working in a functionally structured organization. A disgruntled employee is complaining about problems she is having in that structure. Outline a way you would find out more about her complaints with regard to her being in this type of structure and some ways to assist her.
2. You are a manager working in a networked team structured organization. A disgruntled employee is complaining about problems he is having in that structure. Outline a way you would find out more about his complaints with regard to his being in this type of structure and some ways to assist him.
3. You have been selected to lead a team to decide on a different type of structure in your organization to better serve customers who are complaining about poor service that is slow, impersonal, and not meeting their needs to be heard. Presently, the functional structure isn't working well. Outline some information from your knowledge using this chapter that would help the team in its assignment.
4. You witness a senior executive at your firm engaging in overly aggressive methods of pressuring employees to increase their sales quotas beyond reasonable means. You are in a networked team structure that is partly a matrix. You are uncertain about whom to discuss this issue with. What would you do?
5. As a new graduate, you have been hired to help a medium-sized company come into the 21st century. Products need revamping, people aren't sharing information, and customers are gradually leaving. The firm has a traditional top-down managed, vertical hierarchy. It is believed that the firm has very good potential to sell its products, but new markets may be needed. Outline an agenda you would work on to research and make suggestions with regard to this chapter's focus and content.

Critical Thinking Case

Wells Fargo, Crisis and Scandal

The recent widespread scandal at Wells Fargo jolted and shocked the corporate world. How could such internal corrupt and outrageously illegal and unethical activities by professionals have occurred? Wells Fargo is "an American multinational financial services company headquartered in San Francisco, California" with offices nationwide and "the world's second-largest bank by market capitalization and the third largest bank in the U.S. by total assets." In September 2016 it was discovered that the company was continuing to create fake customer accounts to show positive financial activity and gains. 5,000 salespeople had created 2 million fake customer accounts to meet high-pressure internal sales goals, including a monthly report called the "Motivator."

The out-of-control sales leadership pressured sales employees to meet unrealistic, outrageous sales targets. Dramatically unrealistic sales goals propelled by continuous pressure from management coerced employees to open accounts for customers who didn't want or need them. "Some Wells Fargo bankers impersonated their customers and used false email addresses like noname@wellsfargo.com, according to a 2015 lawsuit filed by the city of Los Angeles."

The "abusive sales practices claimed in a lawsuit that Wells Fargo employees probably created 3.5 million bogus accounts" starting in May 2002. Wells Fargo is awaiting final approval to settle that case for $142 million. However, regulators and investigations found that the misconduct was far more "pervasive and persistent" than had been realized. "The bank's culture of misconduct extended well beyond the original revelations." For example, regulators found that the company was (1) "overcharging small businesses for credit card

transactions by using a 'deceptive' 63-page contract to confuse them." (2) The company also charged at least 570,000 customers for auto insurance they did not need. (3)The firm admitted that it found 20,000 customers who could have defaulted on their car loans from these bogus actions; (4) The company also had created over 3.5 million fake accounts attributed to customers who had no knowledge of such accounts.

Wells Fargo has had to testify before Congress over these charges, which have amounted to $185 million dollars, and more recently the company has been ordered by regulators to return $3.4 million to brokerage customers who were defrauded. The CEO and management team have been fired and had millions of dollars withheld from their pay.

In the aftermath of the scandal, even though Wells Fargo executives were not imprisoned for the extensive consumer abuses committed by the company, the CFPB (Consumer Financial Protection Bureau) and Office of the Comptroller of the Currency (OCC) imposed a $1 billion fine on Wells Fargo for consumer-related abuses regarding auto loan and mortgage products. The OCC also forced the company to allow regulators the authority to enforce several actions to prevent future abuses, such as and including "imposing business restrictions and making changes to executive officers or members of the bank's board of directors." The new president of the company, Tim Sloan, stated, "What we're trying to do, as we make change in the company and make improvements, is not just fix a problem, but build a better bank, transform the bank for the future."

Critical Thinking Questions

1. What happened at Wells Fargo with regard to past activities that led to this major scandal?
2. What internal dimensions of the company were part of the problems that occurred?
3. How might the organizational structure of the company have been part of the problems that occurred?
4. . Identify and use relevant concepts from this chapter as well as your own thoughts and analysis to diagnose the scandal at Wells Fargo. How could such a scandal have occurred in the first place? Who and what was at fault?
5. Suggest some solution paths the company might consider, using knowledge from this chapter and your own thoughts/research, to avoid such a scandal from reoccurring.

Sources: https://en.wikipedia.org/wiki/Wells_Fargo; Pasick, Adam, "Warren Buffett Explains the Wells Fargo Scandal," *Quartz*, May 6, 2017. https://qz.com/977778/warren-buffett-explains-the-wells-fargo-scandal/ https://qz.com/977778/warren-buffett-explains-the-wells-fargo-scandal/; Bloomberg, "The Wells Fargo Fake Accounts Scandal Just Got a Lot Worse," *Fortune*, August 21, 2017. http://fortune.com/2017/08/31/wells-fargo-increases-fake-account-estimate/; Horowitz, Julia, "'huge, huge, huge error' in Wells Fargo Handling of Ethics Line Calls, *CNN*, May, 6, 2017. https://money.cnn.com/2017/05/06/investing/buffett-wells-fargo-berkshire-annual-meeting/index.html; http://money.cnn.com/2018/02/05/news/companies/wells-fargo-timeline/index.html; Wattles, Jackie, Grier, Ben, and Egan, Matt, "Wells Fargo's 17 Month Nightmare," *CNN Business*, February 5, 2018. https://money.cnn.com/2018/02/05/news/companies/wells-fargo-timeline/index.html. Hudson, Caroline, "Wells Fargo Stocks Still Struggling in Wake of Scandal," *Charlotte Business Journal*, April 2, 2018. https://www.bizjournals.com/charlotte/news/2018/04/02/wells-fargo-stocks-still-struggling-in-wake-of.html



5

Ethics, Corporate Responsibility, and Sustainability

Exhibit 5.1 (Credit: Marco Verch /flickr / Attribution 2.0 Generic (CC BY 2.0))

Introduction

Learning Outcomes

After reading this chapter, you should be able to answer these questions:

1. What are ethics and business ethics?
2. What are the types of values that motivate ethics at the individual level?
3. What are major ethical principles that can guide individuals and organizations?
4. Why is ethical leadership important in organizations?
5. What are differences between values-based ethics and compliance in organizations?
6. What purpose can CSR (corporate social responsibility) offer to organizations and society?
7. What ethical issues do organizations and individuals encounter in the global environment?
8. What future near-term forecasts will affect ethical and corporate conduct of organizations?

EXPLORING MANAGERIAL CAREERS

Playing with a Purpose at Hasbro

Hasbro is a global play and entertainment company that takes corporate social responsibility (CSR) very seriously. Founded nearly a century ago in Rhode Island, Hasbro integrates its CSR efforts throughout the organization with the goal of helping to make the world a better place for children of all ages.

In 2017, the company achieved the number one spot in the "100 Best Corporate Citizens" rankings, published annually by *Corporate Responsibility* magazine. Hasbro is no stranger to this achievement; over the past five years Hasbro has consistently been in the top five spots on this prestigious list—and that is no accident.

With more than 5,000 employees, Hasbro relies heavily on its strategic brand blueprint to guide its efforts in CSR, innovation, philanthropy, and product development. With a business portfolio that includes such well-known brands as Nerf, Play-Doh, Transformers, Monopoly, and The Game of Life, the company focuses

its CSR efforts on four key areas: product safety, environmental sustainability, human rights and ethical sourcing, and community.

According to the company, product safety is its highest priority. Hasbro uses a five-step quality assurance process that starts with design and then moves to engineering, manufacturing, and packaging. Another key part of product safety at Hasbro is incorporating continuous feedback from both consumers and retailers and insisting that these high standards and quality processes apply to all third-party factories worldwide that manufacture its products.

Hasbro is also committed to finding new ways to reduce its environmental footprint. Over the past several years, the company has reduced energy consumption, cut greenhouse gas emissions, and reduced water consumption and waste production in its production facilities. In addition, Hasbro has totally eliminated the use of wire ties in all of its product packaging, saving more than 34,000 miles of wire tires—more than enough to wrap around the earth's circumference.

Human rights and ethical sourcing remain a key ingredient of Hasbro's CSR success. Treating people fairly is a core company value, as well as working diligently to make great strides in diversity and inclusion at all levels of the organization. Company personnel work closely with third-party factories to ensure that the human rights of all workers in the Hasbro global supply chain are recognized and upheld.

Philanthropy, corporate giving, and employee volunteering are key components of the Hasbro community. Through its various charitable programs, Hasbro made close to $15 million in financial contributions and product donations in 2016, which reached close to an estimated 4 million children around the globe. Several years ago, the company started an annual Global Day of Joy as a way of engaging its employees worldwide in community service. In a recent year, more than 93 percent of Hasbro's employees participated in service projects in more than 40 countries.

Hasbro is in the business of storytelling, and its CSR efforts tell the story of an ethical, responsible organization whose mission is to "create the world's best play experiences." Its ability to be accountable for its actions and to help make the world a better place one experience at time continues to make it a highly successful company.

Sources: Brian Goldner, "Who Are You Really?—Brian Goldner, President & CEO for Hasbro, Inc.," http://insights.ethisphere.com, accessed June 29, 2017; "CSR Fact Sheet," https://csr.hasbro.com, accessed June 23, 2017; "The World's Biggest Public Companies: Hasbro," *Forbes,* https://www.forbes.com, accessed June 23, 2017; "2016 Global Philanthropy & Social Impact," https://csr.hasbro.com, accessed June 23, 2017; Elizabeth Gurdus, "Hasbro CEO Reveals the Magic Behind the Toymaker's Earnings Beat," *CNBC,* http://www.cnbc.com, April 24, 2017; Jade Burke, "Hasbro Reaches Top spot in CSR Listing," *Toy News,* http://www.toynews-online.biz, April 21, 2017; Kathrin Belliveau, "CSR at Hasbro: What It Means to Play with Purpose," *LinkedIn,* https://www.linkedin.com, April 20, 2017.

This chapter will examine the role of ethics and how it affects organizations. Ethics is examined at the individual level, the organizational level, and also examines the role of ethics and leadership. Corporate social responsibility and how it is different than compliance will also be examined. Finally, ethics around the globe and in different cultures and the emerging issues regarding corporate social responsibility and ethics will be discussed.

5.1 Ethics and Business Ethics Defined

1. What are ethics and business ethics?

Ethics essentially involves how we act, live, lead our lives, and treat others. Our choices and decision-making

processes and our moral principles and values that govern our behaviors regarding what is right and wrong are also part of ethics.[1]

Normative ethics refers to the field of ethics concerned with our asking how *should* and *ought* we live and act? **Business ethics** is applied ethics that focuses on real-world situations and the context and environment in which transactions occur—How should we apply our values to the way we conduct business?

Ethics and business ethics continue to gain influence in corporations, universities, and colleges nationally and internationally. No longer considered a luxury but a necessity, business ethics has awakened a need in the public consciousness due to crises in many areas. For example, the 2008 subprime lending crisis—economic effects of which still persist—revealed widespread corruption of large investment banks and lending institutions internationally. Unsupported mortgages were fraudulently offered with no legitimate financial backing. Some large financial institutions, such as Lehman Brothers Holdings, Inc., went bankrupt; millions of mortgage holders lost their homes. An estimated cost of that crisis to the global economy is over $22 trillion U.S. dollars.[2]

In the early 2000s, CEOs and top-level leaders from notable corporations such as Enron, Tyco, WorldCom, and others were caught committing outrageously greedy and fraudulent crimes of white-collar theft from their organizations and shareholders. The now classic film *The Smartest Guys in the Room* depict how Enron's leaders during that time, Kenneth Lay (now deceased), Jeff Skilling (still serving prison time), and Andrew Fastow (released from prison in 2011), deceived employees, Wall Street, and shareholders. Enron's crisis took an estimated $67 billion of shareholder wealth out of the U.S. economy.[3] These criminal activities ushered in national laws such as the Sarbanes-Oxley Act, which we discuss below.

While these recent historical crises illustrate the continuing relevance and importance of business ethics, ethical issues are not only concerned with financial and economically motivated crimes and misbehaviors. Fast forward to the rise of artificial intelligence (AI), which also is calling attention to the relevance and need for ethics in scientific institutions, businesses, and governments. The public needs to be informed of potential and actual harmful consequences—as well as all the recognizable benefits—of these technologies that are in large part driven by algorithms ("a sequence of instructions telling a computer what to do").[4] Intentional and unintentional misuses of such designs embedded in artificially intelligent technologies can negatively and harmfully affect individual lives as well as entire societies. For example, studies show that a number of minority members of society are often discriminated against by institutions using faulty algorithms to qualify customers for mortgages and to predict who is at risk of being incarcerated. Often times, racial and low-income minorities are discriminated against by such technology designs.[5]

At a societal level, another now classic film, *The Minority Report*, illustrates how misuses of technology can threaten individual rights, privacy, free will, and choice. While this may sound like science fiction, scientific and business luminaries such as Elon Musk, Stephen Hawking, Bill Gates, and others have openly declared that we as a society must be cautious and ethically aware and active to fend off the ill effects of the control and dominant influences of certain AI algorithms in our lives. Scientific and ethical practices in corporate social responsibility (CSR) are one way that ethicists, business leaders, and consumers can support moral self-regulation of technologies. Some scientific and technological firms have adopted ethics boards to help safeguard against harmful social uses of AI technologies.[6] The European Union (EU) has produced policy studies that are forerunners of laws to safeguard against potentially harmful uses of robotics.[7]

Another timely ethical issue is climate change and the environment. Lack of sustainable environmental practices that curb air pollution and destructive uses of land, water, and natural resources have, according to a large community of reputable scientists, threatened Earth's—and our neighborhoods'—atmosphere.[8] Scientific studies and United Nations reports affirm that changes to the earth's atmosphere, melting glaciers, and rising seas are occurring at accelerated rates. For example, "California's coastline could rise up to 10 feet by 2100, about 30 to 40 times faster than sea-level rise experienced over the last century."[9] While university, business, and local community groups are rallying for legal actions to curtail and reverse environmental polluters,

current political executive orders push against such regulations designed to protect against further erosion of the physical environment.[10] The point here is that as these issues described above are not only technological, economic, and political in nature, but also moral and ethical, as the public's health, welfare, and safety are at risk.

Relevant ethical questions can be asked to prevent a crisis: Who is responsible for preventing and addressing what happens to individuals, the public, our institutions, and government and who is responsible for preventing such crises and harmful effects from occurring and reoccurring? At whose and what costs? Whose responsibility is it to protect and preserve the common good of societies? What ethical and moral principles should and can motivate individuals, groups, and society members to act to change course?

Universities and colleges are taking notice. Business ethics and corporate social responsibility courses and offerings are becoming increasingly important. The accrediting national body of business schools, AACSB (Association to Advance Collegiate Schools of Business), reported that "[i]n their curricula, research, and outreach, business schools must be advocates for the human dimension of business, with attention to ethics, diversity, and personal well-being."[11] In addition, NGOs (nongovernmental organizations), emergent groups internationally representing the public's interests and common good, and political action movements are beginning again to give voice to injustices and potentially dangerous ethical as well as fiscal (income inequality), health (the environment), and discriminatory (racism and stereotyping large segments of the society) problems that require **stakeholder** as well as stockholder actions.

In this chapter, we begin by presenting an overview of the dimensions of business ethics at the individual, professional, and leadership levels, followed by the organizational, societal, and global levels.

CONCEPT CHECK

1. What individual and organizational ethical issues can we expect to occur?
2. What are some signs of unethical activities you might notice individually and organizationally?

5.2 Dimensions of Ethics: The Individual Level

2. What types of values affect business ethics at the individual level?

Ethics is personal and unique to each individual. Ethical decision-making also involves other individuals, groups, organizations, and even nations—stakeholders and stockholders—as we later explain. Kenneth Goodpaster and Laura Nash characterized at least three dimensions or levels of ethics that help explain how individual and group values, norms, and behaviors of different stakeholders interact and respond with the aim of bringing orderly, fair, and just relationships with one another in transactions. This approach is illustrated in **Exhibit 5.2**.

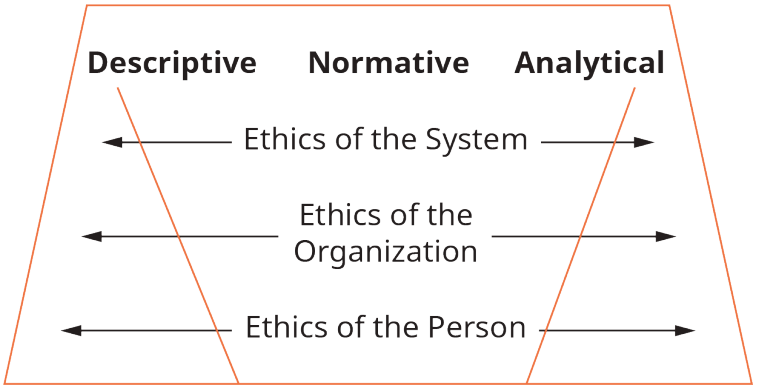

Exhibit 5.2 A Framework for Classifying Levels of Ethical Analysis Source: Adapted from Matthews, John B., Goodpaster, Kenneth E., and Laura L. Nash. (1985). *Policies and persons: A casebook in business ethics*, 509. New York: McGraw- Hill.

Ethical principles generally are codified into laws and regulations when there is societal consensus about such wrongdoing, such as laws against drunk driving, robbery, and murder. These laws, and sometimes unwritten societal norms and values, shape the local environment within which individuals act and conduct business. At the individual level, a person's values and beliefs are influenced by family, community, peers and friends, local and national culture, society, religious—or other types of—communities, and geographic environment. It is important to look at individual values and ethical principles since these influence an individual's decisions and actions, whether it be decisions to act or the failure to act against wrongdoing by others. In organizations, an individual's ethical stance may be affected by peers, subordinates, and supervisors, as well as by the organizational culture. Organizational culture often has a profound influence on individual choices and can support and encourage ethical actions or promote unethical and socially irresponsible behavior.

Ethics and Values: Terminal and Instrumental Values

Of the values that make up an organization's culture, and an individual's motivations, ethical values are now considered among the most important. For instance, when Google took its company public in 2004, its prospectus included an unusual corporate goal: "Don't be evil." That can be a challenge when you're a multibillion-dollar corporation operating around the world, with investors expecting you to produce a profit. Google's operations in the United States and overseas have generated controversy and debate as to how well it's living up to its stated goal. There is a continuing need to integrate ethical values in corporations. The Ethics & Compliance Initiative found 22 percent of global workers reported pressure to compromise their standards.[12] Top corporate managers are under scrutiny from the public as never before, and even small companies are finding a need to put more emphasis on ethics to restore trust among their customers and the community.



Exhibit 5.3 Elon Musk Elon Musk, the CEO of Tesla and SpaceX, pictured here at a TedX conference, is widely admired for his CSR approaches at his companies. Generally, the adoption of electric vehicles, which help reduce pollutants, is viewed as a positive outcome. Musk has, however, come under scrutiny regarding comments about having secured financing to take Tesla private that raise compliance issues. (Credit: Steve Jurvetson/ flickr/ Attribution- 2.0 Generic (CC BY-ND 2.0))

Values can be powerful and motivating guides for individual, group, and organizational behavior. At the individual level, however, a reoccurring issue individuals seem to have with acting ethically is that many people do not consciously know or choose their values. We often act first and think or rationalize later. Secondly and relatedly, the methods and ways we act to reach our goals and objectives are also not always deliberately chosen. Consequently, many times we let the "ends justify the means" and/or "the means justify the ends" in our decisions and actions. **Ethical dilemmas** (i.e., situations and predicaments in which there is not an optimal or desired choice to be made between two options, neither of which solves an issue or delivers an opportunity that is ethical) often originate and occur from an unawareness of how to sort out and think through potential consequences of our actions or inaction. Becoming aware and conscious of our values is a first step toward being able to act ethically and responsibly in order to prevent or lessen harm to ourselves or others.

Toward this end, it is helpful to understand values that have been categorized as terminal and instrumental. **Terminal values** are desired goals, objectives, or end states that individuals wish to pursue. **Instrumental values** are preferred means of behavior used to obtain those goals. Examples of terminal values—at a higher level—are freedom, security, pleasure, social recognition, friendship, accomplishment, comfort, adventure, equality, wisdom, and happiness.[13] Examples of instrumental values are being helpful, honest, courageous, independent, polite, responsible, capable, ambitious, loving, self-contained, and forgiving.[14]

Identifying and separating terminal from instrumental values in any given situation can assist individuals, groups, and work units in distinguishing between the "ends (goals) from the means (methods to reach the goals)" and vice versa in making decisions, thereby helping us choose more ethical options—or at least less unethical ones—in situations. For example, a sales manager has a goal of motivating his sales force to achieve individual sales performance levels at a 17% increase over current levels by the end of the calendar quarter. The means of doing so, according to the manager, are, "Go for it. Use your imagination and fortitude. Just make sure each of you reaches or exceeds that goal." In this case, the terminal value is high achievement to the point of being overly ambitious in order to reach an aggressive financial goal. The instrumental value can also be described as aggressive achievement. Both the terminal and instrumental values in this scenario could very likely create undue pressure and even anxiety for some members of the sales force. The ethical logic underlying this example is to let the "end justify the means." The scenario also raises the question of whether or not individuals in the sales force would choose the values underlying the instruction of the manager if each member identified and reflected on those values.

If the end (terminal) value creates undue pressures and is unrealistic and unobtainable, then the means (instrumental) value would likely create tension and unethical behavior as well. This example in some ways mirrors what actually recently happened at Wells Fargo & Company—an American international banking and financial services holding company headquartered in San Francisco. High pressure and unrealistic sales goals were adopted and implemented from the top down in that organization. A result was that members of that sales force lied, pressured, and misled loyal customers to buy bogus financial products to meet unrealistic sales goals. Such actions when discovered led to and revealed illegal and unethical actions from not only the sales professionals but officers at the top of that organization. Ultimately, the CEO was pressured to resign, 5,300 employees were fired, and several lawsuits ensued.[15]

There are many lessons to take from the Wells Fargo fiasco. From an individual ethical perspective, one insight is to be aware of the underlying values of organizational and other job- and task-related directives issued. Another is to discover your own values and ethical principles that can guide you in work, study, and personal situations so that someone else's problems may not have to become yours. A helpful assessment for discovering your values is the PVA (Personal Values Assessment) found at **https://www.valuescentre.com/our-products/products-individuals/personal-values-assessment-pva**.

Caroucci found that "five ways organizations needlessly provoke good people to make unethical choices" are the following. (1) People feel psychologically unsafe to speak up. (2) Excessive pressure to reach unrealistic performance targets compromises people's choices. (3) When individuals face conflicting goals, they feel a sense of unfairness and compromise their reasoning. (4) Only talking about ethics when there is a scandal. (5)When there is no positive example available, individuals react instead of choose ethical decisions. Familiarizing yourself with ethical principles in the following section is another way of helping you think through complicated situations to make conscious, values-based decisions to do "the right thing."[16]

CONCEPT CHECK

1. What are terminal and instrumental values?
2. What are ways organizations can employ values to induce people to make ethical choices?

5.3 Ethical Principles and Responsible Decision-Making

3. What are major ethical principles that can be used by individuals and organizations?

Before turning to organizational and systems levels of ethics, we discuss classical ethical principles that are very relevant now and on which decisions can be and are made by individuals, organizations, and other stakeholders who choose principled, responsible ways of acting toward others.[17]

Ethical principles are different from values in that the former are considered as rules that are more permanent, universal, and unchanging, whereas values are subjective, even personal, and can change with time. Principles help inform and influence values. Some of the principles presented here date back to Plato, Socrates, and even earlier to ancient religious groups. These principles can be, and are, used in combination; different principles are also used in different situations.[18] The principles that we will cover are utilitarianism, universalism, rights/legal, justice, virtue, common good, and ethical relativism approaches. As you read these, ask yourself which principles characterize and underlie your own values, beliefs, behaviors, and actions. It is helpful to ask and if not clear, perhaps identify the principles, you most often use now and those you aspire to use more, and why. Using one or more of these principles and ethical approaches intentionally can also help you examine choices and options before making a decision or solving an ethical dilemma. Becoming familiar with these principles, then, can help inform your moral decision process and help you observe the principles that a team, workgroup, or organization that you now participate in or will be joining may be using. Using

creativity is also important when examining difficult moral decisions when sometimes it may seem that there are two "right" ways to act in a situation or perhaps no way seems morally right, which may also signal that not taking an action at that time may be needed, unless taking no action produces worse results.

Utilitarianism: A Consequentialist, "Ends Justifies Means" Approach

The utilitarianism principle basically holds that an action is morally right if it produces the greatest good for the greatest number of people. An action is morally right if the net benefits over costs are greatest for all affected compared with the net benefits of all other possible choices. This, as with all these principles and approaches, is broad in nature and seemingly rather abstract. At the same time, each one has a logic. When we present the specifics and facts of a situation, this and the other principles begin to make sense, although judgement is still required.

Some limitations of this principle suggest that it does not consider individuals, and there is no agreement on the definition of "good for all concerned." In addition, it is difficult to measure "costs and benefits." This is one of the most widely used principles by corporations, institutions, nations, and individuals, given the limitations that accompany it. Use of this principle generally applies when resources are scarce, there is a conflict in priorities, and no clear choice meets everyone's needs—that is, a zero-sum decision is imminent

Universalism: A Duty-Based Approach

Universalism is a principle that considers the welfare and risks of all parties when considering policy decisions and outcomes. Also needs of individuals involved in a decision are identified as well as the choices they have and the information they need to protect their welfare. This principle involves taking human beings, their needs, and their values seriously. It is not only a method to make a decision; it is a way of incorporating a humane consideration of and for individuals and groups when deciding a course of action. As some have asked, "What is a human life worth?"

Cooper, Santora, and Sarros wrote, "Universalism is the outward expression of leadership character and is made manifest by respectfulness for others, fairness, cooperativeness, compassion, spiritual respect, and humility." Corporate leaders in the "World's Most Ethical Companies" strive to set a "tone at the top" to exemplify and embody universal principles in their business practices.[19] Howard Schultz, founder of Starbucks; cofounder Jim Sinegal at Costco; Sheryl Sandberg, chief operating officer of Facebook; and Ursula M. Burns, previous chairperson and CEO of Xerox have demonstrated setting effective ethical tones at the top of organizations.

Limitations here also show that using this principle may not always prove realistic or practical in all situations. In addition, using this principle can require sacrifice of human life—that is, giving one's life to help or save others—which may seem contrary to the principle. The film *The Post*, based on fact, portrays how the daughter of the founder of the famed newspaper, the *Washington Post*, inherited the role of CEO and was forced to make a decision between publishing a whistle-blowers' classified government documents of then top-level generals and officials or keep silent and protect the newspaper. The classified documents contained information proving that generals and other top-level government administrators were lying to the public about the actual status of the United States in the Vietnam War. Those documents revealed that there were doubts the war could be won while thousands of young Americans continued to die fighting. The dilemma for the *Washington Post*'s then CEO centered on her having to choose between exposing the truth based on freedom of speech—which was the mission and foundation of the newspaper—or staying silent and suppressing the classified information. She chose, with the support of and pressure from her editorial staff, to release the classified documents to the public. The Supreme Court upheld her and her staff's decision. A result was enflamed widespread public protests from American youth and others. President Johnson was pressured to resign, Secretary of State McNamara later apologized, and the war eventually ended with U.S. troops withdrawing. So, universalist ethical principles may present difficulties when used in complex situations, but such principles can also save lives, protect the integrity of a nation, and stop meaningless destruction.

Rights: A Moral and Legal Entitlement–Based Approach

This principle is grounded in both legal and moral **rights**. Legal rights are entitlements that are limited to a particular legal system and jurisdiction. In the United States, the Constitution and Declaration of Independence are the basis for citizens' legal rights, for example, the right to life, liberty, and the pursuit of happiness and the right to freedom of speech. Moral (and human) rights, on the other hand, are universal and based on norms in every society, for example, the right not to be enslaved and the right to work.

To get a sense of individual rights in the workplace, log on to one of the "Best Companies to Work For" annual lists (http://fortune.com/best-companies/). Profiles of leaders and organizations' policies, practices, perks, diversity, compensation, and other statistics regarding employee welfare and benefits can be reviewed. The "World's Most Ethical Companies" also provides examples of workforce and workplace legal and moral rights. This principle, as with universalism, can always be used when individuals, groups, and nations are involved in decisions that may violate or harm such rights as life, liberty, the pursuit of happiness, and free speech.

Some limitations when using this principle are (1) it can be used to disguise and manipulate selfish and unjust political interests, (2) it is difficult to determine who deserves what when both parties are "right," and (3) individuals can exaggerate certain entitlements at the expense of others. Still, the U.S. Constitution's Bill of Rights, ratified in 1791, was designed as and remains the foundation of, which is based on freedom and justice to protect the basic rights of all.

Justice: Procedures, Compensation, and Retribution

This principle has at least four major components that are based on the tenets that (1) all individuals should be treated equally; (2) **justice** is served when all persons have equal opportunities and advantages (through their positions and offices) to society's opportunities and burdens; (3) fair decision practices, procedures, and agreements among parties should be practiced; and (4) punishment is served to someone who has inflicted harm on another, and compensation is given to those for a past harm or injustice committed against them.

A simple way of summarizing this principle when examining a moral dilemma is to ask of a proposed action or decision: (1) Is it fair? (2) Is it right? (3) Who gets hurt? (4) Who has to pay for the consequences? (5) Do I/we want to assume responsibility for the consequences? It is interesting to reflect on how many corporate disasters and crises might have been prevented had the leaders and those involved taken such questions seriously before proceeding with decisions. For example, the following precautionary actions might have prevented the disaster: updating the equipment and machinery that failed in the BP and the *Exxon Valdez* oil crises and investment banks and lending institutions following rules not to sell subprime mortgages that could not and would not be paid, actions that led to the near collapse of the global economy.

Limitations when using this principle involve the question of who decides who is right and wrong and who has been harmed in complex situations. This is especially the case when facts are not available and there is no objective external jurisdiction of the state or federal government. In addition, we are sometimes faced with the question, "Who has the moral authority to punish to pay compensation to whom?" Still, as with the other principles discussed here, justice stands as a necessary and invaluable building block of democracies and freedom.

Virtue Ethics: Character-Based Virtues

Virtue ethics is based on character traits such as being truthful, practical wisdom, happiness, flourishing, and well-being. It focuses on the type of person we ought to be, not on specific actions that should be taken. Grounded in good character, motives, and core values, the principle is best exemplified by those whose examples show the virtues to be emulated.

Basically, the possessor of good character is moral, acts morally, feels good, is happy, and flourishes. Altruism is also part of character-based virtue ethics. Practical wisdom, however, is often required to be virtuous.

This principle is related to universalism. Many leaders' character and actions serve as examples of how

character-based virtues work. For example, the famous Warren Buffett stands as an icon of good character who demonstrates trustworthy values and practical wisdom. Applying this principle is related to a "quick test" before acting or making a decision by asking, "What would my 'best self' do in this situation?" Others ask the question inserting someone they know or honor highly.

There are some limitations to this ethic. First, some individuals may disagree about who is virtuous in different situations and therefore would refuse to use that person's character as a principle. Also, the issue arises, "Who defines *virtuous*, especially when a complex act or incident is involved that requires factual information and objective criteria to resolve?"

The Common Good

The common good is defined as "the sum of those conditions of social life which allow social groups and their individual members relatively thorough and ready access to their own fulfillment." Decision makers must take into consideration the intent as well as the effects of their actions and decisions on the broader society and the common good of the many.[20]

Identifying and basing decisions on the common good requires us to make goals and take actions that take others, beyond ourselves and our self-interest, into account. Applying the common good principle can also be asked by a simple question: "How will this decision or action affect the broader physical, cultural, and social environment in which I, my family, my friends, and others have to live, breathe, and thrive in now, next week, and beyond?"

A major limitation when using this principle is, "Who determines what the common good is in situations where two or more parties differ over whose interests are violated?" In individualistic and capitalist societies, it is difficult in many cases for individuals to give up their interests and tangible goods for what may not benefit them or may even deprive them.

Ethical Relativism: A Self-Interest Approach

Ethical relativism is really not a "principle" to be followed or modeled. It is an orientation that many use quite frequently. Ethical relativism holds that people set their own moral standards for judging their actions. Only the individual's self-interest and values are relevant for judging his or her behavior. Moreover, moral standards, according to this principle, vary from one culture to another. "When in Rome, do as the Romans do."

Obvious limitations of relativism include following one's blind spots or self-interests that can interfere with facts and reality. Followers of this principle can become absolutists and "true believers"—many times believing and following their own ideology and beliefs. Countries and cultures that follow this orientation can result in dictatorships and absolutist regimes that practice different forms of slavery and abuse to large numbers of people. For example, South Africa's all-white National Party and government after 1948 implemented and enforced a policy of apartheid that consisted of racial segregation. That policy lasted until the 1990s, when several parties negotiated its demise—with the help of Nelson Mandela (**www.history.com/topics/apartheid**). Until that time, international firms doing business in South Africa were expected to abide by the apartheid policy and its underlying values. Many companies in the United States, Europe, and elsewhere were pressured in the 1980s and before by public interest groups whether or not to continue doing business or leave South Africa.

At the individual level, then, principles and values offer a source of stability and self-control while also affecting job satisfaction and performance. At the organizational level, principled and values-based leadership influences cultures that inspire and motivate ethical behavior and performance. The following section discusses how ethical leadership at the top and throughout organizations affects ethical actions and behaviors.[21]

CONCEPT CHECK

1. What are some ethical guidelines individuals and organizations can use to make ethical choices?
2. Can being aware of the actual values you use to guide your actions make a difference in your choices?

5.4 Leadership: Ethics at the Organizational Level

4. Why is ethical leadership important in organizations?

Organizational leadership is an important first step toward identifying and enacting purpose and ethical values that are central to internal alignment, external market effectiveness, and responsibility toward stakeholders.[22] The scholar Chester Barnard defined a values-based leadership approach in 1939 as one that inspires "cooperative personal decisions by creating faith in common understanding, faith in the probability of success, faith in the ultimate satisfaction of personal motives, and faith in the integrity of common purpose."[23] **Exhibit 5.4** illustrates how vision, mission, and values are foundational in guiding the identification and implementation of the strategic and operational questions and alignment of an organization—which is a major part of leadership.

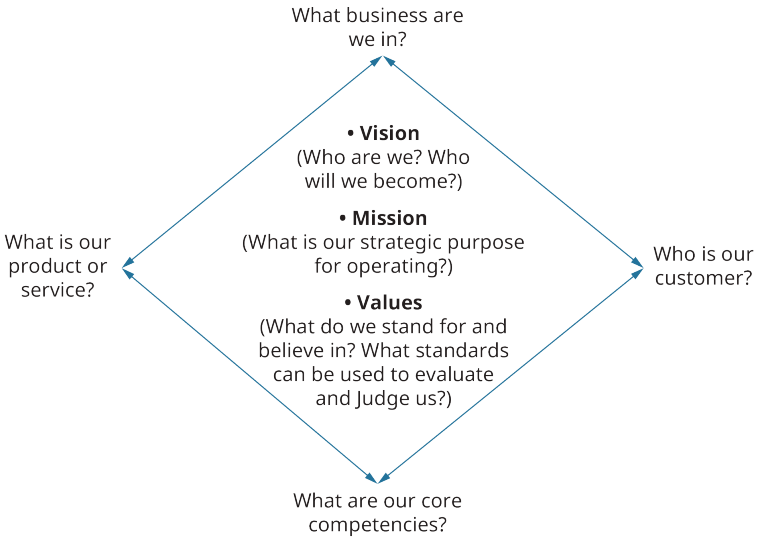

Exhibit 5.4 Strategic Organizational Alignment Source: Joseph W. Weiss. © 2014.

Leadership is defined as the ability to influence followers to achieve common goals through shared purposes.[24] Organizational leaders are responsible to a wide range of stakeholders and stockholders as well as employees toward meeting the goals for the organization. How responsibly and ethically they choose to do so depends on a number of factors. From an ethical and related effectiveness perspective, the leader's values count since these generally become the values of an organization. A leader's influence is referred to as "the tone at the top." While a leader's values should align to those of the organization, its vision and mission, this is not always the case, as we know from the crises discussed earlier when referring to the classical failures at Enron, Tyco, WorldCom, Wells Fargo, and other notable companies.

Since leadership is a most important element in forming and directing an organization's strategy, culture, and governance system, it is often a shared responsibility among other officers and followers that cascades throughout the organization. As an example, the widely acknowledged Ethisphere, a private firm that evaluates firms' ethical behavior and responsibilities, uses five criteria that produce a single Ethics Quotient (EQ) score. The first is a company's ethics and compliance program, which accounts for 35% of the EQ. The

second criterion is whether or not and the extent to which ethics is embedded into a company's culture. The third element is corporate citizenship and responsibility, elements that measure companies' environmental impact. The fourth component is corporate governance—whether a firm's CEO and board chair are held by one or separate people. An increased focus recently emphasized diversity in board and leadership positions. The fifth criterion is leadership, innovation, and reputation.[25]

There were, according to Ephisphere, 124 honorees in 2017, spanning 5 continents, 19 countries, and 52 industry sectors. Among the 2017 list are 13 eleven-time honorees and 8 first-time honorees. Honorees include "companies who recognize their role in society to influence and drive positive change in the business community and societies around the world. These companies also consider the impact of their actions on their employees, investors, customers and other key stakeholders and leverage values and a culture of integrity as the underpinnings to the decisions they make each day."[26] **Table 5.1** includes 10 of the 124 most ethical companies in 2017 as measured by Ethispher's criteria.

World's Most Ethical Companies Honorees		
Company	**Industry**	**Country**
3M Company	Industrial Manufacturing	USA
Accenture	Consulting Services	IRELAND
Aflac Incorporated	Accident & Life Insurance	USA
Allstate Insurance Company	Property & Casualty Insurance	USA
Alyeska Pipeline Service Co.	Oil & Gas, Renewables	USA
Applied Materials, Inc.	Electronics & Semiconductors	USA
Arthur J. Gallagher & Co.	Insurance Brokers	USA
Avnet, Inc.	Electronics & Semiconductors	USA
Baptist Health South Florida	Healthcare Providers	USA

Source: Adapted from Ephisphere, 2017, https://www.worldsmostethicalcompanies.com/honorees/

Table 5.1

For ethical leaders, authenticity and integrity, in addition to their values, are also important components of character and behavior that must also be translated into attitude and action toward followers, external stakeholders, and broader communities. Leaders have a responsibility to show respect toward others, treat all stakeholders fairly, work toward a common good, build community, and be honest. These virtue-related values, also referred to as character-related, as discussed earlier, help create an ethical corporation and environment:

Show Respect for Others

Respecting others requires leaders to recognize the intrinsic worth of others and forces them to treat people as ends in themselves—never as means to an end. In other words, people should be seen as valuable because of who they are (a universal principle), not only because of what they can do for others or how they can help

others advance. Showing respect for others includes tolerating individual differences and affording followers the freedom to think independently, act as individuals, and pursue their own goals. When a leader shows respect for followers by providing them autonomy, subordinates can feel more useful, valued, and confident. Such a situation often leads to greater loyalty and productivity among subordinates.

Treat All Stakeholders Fairly

Ethical leaders strive to treat everyone their decisions may affect in a fair and just manner. Equality is also a top priority for ethical leaders and needs to factor prominently into their decision-making. Ethical leaders must refrain from offering special treatment to others; failure to do so creates winners and losers—in-groups and out-groups—and can breed resentment between those who receive special treatment and those who do not. The only exception occurs when an individual's specific situation warrants special treatment in order for a just outcome to be realized.

Preventing winners and losers from emerging is not always easy. Some situations require the distribution of benefits and burdens, and such situations can test a leader's ability to ensure that justice is achieved. Beauchamp and Bowie defined the common principles that guide leaders facing such dilemmas; their findings can help leaders allocate responsibilities fairly and justly.[27] These principles stipulate that every person must receive an equal share of opportunity according to his needs, rights, effort, societal contributions, and performance.

Work Toward a Common Good

Mahatma Gandhi offers an example of what striving toward a common good entails. Known for his commitment to nonviolent protests and mass civil disobedience, the Indian activist and ideological leader spent 20 years in South Africa opposing legislation that discriminated against Indians. He spent the remainder of his life in India fighting for independence from foreign rule and working to reduce poverty and taxation, liberate women, and end multiple forms of discrimination.[28] He championed such causes not because he would personally benefit, but because a larger, more substantial population would. Gandhi devoted his life to furthering social causes he believed in and developed a personal sense of purpose and meaning that later translated into a societal and then global ethic.

Ethical leaders strive to further social or institutional goals that are greater than the goals of the individual. This responsibility requires the ethical leader to serve a greater good by attending to the needs of others. This type of behavior is an example of altruism: a steadfast devotion to improving the welfare of others. Altruistic behavior may manifest in a corporate setting through actions such as mentoring, empowerment behaviors (encouraging and enabling others), team building, and citizenship behaviors (such as showing concern for others' welfare), to name a few.

Build Community

Whole Foods Market, recently purchased by Amazon, is well known for its community outreach programs on both local and global scales. Every Whole Foods store donates to community food banks and shelters and throughout the year holds "5% days," when 5% of the day's net sales are donated to local nonprofit or educational organizations. Globally, the company established the Whole Planet Foundation to combat world hunger and supports programs addressing issues such as animal welfare, nutrition, and environmentally friendly production methods.

The effort of Whole Foods to strengthen its stores' local and global neighborhoods is a perfect example of leaders building community. When an ethical leader focuses on the needs of others rather than the self, other people will often follow suit. This can lead to a strong contingent of followers working with the leader to achieve a common goal that is compatible with the desires of all stakeholders. Furthering a common goal means that no one can place his needs ahead of the group's goals and an ethical leader cannot impose his will on others. A successful CEO who works with many charities or other individuals to feed the homeless

exemplifies a leader building community.

Be Honest

Honesty is considered desirable by practically everyone, but it is sometimes unclear what honesty actually demands of us. Being honest is not simply telling the truth and avoiding deceitful behaviors; it requires leaders to be as open as possible and to describe reality fully, accurately, and in sufficient detail. Telling the complete truth is not always the most desirable action, however. Leaders must be sensitive to the feelings and beliefs of others and must recognize that the appropriate level of openness and candor varies depending on the situation.

According to a recent survey, 58% of people internationally trust companies, but 42% are less sure. Being more transparent with customers, stakeholders, and stockholders should become a priority for leaders and boards of companies.[29] Dishonesty can be a disastrous practice for a leader. Dishonest leaders distort reality, which can lead to unfavorable outcomes for all stakeholders. Researchers Cialdini, Petia, Petrova, and Goldstein found that dishonest organizations suffer from tarnished reputations, decreased worker productivity, and various damages related to increased surveillance. They concluded that the costs of organizational dishonesty greatly outweigh any short-term gains from such behavior.[30]



Exhibit 5.5 Cialdini Robert Cialdini and other researchers claim that dishonest organizations suffer from tarnished reputations, decreased worker productivity, and various damages related to increased surveillance. They concluded that the costs of organizational dishonesty greatly outweigh any short-term gains from such behavior. (Credit: Dave Dugdale/ flickr/ Attribution-ShareAlike 2.0 Generic (CC BY-SA 2.0))

Stewardship and Servant Leadership Styles

Effective leaders, and followers, who lead by example and demonstrate virtuous practices while demonstrating successful practices are more numerous than the media or press reveal. Such examples are also entrepreneurs who practice both stewardship and servant leadership. Their names are not always recognizable nationally, but their companies, communities, and stakeholders know them well. For example, Inc.com's recent 2017 list of top 10 leaders features four women CEOs who go beyond the "call of duty" to serve others while succeeding in business. For example, Brittany Merrill Underwood started and is CEO of Akola Jewelry and was named in Yahoo's "Best Person in the World" series in 2014. Her company "reinvests 100 percent of their profits to support work opportunities, training, social programs, and the construction of training centers and water wells in impoverished communities throughout the globe."[31]

A classic example of these leadership styles is also represented by Aaron Feuerstein, a previous CEO of a manufacturing plant in Massachusetts, whose example continues to represent both a steward and servant leadership style.[32]

MANAGERIAL LEADERSHIP



Servant Leadership Personified: Aaron Feuerstein at Malden Mills

Aaron Feuerstein, a third-generation owner of Malden Mills in Lawrence, Massachusetts, suffered his factory burning to the ground on December 11, 1995. Feuerstein had the option of using the insurance money to rebuild the plant, but he instead paid the salaries and complete benefits of all the 3,000 workers for 6 months while the factory was rebuilt. He later said that he had no other option than to help the employees. His action was based on his study of the Talmud, and he presented at Xavier University:

"I have the responsibility to the worker, both blue-collar and white-collar. I have an equal responsibility to the community. It would have been unconscionable to put 3,000 people on the streets and deliver a deathblow to the cities of Lawrence and Methuen. Maybe on paper our company is worthless to Wall Street, but I can tell you it's worth more."

Feuerstein exemplified the two ethical leadership styles of stewardship and servant leadership, which focus specifically on how leaders work with followers. (Ethical leadership as a whole concerns the leader's characteristics and encompasses actions in both the internal and external organizational environment.)

Source: Xavier University News and Events, "Former Malden Mills CEO Aaron Feuerstein speaking at Heroes of Professional Ethics event March 30", March 24, 2009, https://www2.xavier.edu/campusuite25/modules/news.cfm?seo_file=Former-Malden-Mills-CEO-Aaron-Feuerstein-speaking-at-Heroes-of-Professional-Ethics-event-March-30&grp_id=1#.W6FLZPZFyUk

Questions

1. How does Aaron Feuerstein exemplify servant leadership principles?
2. If Feuerstein had decided to use the insurance money for other purposes, would he have not been acting ethically?

Stewardship is concerned with empowering followers to make decisions and gain control over their work. **Servant leadership** involves selflessly working with followers to achieve shared goals that improve collective, rather than individual, welfare. There is a wealth of information on both of these styles. We will briefly address both here, as both involve treating followers with respect—a key component of ethical leadership—and endowing followers with the ability to grow both personally and professionally.

The stewardship approach instructs leaders to lead without dominating followers. Leaders who practice stewardship sincerely care about their followers and help them develop and accomplish individual as well as organizational goals. Effective stewardship breeds a team-oriented environment in which everyone works together. Organizations led by steward leaders are marked by decentralized decision-making—that is, leadership is not centered in one person, group, department, or administrative unity; power is distributed among all stakeholders.[33]

The servant-leadership approach was formulated by Robert K. Greenleaf, who believed that leadership is a natural corollary of service. Servant leadership goes beyond stewardship by requiring leaders to eschew personal accolades and devote themselves entirely to a greater cause. Greenleaf stated, "The essential quality that separates servant leaders from others is that they live by their conscience—the inward moral sense of what is right and wrong. That one quality is the difference between leadership that *works* and leadership—like servant leadership—that endures." The following aspects are central to servant leadership:

1. Placing service before self-interest. The servant leader's primary concern is helping others, not receiving recognition or financial reward.
2. Listening to others. Servant leaders recognize the importance of listening to the ideas and concerns of

stakeholders; they never attempt to impose their will on others. This aspect allows servant leaders to strengthen relationships, understand group needs and dynamics, and effectively allocate resources to improve the group's welfare.
3. Inspiring through trust. As we discussed earlier, ethical leaders must be trustworthy. It does not take much effort for servant leaders to be truthful because they usually have strong moral convictions.
4. Working toward feasible goals. Servant leaders realize that many problems cannot be solved by one person. They also tackle the most pressing issues facing their groups.
5. Helping others whenever possible. Servant leaders lend a helping hand when the opportunity arises. An example is the district manager of a fast-food chain who helps part-time employees flip burgers during a lunchtime rush hour. Another is the director of a business unit who observes that a team is short a member and needs help in meeting a deadline; the director joins the team for the afternoon to help meet the deadline.[34]

Another way of understanding the distinguishing characteristics of servant leadership is offered by DeGraaf, Tilley, and Neal:

> The main assumption is that true leadership should call us to serve a higher purpose, something beyond ourselves. One of the most important aspects of leadership is helping organizations and staff identify their higher purpose. The best test of the servant-leadership philosophy is whether or not customers and staff grow as persons! Do customers become healthier, wiser, freer, more autonomous, more likely themselves to become "servants"? And, what is the effect on the least privileged in society? Will they benefit? Or, at least, not be further deprived? To achieve this higher purpose of public organizations, you, as a leader, must be passionate about your desire to improve your community and yourself![35]

Dark Side of Organizational Leadership

However, and as noted earlier, not all leaders lead or model high standards or values. Seven symptoms of the failure of ethical leadership provide a practical lens to examine a leader's shortsightedness:[36]

1. Ethical blindness: They do not perceive ethical issues due to inattention or inability.
2. Ethical muteness: They do not have or use ethical language or principles. They "talk the talk" but do not "walk the talk" on values.
3. Ethical incoherence: They are not able to see inconsistencies among values they say they follow; e.g., they say they value responsibility but reward performance based only on numbers.
4. Ethical paralysis: They are unable to act on their values from lack of knowledge or fear of the consequences of their actions.
5. Ethical hypocrisy: They are not committed to their espoused values. They delegate things they are unwilling or unable to do themselves.
6. Ethical schizophrenia: They do not have a set of coherent values; they act one way at work and another way at home.
7. Ethical complacency: They believe they can do no wrong because of who they are. They believe they are immune.

Examples of highly unethical recent leaders and their dark side leadership practices are described in *Fortune*'s "World's 19 Most Disappointing Leaders." Two illustrations are summarized here. Martin Winterkorn, the former chairman of Volkswagen, who led VW during "a disastrous scandal (which is far from over), as company engineers installed software that manipulated emissions on about 11 million diesel vehicles. Winterkorn has asserted ignorance of any wrongdoing." He is also known as being a micromanager who formed a ruthless culture that emphasized winning over all else. Then there was Rick Snyder, governor of Michigan, who "left the impoverished city of Flint, Mich. with a lead-tainted water supply that is being blamed for illness and brain damage, especially among its youngest residents.". Snyder also blamed "failure of government" and the Environmental Protection Agency for its "dumb and dangerous" rules permitting dangerous amounts of lead in

the water systems.

A major takeaway from both the outstanding and undesirable ethical leadership examples presented here is that organizational culture counts and that without an ethical culture both poor and exemplary moral leadership decisions flourish.[37]

CONCEPT CHECK

1. What role does leadership play in how ethically organizations and its members act and perform?
2. Explain what stewardship is and the role of servant leadership.

5.5 Ethics, Corporate Culture, and Compliance

5. What are the differences between values-based ethics and compliance in organizations?

An organization's culture is defined by the shared values and meanings its members hold in common and that are articulated and practiced by an organization's leaders. Purpose, embodied in corporate culture, is embedded in and helps define organizations. Ed Schein, one of the most influential experts on culture, also defined organizational **corporate culture** as "a pattern of shared tacit assumptions learned or developed by a group as it solves its problems of external adaptation and internal integration that have worked well enough to be considered valid and, therefore, to be taught to new members as the correct way to perceive, think, and feel in relation to those problems."[38]

As Exhibit 5.6 illustrates, culture plays an important integrating role in organizations both externally and internally. Strategy, structure, people, and systems all are affected by an organization's culture, which has been referred to as the "glue" that holds an organization together.[39]

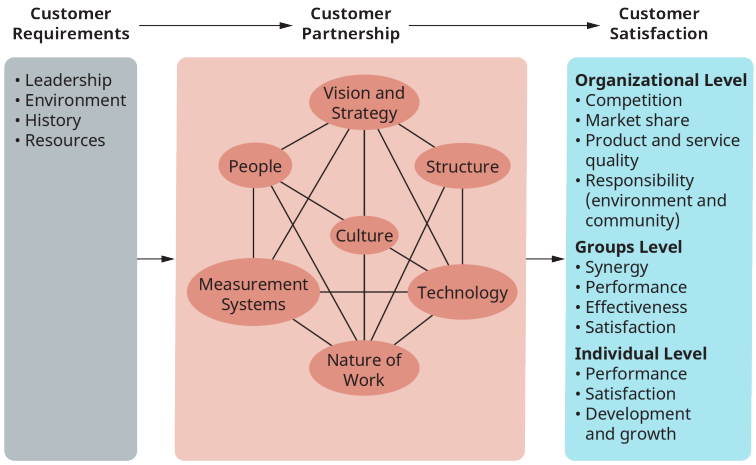

Exhibit 5.6 Role of Culture in Organizational Alignment (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

Leadership, in particular, as stated earlier, exerts a powerful influence, along with other factors, on culture. Schein noted that "culture and leadership are two sides of the same coin and one cannot understand one without the other."[40] Culture is transmitted through and by (1) the values and styles that leaders espouse and practice, (2) the heroes and heroines that the company rewards and holds up as models, (3) the rites and symbols that organizations value, and (4) the way that organizational executives and members communicate among themselves and with their stakeholders. Heskett argues that culture "can account for 20–30% of the differential in corporate performance when compared with 'culturally unremarkable' competitors."[41]

While subcultures develop in organizations, the larger organization's culture influences these, especially with

strong leaders and leadership teams who set the tone at the top and communicate expectations and performance standards throughout. Other factors that indicate and help create a strong ethical culture include the following, which are based on the reputable assessment firm Ethisphere's experience[42]

An organization models and communicates compliance standards through its values; employees are informed of and familiar with the assets and efforts of the compliance and ethics function.

- The culture sets "enduring and underlying assumptions and norms that determine how things are actually done in the organization."[43]
- "Organizations can effectively identify specific locations, business units, job levels and job functions that may lack a full understanding of available resources, feel unwanted pressure, or perhaps hold negative perceptions."
- Companies and investors believe a company behaves and acts ethically.
- Employees are aware of the conduct, values, and communications of senior leaders.
- Employees are engaged and committed, and organizations regularly survey employees to get a sense of their engagement.
- Employees feel "less pressure to compromise company standards to achieve company goals. And if they do observe misconduct, they are more likely to feel comfortable reporting it."
- "Employees perceive the ethical priorities of their coworkers, the values of their organization and willingness to share opinions."[44]

Compliance and Ethics

As the section above indicates, both a values-based and compliance approach are necessary elements of maintaining an ethical corporate culture. Ethics has been characterized as "doing the right thing" and serving as a motivational force that influences professionals' values—resembling a "carrot" approach to professionals' behaviors. Compliance is related to influencing behaviors to act in accordance to the law or face consequences—referred to as a "stick" approach. Studies show that ethical and compliance approaches are interrelated and work best to motivate and sustain lawful and ethical behavior in organizations.[45]

One law in particular set a new baseline of accountability for CEOs and CFOs (chief financial officers): the federal Sarbanes-Oxley Act of 2002, 2010. This law was the first following the Enron scandal and other corporate scandals that placed constraints and issued punitive measures on CEOs and CFOs who could be punished if they knowingly and willingly committed fraud and other crimes. Several new sections of that law also signaled a change in corporate leaders' responsibilities and liabilities; for example, the law "[e]stablishes an independent public company accounting board to oversee audits of public companies; requires one member of the audit committee to be an expert in finance; requires full disclosure to stockholders of complex financial transactions: requires CEOs and CFOs to certify in writing the validity of their companies' financial statements. If they knowingly certify false statements, they can go to prison for 20 years and be fined $5 million; -Prohibits accounting firms from offering other services, like consulting, while also performing audits" (Federal Sentencing Guidelines, 2004). There are other parts of this law that that further establish compliance regulations.[46]

Because of the widespread corporate scandals discussed at the beginning of the chapter, the U.S. Congress implemented legal and compliance standards to curb and discourage illegal activities in corporations. While self-regulation will always play a major role in corporations' "doing the right thing," compliance has proven to be a necessary but not always sufficient element of corporate governance. Ethics continues to complement compliance, especially since the law cannot, does not, and will not cover every aspect of potentially harmful behaviors. Ethical dimensions and practices such as transparency, privacy, honesty, objectivity, integrity, carefulness, openness, respect for intellectual property, civility, confidentiality, accountability, responsible mentoring, and respect for colleagues are all necessary to motivate organizational behavior.

Ethical values become "actionable" in corporations by corporations first becoming aware of and then assuming

responsibility for the corporation's duties toward its stakeholders and stockholders. Social responsibility as a concept originated in 1953 when Howard R. Bowen, known as the "father of corporate social responsibility" (CSR), referred in a book to the "Social Responsibilities of the Businessman."[47]

CONCEPT CHECK

1. In what ways do law and compliance complement ethics in organizations?
2. How does stakeholder management differ from stockholder management?

5.6 Corporate Social Responsibility (CSR)

6. What value do CSR (corporate social responsibility) programs offer to organizations and society?

CSR contributes to another form of self-regulation that goes further and involves firms taking action to help people and the environment. CSR is described as "a belief that corporations have a social responsibility beyond pure profit." In other words, "Firms are social entities, and so they should play a role in the social issues of the day. They should take seriously their 'obligations to society' and actively try to fulfill them."[48] As such, corporations should employ a decision-making process to achieve more than financial success on the assumption that CSR is integral to an optimum long-term strategy.

In the 21st century, sustainability and corporate social responsibility (CSR) have become strategic imperatives for organizations as fundamental market forces for financial viability and success, where consumers are important stakeholders. Businesses worldwide develop CSR initiatives to become better corporate citizens but also to communicate their activity to both internal and external stakeholders, which may involve a number of groups.

A study by Horizon Media's Finger on the Pulse found that "81 percent of Millennials expect companies to make a public commitment to good corporate citizenship."[49] The 2015 Cone Communications Millennial CSR Study found that "[m]ore than nine-in-10 Millennials would switch brands to one associated with a cause (91% vs. 85% U.S. average), and two-thirds use social media to engage around CSR (66% vs. 53% U.S. average)."[50]

The 3 P's (profit, the people, and the planet), or "the triple bottom line" (TBL), is another concept (closely related to and reflective of the mission of CSR and firm activities.[51] TBL—also known as 3BL—incorporates and assists businesses measure accountability in their funding of and support for social, environmental (ecological), and financial benefits to allow for a greater good. Many corporations have started to add triple bottom line metrics to their business plans in order to evaluate their overall performance and reflect on how companies are contributing to society. A small sample of contemporary CSR initiatives make a difference. For example:

- The GE Foundation gave $88 million to community and educational programs in 2016.
- The 3MGives corporation funded $67 million in 2016 to focus on community and the environment, along with educational initiatives boosting student interest in science and technology.
- Apple was named by the environmental organization Greenpeace as the "greenest tech company in the world" for over three years because that firm's packaging is manufactured with 99 percent recycled paper products.
- Walt Disney Company's social mission to strengthen communities states that "by providing hope, happiness, and comfort to kids and families who need it most". The Walt Disney Company donated more than $400 million to nonprofit organizations in 2016.
- Virgin Atlantic's "Change is in the Air" sustainability initiative states its mission as: "Environment, sustainable design and buying, and community investment." This firm has since 2007 "reduced total

aircraft carbon emissions by 22% and [has] partnered with LanzaTech to develop low carbon fuels for the future. Virgin Holidays donates £200,000 annually to the Brandon Center for Entrepreneurship Caribbean to support young entrepreneurs in Jamaica."[52]



Exhibit 5.7 Hasbro Hasbro relies heavily on its strategic brand blueprint to guide its efforts in CSR, innovation, philanthropy, and product development. With a business portfolio that includes such well-known brands as Nerf, Play-Doh, Transformers, and Mr. Potato Head, the company focuses its CSR efforts on four key areas: product safety, environmental sustainability, human rights and ethical sourcing, and community. Here one of its products is featured at the Thanksgiving Day parade in New York City. (Credit: rowenphotography/ flickr/ NoDerivs 2.0 Generic (CC BY-ND 2.0))

Even with the current 2017 U.S. government's executive branch and Congress backing out of international climate change agreements to expand and promote fossil fuel production, taking actions to disable the EPA (Environmental Protection Agency), and not funding the Consumer Financial Protection Bureau, many corporations continue practicing CSR and 3BL principles to support sustainable environmental goals and objectives.[53]

While CSR is not a cure-all that can or will significantly make a difference in ushering in more sustainable environmental practices, help alleviate poverty, and use profits to help lower-income communities, it contributes to both internal and external stakeholder awareness to "do the right thing." For example, Teng and Yazdanifard argue and present evidence that some consumers do take CSR into account while making purchase decision. Also, CSR initiatives and actions have been shown to positively influence both internal and external stakeholders.[54] A study conducted in New Zealand explored the perceptions of internal stakeholders of New Zealand companies to discover the way in which the CSR, sustainability cultures, and identity are communicated internally. It was found that employee behaviors matter, as organizations that are well regarded in the community attract greater external loyalty, have more stable revenues, and face fewer crisis risks. A positive relationship with staff in organizations through CSR policies will not only attract better employees, it will also influence the morale, motivation, and loyalty of existing staff. The effective delivery of CSR initiatives also depends on how responsive employees are. If companies wish to achieve legitimacy by operating within a society's ethical expectations, they must also communicate internally to ensure that CSR activities are integrated into the organizational culture—they cannot "talk the talk" without "walking the walk."[55]

So, does CSR benefit the companies that practice such measures? A meta-analysis of 52 studies with a sample size of 33,878 observations suggested that "corporate virtue in the form of social responsibility and, to a lesser extent, environmental responsibility, is likely to pay off. . . . CSP [corporate social performance] appears to be more highly correlated with accounting-based measures of CFP [corporate financial performance] than with market-based indicators, and CSP reputation indices are more highly correlated with CFP than are other indicators of CSP" . Many business scholars do believe that some of these relationships are positive.[56] Robbins concludes that "[o]n balance, surveys and the research literature suggest that what most executives believe

intuitively, that CSR can improve profits, is possible. And almost no large public company today would want to be seen unengaged in CSR. That is clear admission of how important CSR might be to their bottom line, no matter how difficult it may be to define CSR and link it to profits."[57]

Without exception, the managers articulated the importance of communicating CSR initiatives and policy to their employees, as well as recognizing the need to improve their CSR internal communication strategies. According to the managers, CSR initiatives are promoted to create better corporations and a more ethical business environment. These included recycling, carpooling, staff development, and social activities. External initiatives included volunteering, fund-raising, and charitable donations.

Stakeholder Management

CSR and **stakeholder management** are complementary approaches. Stakeholder theory argues that corporations should treat all their constituencies fairly and that doing so can strengthen companies' reputations, customer relations, and performance in the marketplace.[58] "If organizations want to be effective, they will pay attention to all and only those relationships that can affect or be affected by the achievement of the organization's purposes."[59]

The ethical dimension of stakeholder theory is based on the view that profit maximization is constrained by justice, that regard for individual rights should be extended to all constituencies who have a stake in a business, and that organizations are not only "economic" in nature but can also act in socially responsible ways. To this end, companies should act in socially responsible ways, not only because it's the "right thing to do," but also to ensure their legitimacy.[60]

A stakeholder management approach first involves identifying the stakeholders of a company. A **stakeholder** is any group or individual who can affect or is affected by an organization's strategies, major transactions, and activities. Stakeholders include employees, suppliers, customers, shareholders, the government, media, and others. An illustration of the stakeholder relationships is provided in **Exhibit 5.8**.The term *stakeholder* has become commonplace in organizations. Companies and organizations that base their strategic decisions on the principle of duty to earn stakeholder trust "are likely to yield a number of strategic benefits, too, and can help manage political, social, and reputational risk."[61]

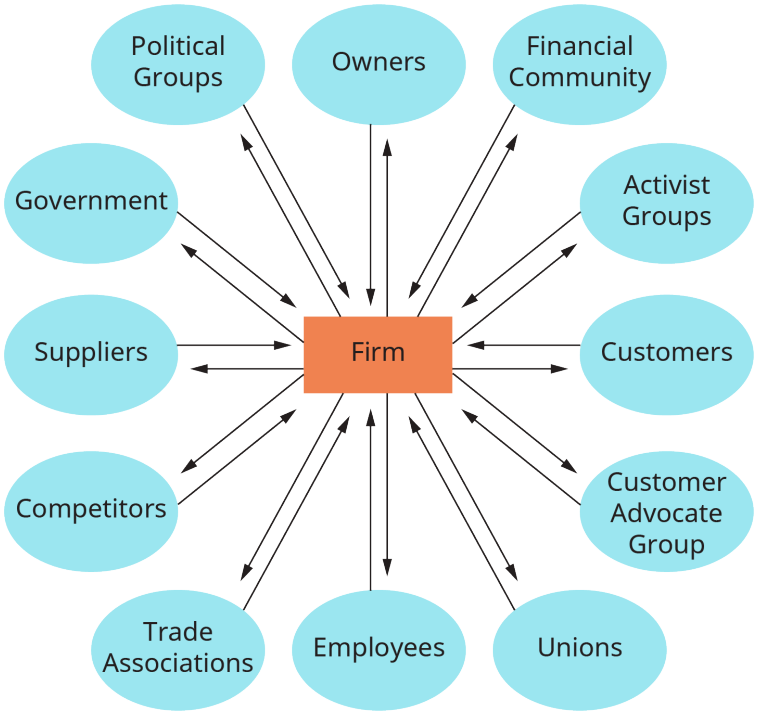

Exhibit 5.8 Stakeholder Map Source: Freeman, R. Edward. (1984). *Strategic management: A Stakeholder approach*, 25. Boston: Pitman. Reproduced with permission of the author.

Identifying and Influencing Major Stakeholders

There are several methods for analyzing stakeholder transactions and relationships with an organization that go beyond the purpose of this chapter.[62] Using an ethical perspective, a goal of this approach is for organizations to employ values of transparency, fairness, and consideration of stakeholder interests in strategic decisions and transactions. Toward that end, the following questions can be used from **Exhibit 5.8**.

1. Who are the stakeholders (that is, people who have an interest in supporting or resisting a proposed course of action, resolving an issue, and addressing a change)?
2. What are their stakes in either supporting or resisting the change?
3. What do the supporters stand to gain and lose from the change?
4. What do the resisters stand to gain and lose from the change?
5. What type(s) of power do the supporters have with regard to the change?
6. What type(s) of power do the resisters have with regard to the change?
7. What strategies can we use to keep the support of the supporters?
8. What strategies can we use to neutralize or win over the resisters?

Based on this approach, an organization's leaders and officers inform, involve, obtain feedback from, and influence each of their stakeholders with regard to strategy, issues, or opportunities the organization pursues. The Coca-Cola Company uses an ongoing stakeholder approach that is described on this site: **https://www.coca-colacompany.com/policies-and-practices/transparency**.

Had BP followed this approach in 2010, the now largest oil spill and rig explosion crisis in the history of such operations that occurred in the Gulf of Mexico, killing 11 workers and damaging over 600 square miles of land and sea, might have been prevented. It appeared that the leadership and culture at BP had been lax and out of touch with its stakeholders—and stockholders. As a consequence, the machinery and equipment were dated and not optimally functioning. One consequence is that employees, workers, communities, and the public may not have suffered that crisis and the continuing after effects.

CSR and stakeholder management have demonstrated benefits to firms' reputations and profitability.[63] The relationship of an organization's ethics and social responsibility to its performance concerns both managers and organization scholars. Studies have shown a positive relationship between ethical and socially responsible behavior and financial results. For example, one study of the financial performance of large U.S. corporations that are considered "best corporate citizens" found that they have both superior reputations and superior financial performance.[64] Similarly, Governance Metrics International, an independent corporate governance ratings agency, found that the stocks of companies run on more selfless principles perform better than those run in a self-serving manner. Top-ranked companies such as Pfizer, Johnson Controls, and Sunoco also outperformed lower-ranking firms on measures such as return on assets, return on investment, and return on capital.[65]

CONCEPT CHECK

1. How do sustainable business practices benefit consumers?
2. Differentiate the roles compliance and CSR programs serve in organizations. Are these the same, or are there differences? Explain.

5.7 Ethics around the Globe

7. What are ethical issues we encounter in the global environment?

Organizations operating on a global basis often face particularly tough ethical challenges because of various

cultural, political, economic, technological, and market factors. The greater the complexity of the environment, the greater the potential for ethical problems and misunderstandings for global organizations.[66] "Think … of the ethical value systems that shape behavior within and between countries, and the unpredictability that can result when there is a re-evaluation of what is acceptable and unacceptable." Recent and reoccurring global ethical problems and risks that organizations face include cybersecurity and political threats, international conflict and warfare, income inequality, planetary climate and environmental pollution and instability, corruption, and human and diversity rights violations. **Exhibit 5.9** illustrates the wide range of stakeholders and issues related to several of the risks in this figure that MNEs (multinational enterprises) must either prevent from occurring or manage when doing business across and within different country borders.

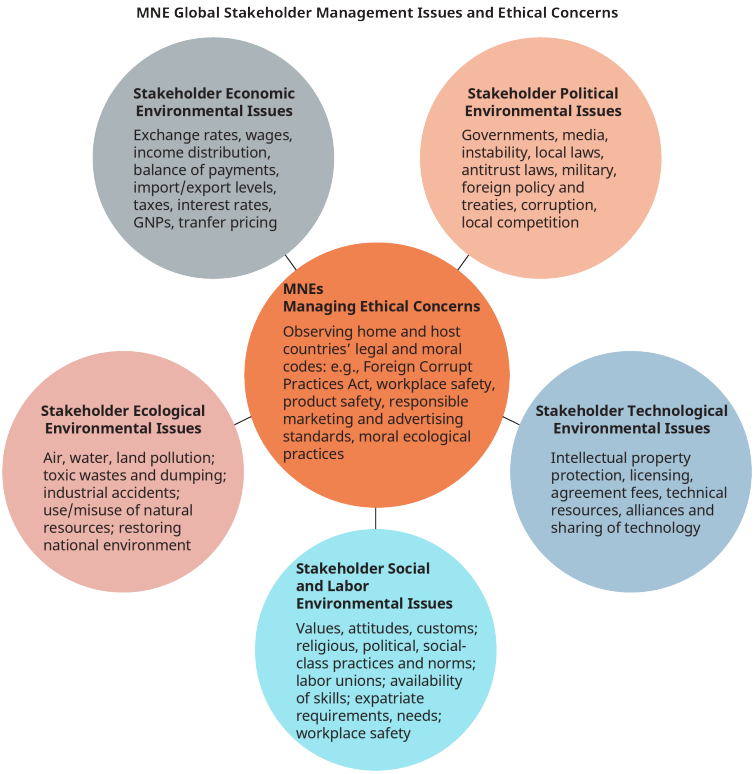

Exhibit 5.9 MNE Global Stakeholder Management Issues and Ethical Concerns Source: Copyright © Joseph W. Weiss, Bentley University, Waltham, MA. 2014.

Following laws related to doing business abroad is an added challenge for global firms. For example, the FCPA (Foreign Corrupt Practices Act) prohibits American firms from accepting or offering bribes to foreign government officials. U.S. individuals who cannot defend their actions with regard to the FCPA's antibribery provisions can face harsh penalties. "U.S. companies can be fined up to $2 million while U.S. individuals (including officers and directors of companies that have willfully violated the FCPA) can be fined up to $100,000 and imprisoned for up to five years, or both. In addition, civil penalties may be imposed."[67] Recently, the U.S. Department of Justice (DOJ) and the Securities and Exchange Commission (SEC) have been more aggressive in enforcing and prosecuting the bribery section of the FCPA. Halliburton Company in 2017 paid the SEC $29.2 million for bribing a friend of an official in Angola to negotiate a seven oil-field services contracts. The result was a disgorgement fine (i.e., a repayment of illegal gains with penalties imposed on wrongdoers by the courts) for violating the FCPA's records and internal accounting controls provisions.[68]

U.S.-based firms are also expected to not engage in unethical or illegal activities such as discriminating against local populations, violating local laws and norms, and disrespecting property and the environment. MNEs can also assist and add value to local countries. For example, the following practices are encouraged:

- Hiring local labor
- Creating new jobs

- Co-venturing with local entrepreneurs and companies
- Attracting local capital to projects
- Providing for and enhancing technology transfer
- Developing particular industry sectors
- Providing business learning and skills
- Increasing industrial output and productivity
- Helping decrease the country's debt and improve its balance of payments and standard of living.[69]

Globalization

The increasing phenomenon of globalization (an integrated global economy consisting of free trade, capital flows, and cheaper foreign labor markets)[70] also pressures global firms facing international risks to rely on governments, NGOs (nongovernmental organizations), the UN (United Nations), and other business and stakeholder alliances and relationships to help meet nonmarket threats. For example, the ten principles of the UN Global Compact serve as guidelines for international firms doing business in LDCs (least developed countries), and abroad, businesses should (1) support and respect the protection of internationally proclaimed human rights, (2) ensure that they are not complicit in human rights abuses, (3) uphold the freedom of association and the effective recognition of the right to collective bargaining, (4) eliminate of all forms of forced and compulsory labor, (5) abolish child labor, (6) eliminate the discrimination of employment and occupation, (7) support a precautionary approach to environmental challenges, (8) promote greater environmental responsibility through initiatives, (9) encourage the development and diffusion of environmentally friendly technologies, and (10) work against corruption, including extortion and bribery.[71]

While these principles may seem so universal as to be unattainable, they do stand as ethical milestones that protect human life, dignity, and personal welfare and values. However, when companies operate in LDCs and other cultures, it often is necessary to negotiate a balance between fairness, equality, and different local values and standards. U.S. and Western values may differ with local cultural norms, such as child labor and employee rights, in many countries. Donaldson and Dunfee offer methods for such negotiations.[72] A classic example was Levi Strauss doing business in Bangladesh several years ago. Children in that country under the age of 14 were working in two of Levi's local suppliers. This employment practice violated Levi's norms but not the local cultural norms. Firing the children would have prevented the children from being able to get an education and would have placed hardships on their families, who depended on the children's wages. A negotiated agreement (between Levi's universal values and local country norms) involved the suppliers agreeing to pay the children regular wages while they went to school and then hiring them when they turned 15 years old. Levi's agrees to provide for the children's tuition, books, and uniforms.

MNEs Corporate Cultures

MNEs must also create inclusive, ethical corporate cultures while managing both external and internal complexities such as hiring and training a diverse workforce, adapting to local culture norms while balancing home country ethics and values, and ensuring a multicultural approach to doing business across countries. Hanna identified five strategic questions that relate to organizational cultural sensitivities when doing business abroad as well as in a home country:[73]

1. "What do customers and stakeholders in our market expect from our organization? (Will their standard of living be raised? Will their cultural expectations be violated?)
2. What is our strategy to be successful in this competitive marketplace? (What can we realistically hope to achieve? What results are we willing to commit to?)
3. What are our governing values that define how we will work with stakeholders and with each other?
4. What organizational capabilities do we need in order to achieve these results?
5. What do our work processes, roles, and systems need to do so that we are consistent with all of the above?"

The author maintains that these questions will help bring an awareness to cultural differences and help organizational leaders and staff reach agreement on customizing decisions to fit a particular market while balancing company principles with local values.

Global firms are also sensitized to the recent #MeToo movement in the United States that raises women's awareness and courage to speak out about sexual harassment and assault in companies and workplaces. This movement further highlights the need to diversify and integrate workforces on the basis of gender and other traits that match customers' and population characteristics. This need is not only based on ethical factors such as fairness, equality, rights, and justice, but also on competitive advantage and marketing awareness. To that end, organizational leaders are implementing more gender-balanced talent pools, especially at the early-to-mid-career levels and the mid-to-upper levels globally. Gender balance is beginning to be seen as "a broader, more strategic cultural shift that includes developing leadership teams representing geographically diffuse markets. These leaders are recognizing that this balance drives the innovation and market understanding they need for other key business transformations. Without balance, they simply won't understand the world that's emerging."[74]

For example, Dutch-based Royal DSM—the $8 billion global company in health, nutrition, and materials science—has shifted from a male-run organization to a gender-balanced leadership team in three steps: (1) setting a vision connecting the goal to business success, (2) engaging men of the firm's dominant nationality, and (3) building competencies while working across nationality and gender differences. In 2000, DSM's top 350 executives were 75% Dutch and over 99% male. In 2017, the firm was 40% Dutch and 83% male. The CEO, Feike Sijbesma, plans to decrease the male ratio down by 2% per year and down below 75% by 2025. He is prioritizing sustainability and credibility more than speed.[75]

Govindarajan's research indicated that, even though organizational cultures may vary widely, there are specific components that characterize a global culture. These include an emphasis on multicultural rather than national values, basing status on merit rather than nationality, being open to new ideas from other cultures, showing excitement rather than trepidation when entering new cultural environments and being sensitive to cultural differences without being limited by them.[76] Managers must also think more broadly in terms of ethical issues. Companies are using a wide variety of mechanisms to support and reinforce their ethics initiatives on a global scale. A useful mechanism for building global ethics in an organization is the social audit, which measures and reports the ethical, social, and environmental impact of a company's operations.[77]

Also, as noted earlier in the chapter, Ethisphere—a renowned organization that evaluates the effectiveness of an organization's communication, training, ethics, culture, and compliance efforts to gain insights into employee concerns—continues to survey and publish annual results of "The World's Most Ethical Companies."[78] These surveys offer benchmarks of global and national companies' best ethical practices. A major finding from one of that organization's conferences stated that "[o]ut of the 644 respondents to the NAVEX Global 2016 Ethics & Compliance Training Benchmark Report, 70 percent said that 'creating a culture of ethics and respect' was one of their top training objectives. When it comes to CEOs, 92 percent agree that a strong corporate culture is important."

CONCEPT CHECK



1. What ways can and do some MNEs demonstrate social responsibility in foreign countries?
2. What are some specific ethical business practices other countries (besides the United States) and regional governing bodies (such as the European Union) practice and demonstrate with regard to the environment and competition?

5.8 Emerging Trends in Ethics, CSR, and Compliance

8. Identify forecasts about contemporary ethical and corporate social responsibility issues.

Predicted trends in ethics, compliance, and corporate social responsibility for Fortune 500 companies, governments, groups, and professionals by Navex Global include:

1. "A shift in the 'power of voice in the story of harassment.'" The #MeToo movement has changed everything. "Bill Cosby, Harvey Weinstein, Charlie Rose, Kevin Spacey, Al Franken, Matt Lauer, and Garrison Keillor" and other high-profile public figures have pressured organizations through public forum social media forums to take action. "Victims of harassment have the power of choice. They can make an internal report and hope that their organization responds properly, or they can choose to take their story public." A clear message for corporations and ethics and compliance officers is, "Create a corporate culture in which employees feel comfortable raising their voices about anything from sexual harassment to feelings of being insulted. This will allow your compliance program to resolve issues before they turn into scandals, and preserve the integrity of your organization's culture internally and its reputation externally. And don't ever tolerate retaliation."
2. The "Glassdoor" effect (when people trust online reviews of their companies more than what companies communicate) and the effect of trust when employee messages go viral on social media. Companies need to create "listen-up" cultures by creating internal reporting systems in which leadership and managers listen to and support employees when they raise their voices for the betterment of the company. "This ensures employees know that their report will be heard, taken seriously, and things will change if necessary."
3. Assisting national disasters that suddenly occur causes havoc not only for vulnerable populations but also for unprepared organizations. Ethics and compliance professionals learned from 2017's natural disasters (hurricanes in particular) to update preparation plans and test emergency hotlines, communications systems, and employee readiness.
4. The acceleration of the need for compliance and ethics programs as economies begin again to grow; "growth without ethics and governance does nobody any favors. Growth with ethics and governance won't simply be a feel-good mantra in 2018, it will be a business imperative."
5. Creating a "culture of compliance" in corporations (a culture of integrity and ethics) over one of "vicious compliance" (an overreliance on laws and regulations). "Finally, and most importantly, leadership accountability is what every employee is watching. In the end, what happens to the top performers who violate the rules will send the loudest message of all to the organization."
6. An increasing need for compliance's role in prevention and mitigation as cybersecurity evolves. "Compliance must play an integral part in any organization's cross-functional cyber security program to make sure such efforts are enterprise-wide."
7. Giving new voice to whistle-blowers is predicted as "regulatory scrutiny is increasing, and the voice of the whistleblower in the [Silicon] Valley is growing louder as well." Corporations need to listen and resolve whistle-blowers' issues internally before they decide to go outside.
8. Managing culture and free speech in the workplace during "polarizing times" continues about "race, gender, sex, sexual orientation, gender identity, national origin, and religion—and people's right to fair treatment, protection, and the rights and benefits enjoyed by others."
9. Data privacy is becoming a larger concern for chief compliance officers in companies as "privacy laws and the environments they regulate, have evolved." Creating a safe and respectful workplace is needed.
10. The role of the compliance professional evolves and innovates as "old networking models are giving way to online networks that provide new and unprecedented opportunities to share ideas and collaborate."

Ethics and compliance go hand in hand as stated earlier. With a strong ethical culture, compliance is more effective in preventing risks, and without a compliance program, those who deliberately choose to break laws and codes of conduct would create disorder. "Strong cultures have two elements: A high level of agreement

about what is valued and a high level of intensity with regard to those values. "In the long run, a positive culture of integrity is the foundation for an effective ethics and compliance program, which, when properly embedded into an organization, can create a competitive advantage and serve as a valuable organizational asset," quoted from Keith Darcy, an independent senior advisor to Deloitte & Touche LLP's Regulatory and Operational Risk practice.[79]

Moral Entrepreneur: A New Component of Ethical Leadership?

An innovative development in ethics and business is the concept of "moral entrepreneur."[80] Brown and Trevino found that people who have been exposed to a **moral entrepreneur** are more likely to become a moral entrepreneur themselves because they have experienced its potential and experienced how it is done. Inspiration certainly takes place, and the person's well-being is improved.[81]

Related to moral entrepreneurship is ethical leadership. Brown and Trevino's ethical leadership is defined as "the demonstration of normatively appropriate conduct through personal actions and interpersonal relationships, and the promotion of such conduct to followers through two-way communication, reinforcement, and decision-making." Examples of such conduct include openness, honesty, and treating employees fairly and thoughtfully. Social learning theory was used to gain an understanding as to why ethical leadership is important to employees and how it is perceived to work.

Ethical leaders are models of ethical conduct who become the targets of identification and emulation for followers. For leaders to be perceived as ethical leaders and to influence ethics-related outcomes, they must be perceived as attractive, credible, and legitimate. They do this by engaging in behavior that is seen as normatively appropriate (e.g., openness and honesty) and motivated by altruism (e.g., treating employees fairly and considerately). Ethical leaders must also gain followers' attention to the ethics message by engaging in explicit ethics-related communication and by using reinforcement to support the ethics message.[82]

In addition to social learning theory, which focuses on why and how supporters follow a leader, a social development approach to the concept of ethical leadership is also needed because it focuses on the direction that leadership should take. Studies on corporate social responsibility are concerned with how companies can contribute to societal development, not only in the sense of solving social problems but also in the sense of improving social welfare, promoting social progress, and creating new social value.

Muel Kaptein argues that there is a third component to ethical leadership—moral entrepreneurship, in addition to the already defined components of the moral person and the moral manager.[83] His belief is that moral entrepreneurship opens avenues for studying various antecedents and outcomes of ethical leadership that hasn't been acknowledged adequately to date.

Studies of the antecedents of ethical leadership, at both the situational and personal levels, have found that leaders who have had ethical role models are more likely to become ethical leaders.[84] These studies have also found that the personality traits of agreeableness and conscientiousness are positively related to ethical leadership. And studies on corporate social responsibility are concerned with how companies can contribute to societal development, not only in the sense of solving social problems, but also in the sense of improving social welfare, promoting social progress, and creating new social value.

According to Kaptein, someone who creates a new ethical norm is called a moral entrepreneur. Becker believes that those people who make moral reform happen are the moral entrepreneurs. He differentiates between two kinds of moral entrepreneurs: those who create new norms and those who enforce new norms. The moral entrepreneur experiences something horrific that prompts him to want to do something to solve the issue, as Kaptein describes, a want to correct by translating a preferred norm into legal prohibitions: however, he risks becoming an outsider themselves if they are not unable to congregate support for the new norm.

Kaptein states that the component of moral entrepreneurship complements the two other components of ethical leadership (moral person and moral manager), because it highlights the creation of new norms instead

of only following and implementing current ethical norms. Becker suggests that helping others is important and having the altruistic trait is important for a moral entrepreneur. Yurtsever, in developing a scale for moral entrepreneurship personality, suggests that moral entrepreneurs demonstrate high moral virtues, such as justice and honesty.[85] Moreover, being a moral manager is important to be able to get the support of others to follow the new ethical norm. In order to be successful as a norm creator, one needs the support of others. Even though the three components of ethical leadership complement each other, it is still possible for someone to only exhibit one or two of the components, making ethical leadership a multidimensional construct. For instance, one can be a moral entrepreneur without being a moral manager (what Becker calls the norm creator), or one can be a moral manager without being a moral entrepreneur, what Becker calls the norm enforcer.

Concluding Comments

So, does it pay to be ethical and moral, whether it be entrepreneurs and individuals or corporations and organizations? We have discussed this question in this chapter and presented different arguments with different views. Scholars and ethicists who have debated whether or not corporations can be ethical differ on their responses. One such conference in the INSEAD Business School in France closed with the following statement: "Theoretically, a strong case can be made for the moral responsibility of firms. However, this does not preclude individual moral responsibility for acts as a corporate member. Moreover, it was also evident that considerable concern exists about corporate misconduct going unsanctioned and the possibility that both good and bad corporate behavior is profoundly influenced by the extent to which individuals and corporate entities are held morally responsible."[86]

This statement implies that both corporations and individuals bear the possibility and responsibility for unethical—as well as illegal—acts. While corporations are not individuals, people work and relate in corporate and work settings. That is why organizational leaders and cultures play such important roles in setting the tone and boundaries for what is acceptable (ethically and legally) and what is not. Ethical values and legal, compliance codes of conduct together work to prevent and if necessary seek correction and justice for unlawful actions. As noted earlier, promoting and rewarding ethical actions are more desirable and in the long-term more profitable.

Prooijen and Ellemers's study using social identity analysis found that individuals are attracted to teams and organizations with positive features such as organizational "competence and achievements" and "moral values and ethical conduct." Since these two features do not always cohere working environments, the authors' study had students choose in three different studies which they would prefer in seeking employment, "perceived competence vs morality of a team or organization." They found that "[r]esults of all three studies converge to demonstrate that the perceived morality of the team or organization has a greater impact on its attractiveness to individuals than its perceived competence."[87]

CONCEPT CHECK

1. What are some emerging national and global issues and trends in ethics and business ethics?

Key Terms

business ethics The area of applied ethics that focuses on real-world situations and the context and environment in which transactions occur.

corporate culture The beliefs and behaviors that determine how a company's employees and management interact inside an organization and also handle outside business transactions. Corporate culture develops organically over time from the cumulative traits of the leaders and the people that the company hires.

ethical dilemma A situation in which a difficult choice has to be made between two courses of action with ethical consequences.

ethical relativism Holds that people set their own moral standards for judging their actions, based on self-interest.

ethics The code of moral principles and values that governs the behaviors of a person or group with respect to what is right or wrong.

instrumental values The preferred means of behavior used to obtain desired goals.

justice Four major tenets: (1) All individuals should be treated equally; (2) Justice is served when all persons have equal opportunities and advantages; (3) Fair decision practices, procedures, and agreements among parties should be practiced; (4) Punishment is served to someone who inflicts harm.

moral entrepreneur Someone who creates a new ethical norm.

normative ethics The field of ethics concerned with our asking how *should* and *ought* we live and act.

rights Legal rights are entitlements that are limited to a particular legal system and jurisdiction, while moral rights are universal and based on norms in every society.

servant leadership Involves selflessly working with followers to achieve shared goals that improve collective, rather than individual, welfare.

stakeholder Any group or individual who can affect or is affected by the achievement of an organization's objectives. The use of the term *stakeholder* has become commonplace in organizations.

stakeholder management The systematic identification, analysis, planning, and implementation of actions designed to engage with stakeholders

stewardship Concerned with empowering followers to make decisions and gain control over their work.

terminal values Desired goals, objectives, or end states that individuals wish to pursue.

virtue ethics Grounded in one's character, focusing on what type of person one ought to be.

Summary of Learning Outcomes

5.1 Ethics and Business Ethics Defined

1. What are ethics and business ethics?

A goal of the chapter is to present ethical principles, guidelines, and questions that inform our individual decision-making and influence actions we can take with regard to questionable ethical situations and dilemmas. We also present and illustrate how business leaders, corporations, and organizations internationally have responded and are responding to questionable ethical problems with the environment in their communities through responsible corporate governance and alliance with concerned stakeholders. Ethics is both local and global; it begins with the individual, moves to the organizational, and reaches to international and global levels of societies.

5.2 Dimensions of Ethics: The Individual Level

2. What are the types of values that motivate ethics at the individual level?

Ethics at an individual level may seem to involve only the individual, but it is a holistic process. There may be high pressure from coworkers, managers, or any other constituent of business culture to be unethical. Individuals may hate such pressures, and they tend to work to avoid the dilemmas.

5.3 Ethical Principles and Responsible Decision-Making

3. What are the major ethical principles that can guide individuals and organizations?

There are many approaches for both individuals and organizations to take with regard to ethical principles. They are utilitarianism; universalism, which is a duty-based approach; a rights approach, which takes a moral and legal approach; justice; virtue; common good; and finally the ethical relativism approach.

5.4 Leadership: Ethics at the Organizational Level

4. Why is ethical leadership important in organizations?

After the failures of Enron and other organizations, people have started emphasizing the concept of ethical leadership. An organization can incorporate ethical practices only if its leaders enforce ethical values into the organization. While such basic concepts of ethics such as being honest are crucial to ethical leadership, a modern approach is to take the servant leadership approach, where the leader serves the interests of all stakeholders in an ethical manner.

5.5 Ethics, Corporate Culture, and Compliance

1. What are the differences between values-based ethics and compliance in organizations?

A compliance-based ethical approach is simple and direct. It provides a basic integrity to the participant since it is spelled out in clear terms. If the individual or organization exhibits destructive behaviors, their rights can be restricted. An integrity-based ethics code fills the receiver with demands based on the highest expectations.

5.6 Corporate Social Responsibility (CSR)

6. What value do CSR (corporate social responsibility) programs offer to organizations and society?

Corporate social responsibility is about an organization taking responsibility for the impacts of its decisions and activities on all aspects of society, the community, and the environment. Corporate social responsibility is about contributing to the health and welfare of society and operating transparently and ethically. More importantly, this way of operating should be embedded in the business, rather than an afterthought.

5.7 Ethics around the Globe

7. What are ethical issues we encounter in the global environment?

Some of the most common ethical issues organizations encounter globally include outsourcing, working standards and conditions, workplace diversity and equal opportunity, child labor, trust and integrity, supervisory oversight, human rights, religion, the political arena, the environment, bribery, and corruption.

5.8 Emerging Trends in Ethics, CSR, and Compliance

8. Identify forecasts about contemporary ethical and corporate social responsibility issues.

Among the emerging issues in the area of ethics are in the area of harassment in the era of #MeToo. Organizations and individuals are also more accepting of their roles in assisting with such things as natural disasters and national emergencies. Finally, there is increasing attention to issues of compliance and governance to ensure that organizations meet their stated ethical standards.

Chapter Review Questions

1. What is the difference between ethics and business ethics?
2. What is normative ethics?
3. Why are values an important element of ethics for individuals and organizations?
4. What are the differences between instrumental and terminal values?
5. Can an individual be ethical without using ethical principles described in the chapter? Explain.

6. Identify major classical ethical principles.
7. Differentiate between the principle of rights and utilitarianism and between justice and universalism.
8. Why is leadership important for ethical conduct in corporations?
9. Identify two types of ethical leaders and the important role each plays.
10. What is the difference between ethics and compliance in organizations?
11. What is CSR, and why is it important?
12. What is stakeholder management?
13. What is the difference between stakeholders and stockholders?
14. What is different about ethics in a global or international context and ethics in a national context or setting?
15. What are some global issues that corporations must face today, and why are these important?
16. Identify some contemporary ethical and compliance trends affecting corporations, employees, and individuals now.
17. What is a moral entrepreneur?
18. Does ethics pay? Explain.
19. After reading this chapter, what are major insights you have about ethics and CSR?

Management Skills Application Exercises

1. What are some advantages and disadvantages of leaders, managers, and employees having and working with a principle-centered approach (using some ethical principles in the chapter) rather than taking a "come what may," trust in luck, circumstance and chance approach?
2. Would you rather work for a company that takes a stakeholder or stockholder approach in its dealings with customers, employees, suppliers, and other constituencies in its network? Explain.
3. What are some principles (from the chapter) that leaders and managers can use to guide their actions in ethical ways?
4. What can organizational managers and leaders learn with regard to organizational cultures that would inspire and motivate employees to do the right thing in their work?
5. What type of leaders and leadership styles and practices often lead to problems with employees, customers, and other stakeholders and stockholders?
6. Describe how a leader, manager, and employee might think and act differently if their organization seriously adopted and practiced doing business with a corporate social responsibility mindset.
7. What are some concerns that have ethical implications that a leader, manager, or employee might have when doing business internationally or globally?
8. After reading the section in the chapter on ethical and compliance trends going forward, what top two or three things do you think organizational leaders and managers would want to take action on preparing for now? Why?

Managerial Decision Exercises

1. You are a manager, and your boss—who is also a friend—has reprimanded a fellow employee (also a friend) in ways that are demonstrably unfair and unethical but not illegal. That employee has confided in you with the facts, and you agree. The employee asks you not to mention anything to the boss but to go with her to human resources for support while she reports him for those actions. What would you do, if anything, and why? Explain.
2. One of your direct reports thinks that you are not acting responsibly or in the best interests of the company with him or the department in which you work. The direct report has informed you that your communication and work style are lacking and that this is also causing problems with others in the department. You are upset over this news and realize it could cause you problems with your boss and those above. What would you do, when, why, and how?
3. You learn that a woman in your department has complained about sexually improper advances toward

her by your boss and another more senior person above that boss. You know the woman but not well. She may be right in this instance. You have heard rumors that she often exaggerates and sometimes can't be trusted. You don't particularly like her and are concerned about your own reputation if she's wrong. What would you do and why?

4. Your department boss wants you to select a few others in your organization to explore adopting corporate social responsibility practices. Some of your friends think that CSR isn't effective and in fact wastes resources and time of those who get involved. To take on this assignment would require time out of doing your own work. However, you have noticed that your organization's leadership isn't all that responsible and responsive to employees and many customers. Maybe adopting more ethical standards and practices could improve business and some of the questionable leaders' behaviors. What would you do and why?



Critical Thinking Case

Wells Fargo

The Wells Fargo recent crisis over mismanaging customer relationships, fraudulently implementing illegal and unethical sales practices with trusted clients, has cost the company in fines, lost business, and the resignation of the CEO. The following online sources offer a narrative and factual source of what happened, when, to whom, and why. Use these sources to answer and provide evidence to the following questions to present to the class:

Critical Thinking Questions

1. What were the sources and causes the problems in the first place? Explain.
2. Who were some of the primary decision makers that led to the illegal sales activities?
3. What were these individuals' motives and motivations?
4. How were the illegal and fraudulent activities discovered?
5. Who was to blame?
6. What unethical activities occurred before the illegal actions took place?
7. What would you have done, if anything, had you been one of the sales professionals pressured to engage in unethical, illegal practices there?
8. How would a stakeholder approach, if taken by the company's top leaders and board of directors, have possibly prevented the crisis?

Sources: Comrie, Harley, "Wells Fargo Fake Accounts Scandal", Seven Pillars Institute, March 15, 2017, http://sevenpillarsinstitute.org/case-studies/wells-fargo-fake-accounts-scandal ; "Wells Fargo Banking Scandal a Financial crisis We Can Finally Understand", *The Guardian*, accessed January 2, 2019, https://www.theguardian.com/business/us-money-blog/2016/oct/07/wells-fargo-banking-scandal-financial-crisis; Glazer, Emily, "Wells Fargo's Textbook Case of Botched Crisis Management", The Wall Street Journal, October 13, 2017, https://www.wsj.com/articles/wells-fargos-textbook-case-of-how-not-to-handle-a-crisis-1476380576.



6

International Management

Exhibit 6.1 (Credit: Xiquinho Silva /Flickr/ Attribution 2.0 Generic (CC BY 2.0))

Introduction

Learning Outcomes

After reading this chapter, you should be able to answer these questions:

1. Why is it important to understand and appreciate the importance of international management in today's world?
2. What is culture, and how can culture be understood through Hofstede's cultural framework?
3. How are regions of the world categorized using the GLOBE framework, and how does this categorization enhance understanding of cross-cultural leadership?
4. Why is an understanding of cultural stereotyping important, and what can students do to prepare for cultural stereotyping by looking at social institutions?
5. What steps can you undertake to be better prepared for cross-cultural assignments?
6. What are the main strategies that companies can use to go international?
7. Why might it be necessary for a company to go international, and how might it accomplish this goal?

EXPLORING MANAGERIAL CAREERS

Mike Schlater, Domino's Pizza

Domino's Pizza has more than 14,000 stores worldwide. As executive vice president of Domino's Pizza's international division, Mike Schlater is president of Domino's Canada with more than 440 stores. Originally from Ohio, Schlater started his career with Domino's as a pizza delivery driver and worked his way up into management. Schlater saved his earnings, and with some help from his brother, he was able to accept the opportunity to have the first international Domino's franchise in Winnipeg, Manitoba, in 1983. Within weeks, Schlater's store in Canada reached higher sales than his previous store in Ohio had ever attained.

However, it was not an easy start. Schlater faced a number of challenges going international. First, he had to identify the international suppliers and get them approved to sell their products to Domino's. This shows

one of the challenges that organizations face when entering new global markets. To meet quality standards designed to protect a brand, companies must undertake an extensive review of potential new suppliers to ensure consistent product quality.

Second, as discussed in this chapter, a major challenge when opening a business on foreign soil is negotiating the political, cultural, and economic differences of that country. Domino's relies on local master franchisees to take advantage of their local expertise in dealing with marketing strategies, political and regulatory issues, and the local labor market. The master franchisees of Domino's Pizza's international business are individuals or entities who, under a specific licensing agreement with Domino's, control all operations within a specific country. Such master franchisees have deep local knowledge that helped Domino's succeed. For example, it takes local experience to know that only 30 percent of the people in Poland have phones, so carryout needs to be the focus of the business; that Turkey has changed its street names three times in the past 30 years, so delivery is much more challenging; or that, in Japanese, there is no word for pepperoni, the most popular topping worldwide. These are just a few of the challenges that Domino's has had to overcome on the road to becoming the worldwide leader in the pizza delivery business. Under the leadership of people like Schlater, and with the help of dedicated, local master franchisees, Domino's has been able to not only compete in, but lead the global pizza delivery market.

Such an impressive career path might seem like luck to some, but Schlater achieved his success due to determination and attention to detail. Additionally, despite such success, Schlater has been socially responsible. Consider that Schlater recently won $250,000 in a lottery. Since Schlater believes in philanthropy, he donated the entire amount to Cardinal Carter High School in his hometown. Over the years, Schlater has donated millions of dollars to foundations and charities, such as the London Health Sciences Foundation, because he now has the ability to indulge after spending decades climbing the corporate ladder at Domino's Pizza. Such charitable focus has also shone light on his socially responsible tendencies, another critical aspect of success.

Schlater is now president of Domino's of Canada, Ltd., which operates more than 440 stores located in every province, as well as the Yukon and Northwest Territories.

Sources: "Domino's Pizza Corporate Facts," http://phx.corporate-ir.net, accessed June 20, 2017; Domino's Canada website, https://www.dominos.ca, accessed June 20, 2017; Trevor Wilhelm, "Domino's CEO, who lives in Leamington, will donate $250K lotto winnings to high school," *Windsor Star*, February 27, 2015.

The above example shows that Domino's has successfully managed global challenges to become successful internationally. For many business leaders over the past few decades, the business world was becoming "flat" because barriers to trade were slowly disappearing. The expectation was that soon global companies would operate unconstrained by national borders. However, recent trends suggest that the business world is now seeing a barrage of protectionism and nationalism as many countries and their leaders emphasize the negatives of globalization. Consider that the U.K. is currently experiencing the Brexit negotiations and a potential exit from the European Union. The European Union has provided the means to the U.K. to freely trade with a number of other European countries without hindrance. At the same time, rhetoric about policies and practices to protect local industries against global competition and to protect local jobs is increasing. But does this mean globalization is dead? Far from it—experts have analyzed recent trade data and shown that globalization is actually strengthening. The **DHL Global Connected Index**, which tracks the flow of capital, information, trade, and human resources, indicates that the degree of globalization continues to rise.[1] This finding suggests that any serious management scholar will need to be aware of the importance of international management and the need to be able to adapt practices to ensure that management of global operations goes smoothly.

No company is immune to the forces of globalization. Whether you run a small company based in Wisconsin or

manage a Fortune 500 company, you are affected by global forces. You may compete with firms from China or India, have coworkers from Egypt, Brazil, or Germany, or have to negotiate with someone from Russia. This chapter will prepare you for the complexities of international management by discussing some of the crucial issues faced by managers of international companies today. The chapter begins by discussing some of the key factors in making the business world global today and why an understanding of international management is so critical. The chapter then explores the importance of national cultures because cross-cultural conflicts can make an international business difficult to navigate and manage. By understanding the countries and the cultures they find themselves in, international managers can better prepare to deal with such differences, including appropriate preparation for cross-cultural assignments, preferred leadership styles around the world, and the potential for stereotyping.

The chapter concludes with coverage about the various approaches to taking a company international, the advantages and disadvantages of each approach, and the types of business strategies available to companies in the international arena.

6.1 Importance of International Management

1. Why is it important to understand and appreciate the importance of international management in today's world?

International management is a critical area for any serious student of management because of **globalization**, the worldwide phenomenon whereby the countries of the world are becoming more interconnected and where trade barriers among nations are disappearing. Companies of all kinds are no longer limited to producing and selling their goods and services in domestic markets. In fact, companies are encouraged to explore global markets to stay competitive and are thus likely to have business activity anywhere in the world. Globalization is being facilitated by several key factors, and companies that want to succeed in this environment must understand the key factors that are making the business world more globally connected.

Globalization Factor 1: Lowering Trade Barriers

The first critical factor is the lowering of trade barriers through **trade agreements**, government policies through which countries agree to eliminate cross-border barriers to trade and to promote global integration. To understand the importance of trade agreements, it is necessary to note that countries have long used tariffs to protect local industries and companies. **Tariffs** are taxes that are added to the price of imported international products. Because these tariffs are usually passed along to the consumer in the form of higher prices, imposing tariffs on imported goods gives domestic companies a price advantage and protects them from foreign competition.[2] The goal of most trade agreements has been to reduce or eliminate tariffs and other barriers to make cross-border trade easier.

One of the more significant worldwide trade agreements are the rules members in the World Trade Organization (WTO) agree to.[3] The WTO is the only truly global organization that deals with the rules of trade around the world. It was established January 1, 1995, and had 164 country members as of July 2016. The WTO serves many functions, but the four most important are 1) providing the mechanism for countries to negotiate trade agreements, 2) monitoring such agreements, 3) providing the means to handle trade disputes, and 4) providing training to less-developed countries to implement agreements.

Globalization Factor 2: Foreign Direct Investment

Foreign direct investment (FDI) refers to deliberate efforts of a country or company to invest in another country through the form of ownership positions in companies in another country. In 2017, global FDI flows amounted to USD $1.52 trillion.

Exhibit 6.2 shows the top 15 recipients of FDI in 2016. As you can see, many of the world's developed economies, such as the U.S., Germany, Canada, and France, are among the top recipients of FDI. However, it is

also important to note that many emerging markets, such as China, Brazil, Mexico, and India, figure prominently on this list. **Emerging markets**, defined as those markets in nondeveloped countries that present tremendous potential for multinationals, have played a critical role in the global business environment for the last decade. Countries such as Brazil, India, China, and South Africa have all experienced tremendous growth and are driving business trends.

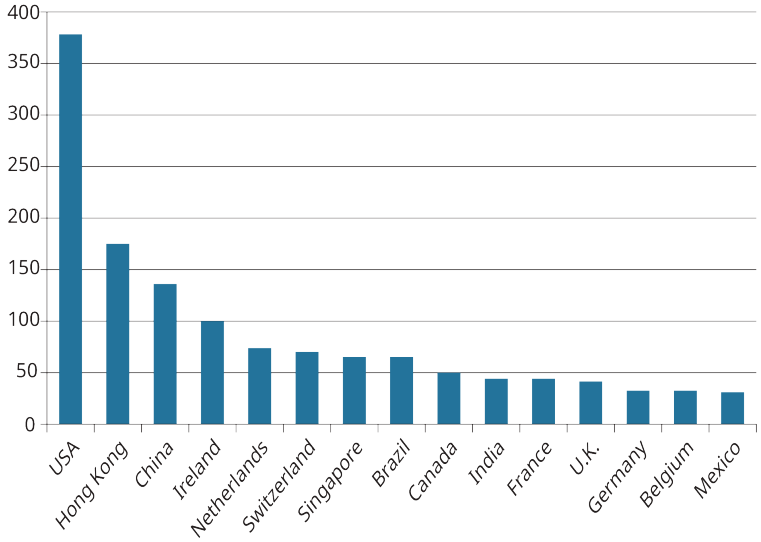

Exhibit 6.2 Foreign Direct Investment Inflows from Other Countries Based on: UNCTAD, 2016, *World Investment Report, 2016*.

An important consequence of the rise of emerging markets has been the growing importance of emerging market multinationals. **Emerging market multinationals** are influential companies from emerging markets that compete head-on with established multinationals and rewrite the rules of competition by using new business models. Consider the case of CEMEX, the Mexican cement manufacturer; Shoprite, the South African retailer; and WIPRO and Infosys, India's leading software companies. These emerging market multinationals are industry leaders in their fields and are pushing more established multinationals to the competitive edge.



Exhibit 6.3 A CEMEX train in Germany Mexican company CEMEX, whose primary businesses are cement and concrete, has pursued a strategy of differentiation. It defines itself as a provider of solutions for builders and local governments, particularly in emerging economies and for those seeking environmental sustainability. As part of this evolution, CEMEX rebounded from a near bankruptcy during the 2008 economic crisis to regain its position as a leading company in the global construction materials industry. (Credit: Paul Smith/ flickr/ Attribution 2.0 Generic (CC BY 2.0))

The lowering of trade barriers and the increase in foreign direct investment indicate that global trade will continue to stay strong and contribute to globalization. Such trends suggest that companies will need to continue to contend with and take advantage of global opportunities. The rising competition from emerging

markets and emerging market multinationals means that companies will need to continue to understand and manage the global environment to compete.

Globalization Factor 3: The Internet

Thanks to the pervasiveness of the Internet today, any company in the world can sell its products to anyone in the world. In fact, the developments in information technology and the reduction in costs of technological equipment mean that any multinational can reach anyone in the world. Social media, such as Twitter and Facebook, also provide a means for multinationals to build relationships with customers worldwide. Data also suggests that even countries that previously had little access to the Internet are now experiencing tremendous growth. To give you more insights on Internet growth, consider **Exhibit 6.4**.

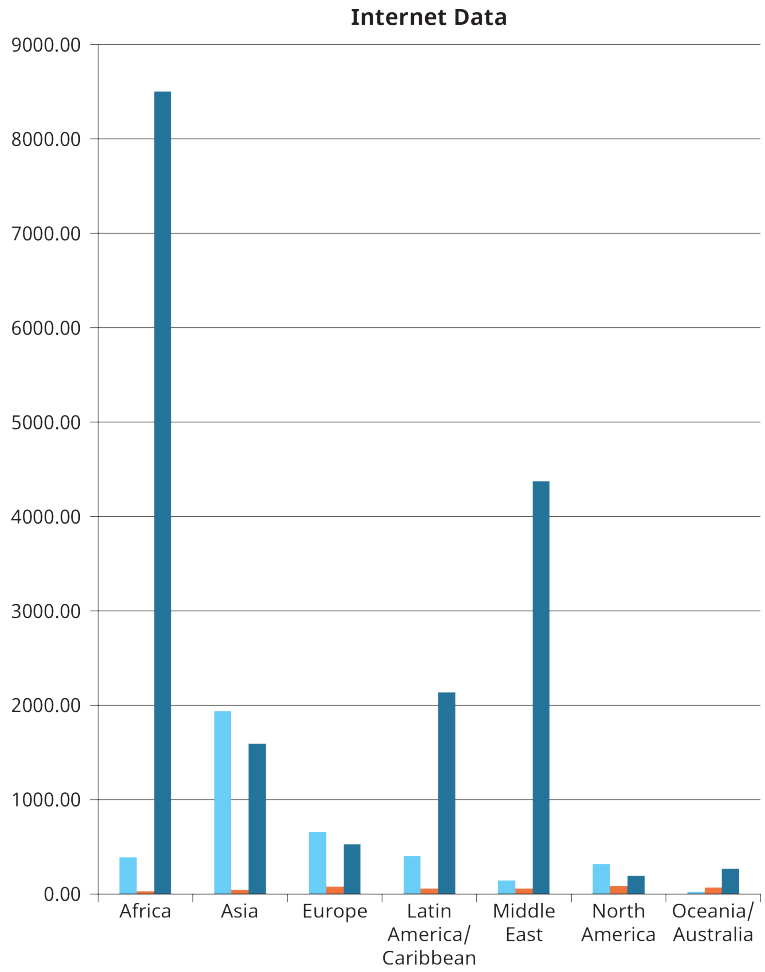

Exhibit 6.4 Internet Growth and Penetration Rates (% of population with access to Internet) Based on www.Internetworldstats.com

As **Exhibit 6.4** shows, the pervasiveness of the Internet cannot be ignored. Collectively, Internet users amount to 3.8 billion individuals, representing half of the world's population. Additionally, while the penetration rates in some regions such as Europe and North America are high, the rates of penetration in regions in Asia (46.7%) and Africa (31.2%) suggest that these countries have great potential. When coupled with the dizzying growth rates of the Internet in regions such as Africa (more than 8000% increase from 2000 to 2017), Latin America (2137%), and the Middle East (4374%), any multinationals have to appreciate the importance of the growth of the Internet.

What are the implications of this factor for international management? As mentioned earlier, companies located anywhere in the world will be able to find new markets and new ways to reach new customers. Consider the case of Russian entrepreneur Dmitrii Dvornikov, who was selling jewelry and table clocks made

from Russian semiprecious stones.[4] Until 2013, Dvornikov was not able to expand beyond local markets. However, he decided to list his products on eBay. This has allowed his business sales to grow by 30%. Such success was spurred by the implementation of software by eBay's operators in Russia. This software enabled smaller companies to sell anywhere in the world. Such factors have greatly expanded **e-commerce**, the buying and selling of products using the Internet.

E-commerce doesn't necessarily have to be between companies and individual customers. In fact, there are many other forms of e-commerce, such as business-to-consumer (e.g., eBay), business-to-business (B2B, where companies sell to each other), consumer-to-business (C2B, where consumers can sell to businesses), and consumer-to-consumer (C2C, where consumers can sell to other consumers). These forms of e-commerce are all contributing to making the global business world more interconnected.

It is critical for multinationals to appreciate the importance of the Internet. Not only can companies reach new consumers, but they can also improve their business models. Additionally, the Internet provides the opportunity to companies to build relationships with consumers worldwide.

CONCEPT CHECK

1. Describe the lowering of trade barriers and its impact on international business.
2. What is foreign direct investment?
3. What has the role of the Internet had on international business?

6.2 Hofstede's Cultural Framework

2. What is culture, and how can culture be understood through Hofstede's cultural framework?

As the business world becomes more global, employees will likely face someone from another country at some point in their careers, companies will negotiate with companies from other countries, and even employees of domestic companies will likely encounter someone from another country.

Furthermore, trends suggest that **immigration**, the movement of people from their home country to other countries, will continue to grow worldwide, a process that will contribute to making companies' workforces increasingly diverse. Additionally, many multinational companies rely on expatriates to run their local operations. An **expatriate** is foreign employee who moves to and works in another country for an extended period of time. All of these trends mean that during your career you are likely to encounter someone from a different culture and that the potential for cross-cultural tensions is high. It is therefore important for any international management student to understand culture to better prepare for dealing with such tensions.

According to Geert Hofstede,[5] a Dutch social psychologist, **culture** is "the collective programming of the mind which distinguishes the member of one group or category of people from another." It tells people who they are, which behaviors are appropriate, and which are not acceptable in any society. It affects almost everything we do, see, feel, and believe. In fact, if you have heard of the "American dream," where if one works hard, one can achieve one's dream, you are aware of one characteristic aspect of American culture.

Consider any aspect of your life, and it is likely influenced by your culture. The food you eat, the clothes you wear, and even how you address your boss or teacher are influenced by your culture. Societies develop cultural norms, values, and beliefs to assist their members in adapting to their environments.

Why is an understanding of culture critical to a manager in a global environment? As you have already seen, anyone from any country is likely to encounter someone from another country at the workplace. Such interactions can result in misunderstanding or tensions if not properly managed. Business magazines are full

of examples of cross-cultural misunderstandings that have doomed relationships and business. For another example, U.S. managers sent to Beijing, China, get frustrated because they find that their hosts are more interested in socializing than concluding a deal. Understanding Chinese culture would have prevented the latter misunderstanding because the U.S. managers would understand that it is very important for Chinese companies to get to know who they are working with before signing any deal. In this section, you will learn about one of the most powerful tools for understanding cultural differences: **Hofstede's model of national culture**. (See Table 6.1)

Hofstede's Model of National Culture				
Countries	**Power Distance**	**Individualism**	**Uncertainty Avoidance**	**Masculinity**
Australia	Low	High	Low	High
Canada	Low	High	Low	High
China	High	Low	Medium	Medium
Germany	Low	High	Medium	High
Mexico	High	Medium	High	High
France	High	High	High	Low
Spain	Medium	Medium	High	Low
Greece	Medium	Medium	High	Medium
Denmark	Low	High	Low	Low
Finland	Low	High	Medium	Low
Brazil	High	Medium	Medium	Medium
India	High	Medium	Low	Medium
Japan	Low	Medium	High	High
U.K.	Low	High	Low	High
U.S.A.	Low	High	Low	High

Adapted from Geert Hofstede, "*Culture's consequences: Comparing values, behaviors and institutions across nations*," 2nd edition, 2001, Thousand Oaks, CA: Sage Publications.

Table 6.1

Although there are several frameworks to understand cultural differences, one of the most powerful is Hofstede's model.[6] Hofstede is a Dutch social scientist who developed his model by surveying over 88,000 employees in IBM subsidiaries from 72 countries. Hofstede developed this cultural model primarily on the basis of differences in values and beliefs regarding work goals. Hofstede's framework is especially useful

because it provides important information about differences between countries and how to manage such differences. Recent reviews of research have shown the utility of Hofstede's framework for a wide variety of managerial activities, such as change management, conflict management, leadership, negotiation, and work-related attitudes.[7]

Cultural Dimension 1: Power Distance

Hofstede's original survey of the more than 88,000 employees of the 72 countries revealed four major cultural dimensions. The first cultural dimension is **power distance**, the degree to which members of a society accept differences in power and authority. In societies with **high power distance**, people are more likely to accept that power inequality is good and acceptable. People in high power distance societies are more likely to accept that there are some powerful people who are in charge and that these people are entitled to special benefits. In contrast, societies with **low power distance** tend to consider that all members are equal. Table 6.2 shows the levels of power distance (and the other cultural dimensions discussed later) in 15 selected societies. Hofstede's scores range from 100 (the highest power distance) to 0 (the lowest). In the table, we break Hofstede's scores into high (70–100), medium (40–69), and low (0–39).

Implications of Power Distance		
Type of Work Activity	**High Power Distance**	**Low Power Distance**
Organizational structures	• Very centralized • Tall hierarchies with clear levels of managers and subordinates	• Flat organizational hierarchies • Decentralized structures
Managerial authority	• Concentration of authority at the top • Managers rely on formal rules to manage • Authoritative managerial style and decision making	• Dispersed authority • Managers rely on personal experience • More consultative or collaborative forms of decision making
Relationship with supervisors	• Subordinates expect to be told what to do • Perfect boss is seen as one who is an autocrat • Information sharing constrained by hierarchy	• Subordinates often expected to be consulted • Ideal manager is seen as a democratic leader • Openness to sharing information
Other issues	• Wide salary gap between top and bottom of organization • Managers often feel underpaid and dissatisfied with careers	• Low salary gap between top and bottom of company • Managers feel paid adequately and are satisfied

Adapted from Geert Hofstede, "*Culture's consequences: Comparing values, behaviors and institutions across nations*," 2nd edition, 2001, page 107-108, Thousand Oaks, CA: Sage Publications.

Table 6.2

As Table 6.1 shows, many of the emerging markets in regions such as Asia and Latin America, such as India,

Brazil, and Mexico, all have high power distance scores. In such countries, the concern for hierarchy and inequality in organizations is rooted in early socialization in the family and school. In these countries, children are expected to obey their parents and elders. When these children enter school, teachers assume the dominant role. Children must show respect, and they seldom challenge a teacher's authority. As these individuals take on work roles, the allegiance to teachers is transferred to bosses. Thus, people in high power distance societies will seldom question their supervisors. In contrast, Anglo countries such as the United States, Canada, and the United Kingdom have low power distance. In these countries, people do not expect power differences, and everyone is seen as an equal.

Management Implications of Power Distance

What are the implications of power distance for international management? Table 6.2 shows some of the key differences between high and low power distance societies for work-related issues. As you can see, it is important for managers to express their authority and know-how in high power distance societies. Subordinates expect clear directions from their managers and assume they will be told what to do. In high power distance societies, employees will often equate age with wisdom and seniority. For instance, if a multinational is sending people to negotiate in a high power distance country, they should send higher-level and older managers if they want to be taken seriously.

Cultural Dimension 2: Individualism and Collectivism

The second cultural dimension we consider here is individualism/collectivism. **Individualism** refers to the degree to which a society focuses on the relationship of the individual to the group. **Collectivism** refers to the degree to which a society focuses on the relationship of the group as a whole.

In societies with high individualism (or low collectivism) scores, individuals are valued for their achievements and are rewarded and recognized for such achievements. In contrast, people who live in societies with low individualism (high collectivism) are seen as being part of a wider group, known as the in-group. The in-group includes the family, team, or social class, and how individuals relate to such wider groups is seen as important to their success. In other words, people's success is gauged by how others in their groups view and support them.

Table 6.1 shows the levels of individualism in the selected 15 nations. We again see similar patterns whereby more Anglo cultures such as the U.S., Canada, and the U.K. have relatively high levels of individualism. In contrast, Asian, Latin American, and many emerging countries tend to have cultures that are either on the medium or low range of the individualism dimension. Table 6.3 shows some of the implications of individualism for management. The effects of most management practices are determined by whether they are done at a group or individual level. For example, in countries with low individualism, one will find that employees are hired and promoted mostly on the basis of association with a larger group, such as a university or high school. In such societies, emphasis is placed on loyalty, seniority, and age. To operate smoothly in such societies, companies need to appreciate the importance of the larger social group. Additionally, as Table 6.3 also shows, care should be taken in terms of how rewards are distributed. Rewarding individual team members in low individualism societies can result in tensions because the individual team member may become stigmatized. In such cases, rewards done on a group level may work best.

Implications of Individualism		
Type of Work Activity	**Low Individualism/High Collectivism**	**High Individualism/Low Collectivism**
Relationship with companies	• Employees act in the interest of in-group (members of the family or same university) • Employee commitment to company relatively low • Employee-employer relationships is almost like a family link	• Employees act in their own interests • Employee commitment to organizations high • Employee-employer relationship based on the market
Human resource, management	• Hiring and promotion takes in-group into consideration • Better to reward based on equality (give everyone the same reward) rather than equity (base reward on work effort) Relatives of employees preferred in hiring • Training best when focused at group level	• Hiring and promotions based on rules • Family relationships unimportant in hiring • Better to reward based on equity • Training done best individually
Other issues	• Belief in collective decisions • Treating friends better than others is normal • Support of teamwork • Less mobility across occupations • Personal relationships very critical in business	• Belief in individual decision making • Treating friends better than others at the workplace is considered unethical • More mobility across occupations within company • Tasks and company prevail over personal relationships in business

Adapted from Geert Hofstede, "*Culture's consequences: Comparing values, behaviors and institutions across nations*," 2nd edition, 2001, page 169-170, Thousand Oaks, CA: Sage Publications.

Table 6.3

Cultural Dimension 3: Uncertainty Avoidance

Hofstede's third cultural dimension is **uncertainty avoidance**, the degree to which people in a society are comfortable with risk, uncertainty, and unpredictable situations. People in high uncertainty avoidance societies tend to want to avoid uncertainty and unpredictability. As a result, work environments in such countries try to provide stability and certainty through clear rules and instructions. In contrast, societies with low uncertainty avoidance are comfortable with risk, change, and unpredictability. In these countries, risky and ambiguous

situations are less likely to upset people.

Table 6.1 shows details of the levels of uncertainty avoidance for the selected 15 countries. We see that Anglo and Scandinavian countries have relatively lower uncertainty avoidance scores. In contrast, many emerging markets (such as Brazil, Mexico, and China) have medium to high uncertainty avoidance scores. Such findings suggest that companies should adapt their practices to conform to the levels of uncertainty avoidance. In high uncertainty avoidance countries, for example, managers are advised to provide structure and order to reduce uncertainty and ambiguity for subordinates. Companies in these cultures have many written rules and procedures that tell employees exactly what the organization expects of them. Additionally, managers should give clear and explicit directions to their subordinates about exactly what is expected of them in performing their jobs. By reducing any ambiguity, subordinates are less anxious.

In contrast, in low uncertainty avoidance countries, subordinates are much more comfortable and ambiguity. Managers can therefore give more flexibility and freedom to employees. Design of organizations also allows for fewer rules and regulations.

Table 6.4 provides more detail on the implications of uncertainty avoidance on several managerial aspects.

Implications of Uncertainty Avoidance		
Type of Work Activity	**Low Uncertainty Avoidance**	**High Uncertainty Avoidance**
Relationship with companies	• Weak loyalty to companies • Average duration of employment shorter • Preference for smaller organizations	• Strong loyalty to employing organizations • Employment are long term in duration • Preference for larger companies
Characteristics of supervisors/managers	• Superiors optimistic about subordinate ambition and leadership abilities • Top managers usually involved in strategy • Power of superiors based on relationships and position • Transformational leaders preferred	• Superiors pessimistic about subordinate ambition • Top managers often involved in operations • Power of superiors based on control of uncertainties • Hierarchical control roles preferred
Entrepreneurship and innovation	• Innovators feel less constrained by rules • Renegade championing • Tolerance for ambiguity in procedures and structures • Innovation welcomed	• Innovators feel constrained by rules • Rational championing • Formalized management structures • Innovation resisted

Based on Geert Hofstede, "*Culture's consequences: Comparing values, behaviors and institutions across nations*," 2nd edition, 2001, page 169-170, Thousand Oaks, CA: Sage Publications.

Table 6.4

Cultural Dimension 4: Masculinity

The fourth and final dimension we consider is **masculinity**, the degree to which a society emphasizes traditional masculine qualities such as advancement and earnings. In high masculinity societies, work tends to be very important to people, gender roles are clear, and work takes priority over other aspects of a person's life, such as family and leisure. In addition, masculine societies emphasize earnings and achievements, and employees tend to work very long hours and take very little vacation time.

Table 6.5 shows the masculine scores for selected societies. As the table shows, Anglo cultures such as the U.S. and Canada tend to have high masculinity. This is not surprising given that both the U.S. and Canada tend to have some of the highest number of hours worked. In contrast, Latin European countries such as France and Spain have much lower masculinity as reflected in the importance of leisure in these societies. Scandinavian cultures also reflect low masculinity, a characteristic that is consistent with the preference for quality of life in such countries. We also see that many of the emerging nations have medium to high masculinity.

Table 6.5 provides some more insights into the implications of masculinity differences for work-related issues. As you can see, companies in high masculinity societies can count on very work-oriented employees. Multinationals are therefore advised to motivate their employees through pay and security. In contrast,

individuals in more feminine societies tend to prefer interesting work and more leisure. Strong motivational policies in these societies emphasize a balance between work and leisure, and multinationals in such societies tend to have stronger policies catering to both genders.

Implications of Masculinity		
Type of Work Activity	**High Masculinity**	**Low Masculinity**
Relationship with work	• Live in order to work • Preference for high pay • Workers look for security, pay and interesting work	• Work in order to live • Preference for lower number of work hours • Workers look for better working conditions and relationships in work
Managers' characteristics	• Managers seen as cultural heroes • Successful managers primarily exhibit male characteristics • Managers need to be competitive, firm, aggressive, and decisive Managers are very ambitious • Fewer women in management • Managers prepared to move family for career reasons	• Managers are employees like others • Successful managers are seen as possessing both male and female characteristics • Managers hold fairly modest career ambition • More women in management • Managers less prepared to uproot family because of career move
Other issues	• Large pay gap between genders Job applicants oversell their abilities • Absences due to sickness lower • General preference for larger companies • Conflicts are resolved through fighting until the best "man" wins	• Low salary gap between top and bottom of company [what about gender gap?] • Managers feel paid adequately and are satisfied • Absences because of sickness higher • Preference for smaller organizations • Conflicts are resolved through compromise and negotiations

Based on Geert Hofstede, "*Culture's consequences: Comparing values, behaviors and institutions across nations*," 2nd edition, 2001, page 318, Thousand Oaks, CA: Sage Publications.

Table 6.5

One of the underlying themes of cross-cultural research is that countries tend to cluster around cultural dimensions. For instance, we saw how Anglo cultures, Latin American cultures, and Scandinavian cultures countries tend to share similar cultural characteristics. Such categorizations are useful because they help managers simplify their organizational world.

CONCEPT CHECK

1. Describe Hofstede's approach to defining national culture.
2. Describe power distance and its implications for managers in cultural contexts.
3. Describe individualism versus collectivism and its implications for managers in cultural contexts.
4. Describe uncertainty avoidance and its implications for managers in cultural contexts.

6.3 The GLOBE Framework

3. How are regions of the world categorized using the GLOBE framework, and how does this categorization enhance understanding of cross-cultural leadership?

A second important cultural framework, the Global Leadership and Organizational Behavior Effectiveness (GLOBE) project provides managers with an additional lens through which they can better understand how to perform well in an international environment. While the Hofstede framework was developed in the 1960s, the **GLOBE project developed in the 1990s** is a more recent attempt to understand cultural dimensions.[8] The GLOBE project involves 170 researchers from over 60 countries who collected data on 17,000 managers from 62 countries around the world.

Similar to Hofstede, the GLOBE researchers uncovered nine cultural dimensions. However, basing their work on Hofstede's cultural dimensions, it is not surprising to note that five of these dimensions are similar to those uncovered by Hofstede, namely 1) uncertainty avoidance, 2) power distance, 3) future orientation (degree to which society values the long term) 4) assertiveness orientation (masculinity), 5) gender egalitarianism (femininity), 6) institutional, and 7) societal collectivism (similar to individualism/collectivism). The only two cultural dimensions unique to the GLOBE project are **performance orientation** (degree to which societies emphasize performance and achievement) and **humane orientation** (extent to which societies places importance on fairness, altruism, and caring).

Similar to Hofstede, the GLOBE researchers categorized countries into **clusters** of countries with similar cultural characteristics. This categorization provides a convenient way to summarize cultural information for a larger number of countries and simplifies the task of the international manager attempting to manage effectively in countries within clusters. Because the clusters include societies with similar cultural profiles, similar cultural adaptations can be made. Although the GLOBE study identified ten clusters, we will discuss only the seven clusters most relevant for international managers: the Anglo cluster, the Confucian Asia cluster, the Germanic Europe cluster, the Nordic Europe cluster, the Latin America cluster, the Middle East cluster, and

the sub-Saharan cluster. Table 6.6 shows these various clusters and the countries in each cluster.

Country Clusters						
Anglo	**Confucian Asia**	**Germanic Europe**	**Latin America**	**Nordic Europe**	**Middle East**	**Sub-Saharan Africa**
Australia	China	Austria	Argentina	Denmark	Qatar	Namibia
Canada	Hong Kong	Switzerland	Bolivia	Finland	Morocco	Nigeria
Ireland	Japan	Netherlands	Brazil	Sweden	Turkey	South Africa (Black)
New Zealand	Singapore	Germany (former East)	Colombia		Egypt	Zambia
South Africa (White)	South Korea	Germany (former West)	Costa Rica		Kuwait	Zimbabwe
United Kingdom	Taiwan		El Salvador			
United States			Guatemala			
			Mexico			
			Venezuela			

Based on Dorfman, P., Paul J. Hanges, and F. C. Brodbeck. 2004. "Leadership and cultural variation: The identification of culturally endorsed leadership profiles." In R. J. House, P. J. Hanges, M. Javidan, P. W. Dorfman, and V. Gupta, eds. *Culture, Leadership, and Organizations.* Thousand Oaks, CA: Sage Publications, 669–720.

Table 6.6

To compare how the different clusters rate different forms of leadership, the GLOBE researchers considered six leadership profiles:

- charismatic type (degree to which the leader can inspire and motivate others)
- team oriented (degree to which the leader can foster a high functioning team),
- participative type (degree to which leaders involve others in decision-making)
- humane-oriented type (degree to which the leader shows compassion and generosity)
- autonomous (degree to which the leader reflects independent and individualistic leadership)
- self-protective (degree to which the leader is self-centered and uses a face-saving approach)

Table 6.7 shows how the various clusters rank these leadership types.

Country Clusters and Preferred Leadership Styles							
Leadership Style	**Anglo**	**Confucian Asia**	**Germanic Europe**	**Latin America**	**Middle East**	**Nordic Europe**	**Sub-Saharan Africa**
Charismatic	High	Medium	High	High	Low	High	Medium
Team-oriented	Medium	Medium/ High	Medium/ Low	High	Low	Medium	Medium
Participative	High	Low	High	Medium	Low	High	High
Humane-oriented	High	Medium/ High	Medium	Medium	Medium	Low	Medium
Autonomous	Medium	Medium	High	Low	Medium	Medium	Low
Self-protective	Low	High	Low	Medium/ High	High	Low	Medium

Based on Dorfman, P., Paul J. Hanges, and F. C. Brodbeck. 2004. "Leadership and cultural variation: The identification of culturally endorsed leadership profiles." In R. J. House, P. J. Hanges, M. Javidan, P. W. Dorfman, and V. Gupta, eds. *Culture, Leadership, and Organizations*. Thousand Oaks, CA: Sage Publications, 669–720.

Table 6.7

Table 6.7 provides further insights to understand how cultural differences affect preferences for leadership styles.[9] Consider, for example, the Nordic Europe cluster, including Scandinavian countries such as Denmark, Finland, and Sweden. These countries have low levels of masculinity, low levels of power, and high individualism. It is therefore not surprising to see that individuals in such societies prefer leaders who are more charismatic and who demonstrate participative leadership tendencies. The least preferred style for this cluster is the self-protective leader, which is more representative of individualist cultures.

Countries in the Latin American cluster (which includes some of the emerging markets of Argentina, Mexico, and Brazil) tend to be more collective, have high power distance, and have high uncertainty avoidance. It is therefore not surprising that leaders who are successful in this cluster are those who make decisions collectively, who treat their subordinates with formality, and who display charisma.

The countries in the Middle East cluster (which includes countries such as Egypt, Morocco, and Turkey) tend to score high on uncertainty avoidance, high on collectivism, and medium on power distance. As a result, because of the high levels of uncertainty avoidance, subordinates are often reluctant to make decisions that involve risk, thereby explaining the high ranking for autonomous leadership style. Thus, it is not surprising that the Middle East cluster prefers leaders who are less participative. Furthermore, the preferred leadership style in this cluster behaves in a collective manner and tries to maintain harmony because of the high level of collectivism.

Although there are cultural differences between clusters, it is important to see that the clusters do share some similarities. For example, the charismatic leadership style is preferred in all clusters except the Middle East cluster. In addition, Table 6.8 shows that the humane-oriented leadership style is preferred in all but the Nordic Europe cluster.

In contrast, leadership styles based on individualist tendencies, such as the autonomous and the self-

protective types, tend to be least preferred.

Traits and Behaviors That Are Universally Admired and Disliked	
Positively-Regarded Traits and Behaviors across the World	
Trustworthy	Dependable
Intelligent	Just
Honest	Decisive
Plans ahead	Effective bargainer
Encouraging	Win-win problem solver
Positive	Skilled administrator
Dynamic	Communicator
Motivator	Informed
Confidence builder	Team builder
Negatively-Regarded Traits and Behaviors across the World	
Loner	Egocentric
Antisocial[what does this mean? is it different from antisocial?	Ruthless
Not cooperative	Dictatorial
Nonexplicit	

Based on Den Hartog, Deanne N., Robert J. House, Paul J. Hanges, Peter W. Dorfman, S. Antonio Ruiz-Quintanna, and 170 associates. 1999. "Culture specific and cross-culturally generalizable implicit leadership theories: Are attributes of charismatic/transformational leadership universally endorsed?" *Leadership Quarterly,* 10, 219–256.

Table 6.8

The GLOBE team also found that a number of traits, such as being honest, trustworthy, positive, and dynamic, were viewed positively worldwide and were endorsed irrespective of national culture. Similarly, leadership behaviors such as being a loner, egocentric, and dictatorial were viewed in a negative light by all clusters. **Table 6.8** shows which traits are viewed as positive and which are viewed as negative by the various clusters.

Summary

In this section, we have learned about the various tools that managers can use to understand and prepare for cross-national differences and how they impact behaviors of employees across multinational corporations. We've also seen that there are many similarities among cultures. Relying solely on such frameworks to understand a culture can be misleading, however. In the next section, we discuss some of the dangers of

cultural stereotyping and examine the need to be cautious and to take into account the interaction between a nation's culture and its social institutions.

CONCEPT CHECK

1. Describe how the GLOBE tools can be used by managers to prepare for cross-national situations.
2. What are the similarities and differences among clusters?

MANAGING CHANGE



Negotiations in Malaysia and China

You are a rising star in your company, and your CEO asks you to accept an exciting and promising assignment in Malaysia and China, during which you will meet with representatives of your company's local affiliates. In Malaysia, you are introduced to the company executives in a flashy ceremony. You understand that the affiliate's CEO is named Roger, and you have a great time socializing with him. You even decide to show your fondness for him by calling him "Rog." However, later you find that your host's name is actually Rajah.

After your trip to Malaysia, you go to China. You are welcomed lavishly by the local affiliate's executives and are invited to several important meals. Over the next few days, you seem to be spending time mostly at lunches or dinners. Whenever you try to discuss specifics of your products, you find that your hosts are more interested in eating and drinking. You attempt to provide your hosts with contracts that your company has drafted, but you are not successful.

Despite your reservations, you return home feeling strongly about your efforts. However, your CEO soon asks to meet with you. During the meeting, she mentions that neither the Malaysian company nor the Chinese company is interested in doing further business with your company. In fact, both companies decide to go with competitors. The CEO wants to know what happened, and you need to figure out what went wrong.

Discussion Questions

1. Discuss where the United States, Malaysia, and China stand on Hofstede's cultural dimensions.
2. What are the implications of the above differences for how business is conducted in Malaysia and China?
3. How can these cultural differences explain why you were not successful? What should you have done differently?

6.4 Cultural Stereotyping and Social Institutions

4. Why is an understanding of cultural stereotyping important, and what can students do to prepare for cultural stereotyping by looking at social institutions?

The above sections provided you with some strong insights into cultural differences. However, despite these observations, cultural scholars often find examples where cultural realities don't necessarily fit neatly or completely into the categories proposed by models. Consider, for instance, that American managers tend to think of themselves as very egalitarian and will typically ask their subordinates to address them by their first name. American managers will also encourage subordinates to share their views on work-related matters. In

contrast, Japanese managers are often seen as autocratic, and decisions are driven by those at the top. The implications of such preferences suggest that American managers are more likely to make decisions that reflect the egalitarian position of incorporating subordinates' views. In contrast, the Japanese managers are expected to make decisions on their own, with little input from subordinates. As a result, when American teams and Japanese teams work together, there is often intense confusion. Such confusion stems from the observation that although American managers tend to be viewed as egalitarian, in reality they are not, and decisions are often made unilaterally by those at the top. At the same time, Japanese managers tend to prefer consensus-based decisions even though they are seen as autocratic.

As detailed by Erin Meyer, a professor at INSEAD,[10] the above preferences are often sources of friction when American and Japanese teams work together. Such confusion often occurs because American managers believe that Japanese managers have authority because of the Japanese culture's autocratic preferences. The incident of what happened when Suntory, a Japanese whisky manufacturer, became the majority holder of Jim Beam, an American bourbon maker, clearly illustrates the resulting conflict. When a critical decision had to be made, a Jim Beam manager went to Japan to present the proposal to a Japanese manager, thinking that the manager would have the authority to make the decision. However, the Jim Beam manager found that he was not able to have any effect during the meeting because a decision had already been made by consensus.

The above example shows an instance of a **cultural paradox**, where the insights from an understanding of culture may not necessarily coincide with reality.[11] Why would Japanese managers, who are often perceived as autocratic, take the time to make decisions by consensus? As another example of cultural paradox, the Japanese tend to have a low tolerance for uncertainty because of their high uncertainty avoidance, yet they will often have contracts that incorporate significant ambiguity. In contrast, Americans, who are much more comfortable with uncertainty, write very explicit contracts.

If an international management student or manager doesn't appreciate the importance of cultural paradoxes, they can engage in cultural stereotyping. **Cultural stereotyping** occurs when one assumes that all people within a culture act, think, and behave the same way. While national cultures can provide a lens to gain insights into a country, broad generalizations may not necessarily be helpful. In such cases, it is much more prudent to be cautious and to understand that there are significant differences among people within a culture.

The Role of Social Institutions in International Management

Recent research examining Hofstede's work provides some evidence of the need to be cautious about using culture as the only source of understanding of societies.[12] The researchers examined the ongoing assumption that that all residents of a given country will behave according to broad cultural norms and found that 80% of variation in cultural values is actually *within* countries. In other words, the assumption that people between countries are more different than people within a country may not be accurate. The researchers actually found that other cultural factors pertaining to people's occupations or the country's wealth also play a critical role. These findings suggest that other factors besides national culture need to be examined. One of these factors is a country's social institutions.

A **social institution** is "a complex of positions, roles, norms, and values lodged in particular types of social structures and organizing relatively stable patterns of human resources with respect to fundamental problems in . . . sustaining viable societal structures within a given environment."[13] In other words, as you see below, social institutions such as education and the degree of social inequality have an impact on how individuals within a society behave.

Similar to national cultures, social institutions have strong effects on how people think, act, and behave. While there are many social institutions in any given country or culture, we limit ourselves to the three institutions that are most relevant in the workplace: social stratification, level of education, and religion.

Social Stratification

Social stratification refers to the degree to which "social benefits are unequally distributed and those patterns . . . are perpetuated for life."[14] These social benefits include wealth and distribution of income. Through school and parenting, children are taught to accept such inequality, and over time, it becomes a solidly established, taken-for-granted fact of life. Because the level of social stratification in a country impacts how work elements are perceived, it is important for managers to understand a country's level of social stratification.

Current research suggests that the level of social stratification typically results in societies where only the privileged few have access to jobs with work-related advantages such as the ability to work at enriched jobs that can contribute to personal growth or that may not be under close supervision. In countries with a high level of social stratification, employees may not have a very positive outlook of work. The same research shows that employees in countries with high levels of social inequality tend to have lower levels of attachment to their work. Thus, it is important for multinational managers to understand employee attitudes toward work in the society in which the company operates. **Exhibit 6.5** shows the level of social inequality worldwide as represented by the GINI index, which measures the degree to which income is unequally distributed within a nation. Countries such as South Africa, Lesotho, Namibia, Hong Kong, and Colombia have some of the highest GINI indices, indicating great social inequality. In contrast, countries such as Finland, Moldova, and Germany have among the lowest degrees of social inequality. International management students can use these indices to gain another level of understanding in any society.

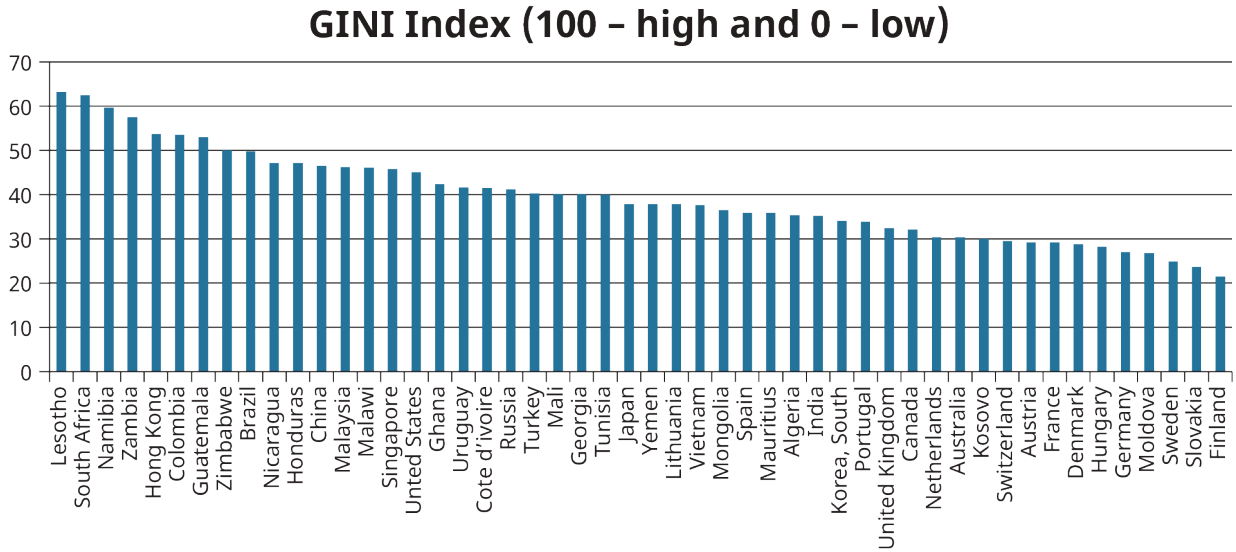

Exhibit 6.5 Level of Social Inequality Based on CIA World Factbook - https://www.cia.gov/library/publications/the-world-factbook/rankorder/2172rank.html

Education

A second social institution is **education**, the socializing experiences which prepare individuals to act in society. Education plays a critical role in socializing individuals into expected norms in their society. One of the critical ways countries differ is on the level of education. In some countries, such as the United States and Western European countries, education is accessible to most members of societies. In other societies, such as many found in Western Africa, South Asia, and Latin America, however, education may be much more elitist and not as accessible to the members of the population.

How does education affect the workplace? Research shows that education has an impact on many aspects of work, including employee attachment to work and gender roles. For example, in a study of 30,270 individuals from 26 countries, the findings show that the more accessible education is, the less likely people are to attach to work.[15] The researchers argue that the more individuals have access to education, the more likely they have

the means to feel satisfaction in life and the less likely work plays a critical role. In contrast, where education is less accessible, individuals have to rely on their work to achieve desired rewards.

Another study shows that education also affects how managers view gender roles.[16] Examining a sample of over 1,500 managers located in 19 countries, the study finds that greater accessibility to education affects managers' perception of gender roles. Specifically, in societies with more access to education, managers had less traditional views about the role of women in society and were therefore more open-minded about women in the workplace.

The above findings also point to the importance of education as an influence in society. Societies and individuals that have similar levels of education accessibility may behave more similarly irrespective of cultural differences. Astute international managers are therefore well advised to take such issues into consideration when managing international operations.

Religion

The final social institution we consider is **religion**, the shared set of beliefs, activities, and institutions based on faith in supernatural forces.[17] Religion has always been and continues to be an extremely critical aspect of the international business environment. Most countries have seen a strong growth in popularity of religions. For instance, Islam continues to gain new adherents in many parts of the world. Similarly, the tremendous growth of Protestantism in Latin America and the sustained role of Hinduism in Indian society all suggest that religion has significant influences on societal members as well as the businesses they operate in.

In this section, we first consider the major types of religions in the world.[18] **Exhibit 6.6** shows that Christianity remains the world's dominant religion, representing around 31% of the world's population (or 2.3 billion of the 7.3 billion individuals in the world). Adherents of Islam follow, representing 24.1% of world's population, followed by Hindus (15.1%). The other substantial religion is Buddhism, practiced by 6.9% of the world's population. Finally, Judaism is practiced by only 0.2% of the world's population.

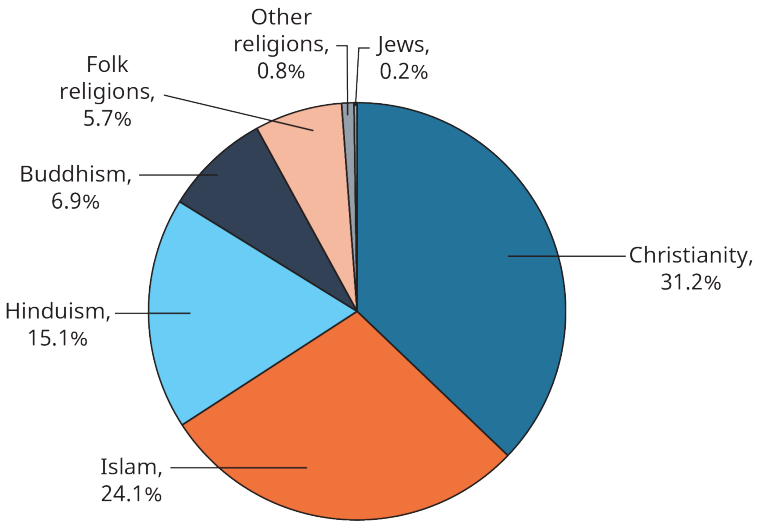

Exhibit 6.6 Religions of the World Based on Pew Research: http://www.pewresearch.org/fact-tank/2017/04/05/christians-remain-worlds-largest-religious-group-but-they-are-declining-in-europe/

Given that Christianity, Islam, and Hinduism represent around 70% of the world's population, we will look at a brief description of each of these religions and their implications for the workplace.[19]

Christianity

Christianity is a faith based on the life, teachings, death, and resurrection of Jesus. Adherents of Christianity all share the same belief that Jesus is the incarnation of God who was sent to clean the sinfulness of humanity. Jesus is often associated with the possibility of humans to connect with God through penance, confessions of

one's sins, self-discipline, and purification.

Christianity has strong influences on the workplace. For example, the impact of Protestantism, a branch of Christianity, on the development of capitalism is seen as evidence of the link between religion and the economic structuring of societies. Through Protestantism, wealth and hard work were for the glory of God. This emphasis therefore allowed a focus on goals attached to economic development and wealth accumulation. This belief explains much of the sustained development of capitalism in the Western Protestant societies.

International management scholars recognize that Christianity is generally supportive of business and wealth, and so multinationals located in countries where a majority of people are Christian should expect to face an environment in which work and accumulation of wealth are celebrated. Additionally, recent research also shows that Christianity even affects levels of entrepreneurship in a society.[20] In that study, researchers examined data from a sample of 9,266 individuals from 27 predominantly Christian countries. The study looked at the impact of different manifestations of Christianity on entrepreneurship and found that Christianity encouraged entrepreneurship, especially in societies characterized by strong knowledge investments in research and development. This study provides further evidence that Christianity supports economic development.

Islam

The essence of **Islam**, the second largest of the world's religions, is described in the Qur'an as the submission to the will of Allah (God). It has adherents primarily in Africa, the Middle East, China, Malaysia, and the Far East but is growing rapidly in many countries, especially in Europe. Current evidence suggests that Islamic societies are generally supportive of work and accumulation of wealth as well as entrepreneurship. However, there are some Islamic principles to which multinationals must adhere if they are to succeed in primarily Islamic nations.

Muslim society is very heavily influenced by Islamic standards and norms. Islam provides encompassing guidance in all spheres of life, both social and economic. In fact, the practicing Muslim lives by adhering to the five major pillars of sharia law:

- *Shahada*, or confession (believing and professing the message of Allah)
- prayer (must pray five times a day while facing Mecca, the spiritual home of Islam)
- *Zakat*, or almsgiving (the need to donate a portion of one's income to others to help reduce greed and inequality)
- fasting (the avoidance of eating, including the obligatory fast during the month of Ramadan)
- the *hajj*, or pilgrimage to Mecca (all Muslims who can make the pilgrimage are expected to do so at least once in their lifetime).

These are all important aspects of Islam that have significant implications for the business environment.

For the multinational operating in Islamic nations, these pillars provide important guidance. For instance, managers are advised to provide employees with space and the opportunity to pray. Additionally, adherents of Islam also fast for a month during the month of Ramadan. During that month, Muslim employees are not allowed to eat, drink, smoke, or even take medicines from dawn until dusk. Ramadan is considered holy, and multinational companies should expect their workers to be more concerned with sacred matters and a heightened spiritual atmosphere during this time. Therefore, multinational managers are advised to take steps to ensure that business activities are not disrupted during Ramadan.

Another implication of Islam for global business is that interest is viewed as profits generated without wealth and is therefore prohibited. In most Islamic countries, governments have instituted financial laws that therefore see interest as illegal. For any company with operations in a Muslim country, the prohibition of interest presents a serious challenge both in terms of access to loans as well as repayment of obligations. Multinational companies are therefore strongly advised to work with local banks and financial institutions to

find creative ways to pay interest in the form of profit sharing or other financial transactions.

Hinduism

Finally, **Hinduism** is represented by all those who honor the ancient scriptures called the Vedas. There are currently around 760 million Hindus residing in India, Malaysia, Nepal, Suriname, and Sri Lanka. Unlike Christianity or Islam, Hinduism has significant variations in practices and rituals, leading some experts to suggest that there are no central traditions. Other experts suggest that the quest for Brahman, the ultimate reality and truth and the sacred power that pervades and maintains all things, is the ultimate quest for many Hindus.

Similar to the other religions, Hinduism has implications for the way business is conducted. One of the facets of Hinduism is the caste system, which refers to the ordering of Indian society based on four occupational groups: 1) priests, 2) kings and warriors, 3) merchants and farmers, and 4) manual laborers and artisans. Although the caste system is illegal in India today, its original purpose was to create a system that would subordinate individual interests to the collective good.

Unfortunately, the caste system became a legitimate way to discriminate against the lower castes. The system remains a dominant feature of life in India today, and multinational companies operating in India must be aware of it. For instance, having a member of a lower caste supervise higher-caste individuals can be problematic. Additionally, members of lower castes may face promotion ceilings in organizations because of their caste membership. Nevertheless, it is critical for multinationals to play a critical role in reducing discrimination that is fostered by the caste system. Many companies located in India, such as Infosys, have implemented programs to train lower-caste members to get jobs.

Finally, it is important for multinational managers to appreciate Hindu beliefs. One of the most relevant beliefs is that Hindus consider cows sacred. Companies such as McDonald's have been very careful to honor this belief and only offer foods that do not include beef products. Multinational managers also need to be aware of the various Hindu festivals and celebrations because employees generally expect time off and gifts for holidays such as Diwali, the festival of lights.

Summary

This section presented some of the social institutions that may bring a deeper understanding of cross-national differences. Relying solely on national culture dimensions may not be useful in the presence of cultural paradoxes. Carefully understanding a nation's social institutions can therefore bring additional insights into better international management.

CONCEPT CHECK

1. Describe the social institutions that can provide a deeper understanding of cross-national differences.
2. How can managers use insights from Hofstede and GLOBE in conjunction with an understanding of social institutions?

6.5 Cross-Cultural Assignments

5. What steps can you take to be better prepared for cross-cultural assignments?

At some point in your career, you are very likely to be asked to be involved in cross-cultural operations. You may encounter employees from other countries in the local company you work for, or your company may send you to another country to run international operations. When these situations arise, you will need to be prepared to manage cultural differences. In this section, we discuss some of the things companies and

individuals can do to better prepare for cross-national differences.

One of the goals of any cross-cultural training is to increase an employee's cultural intelligence. **Cultural intelligence** refers to "individuals' capabilities to function and manage effectively in culturally diverse settings."[21] The culturally intelligent manager is someone who can operate without difficulty in cross-national settings. Recent research suggests that cultural intelligence is made up of four dimensions:

- a **cognitive dimension**, focusing on the individual's knowledge of values and practices inherent in the new culture acquired through education and personal experiences
- a **meta-cognitive dimension**, which reflects an individual's ability to use cross-cultural knowledge to understand and adapt to the cultural environment they are exposed to
- a **motivational dimension**, which reflects the ability and desire to continuously learn new aspects of cultures and adapt to them
- a **behavioral dimension**, based on the ability of the individual to exhibit the appropriate forms of verbal and nonverbal behaviors when interacting with people from another culture

To give you more insights into the cultural intelligence measure, Table 6.9 provides some representative statements used to gauge a person's understanding of these four dimensions of cultural intelligence various aspects of cross-cultural interactions.

Cultural Intelligence Statements	
Metacognitive	• I am conscious of the cultural knowledge I use when interacting with people with different cultural backgrounds. • I am conscious of the cultural knowledge I apply to cross-cultural interactions.
Cognitive	• I know the legal and economic systems of other cultures. • I know the cultural values and religious beliefs of other cultures.
Motivational	• I enjoy interacting with people from different cultures. • I enjoy living in cultures that are unfamiliar to me.
Behavioral	• I change my non-verbal behavior when a cross-cultural interaction requires it. • I alter my facial expressions when a cross-cultural interaction requires it.

Based on Jacob Eisenberg, Hyun-Jung Lee, Frank Bruck, Barbara Brenner, Marie-Therese Claes, Jacek Mironski and Roger Bell, "Can business schools make students culturally competent? Effects of cross-cultural management courses on cultural intelligence," *Academy of Management Learning and Education,* 2013, Vol. 12, pp. 603-621.

Table 6.9

Cross-Cultural Training through Education and Personal Experience: Low and High Rigor

Current research suggests that cross-cultural training can influence cultural intelligence. At a basic level, you can acquire cultural intelligence by taking classes in your program. Research has shown that taking cross-cultural management courses can enhance cultural intelligence.[22] For example, in a study of 152 MBA students, researchers found that cultural intelligence of the students increased after they took a cross-cultural management course. In another longitudinal study, researchers found that study abroad has significant impact on the cognitive and metacognitive aspects of cultural intelligence. How do multinationals approach

cross-cultural training? The above provides examples of **low-rigor training**, in which individuals are exposed to critical information to help them understand the realities of a different culture but are not actively and directly engaged with the culture.[23] In such cases, instructors transfer basic information and knowledge to students through lectures, books, and case studies.

Low-rigor training has several important disadvantages. Participants often just receive information; they learn that differences exist but do not necessarily learn how to deal with cultural differences in a real-life situation. Furthermore, cross-cultural differences can be very subtle and nuanced, and this method cannot expose participants to such nuances. Balancing these significant disadvantages is one key advantage: low-rigor training tends to be the most cost effective.

Companies can also rely on **high-rigor** methods of training, in which participants are actively engaged in the process and can learn some tacit aspects of cross-cultural differences.[24] Examples of high-rigor training include classroom language training, case studies, and sensitivity training. High-rigor training also includes more experiential approaches such as role-playing, simulations, and field experiences. Some MNCs (multinational corporations) also offer on-the-job training, during which employees are coached and trained while working at their jobs. This method allows the trainee not only to see the new culture, but also to learn how that culture interacts with the work environment. The advantage of this method is that it enables the participant to be much more actively engaged in learning, thereby facilitating transfer of knowledge. But as you might have guessed, high-rigor training is much more expensive to provide.

Which method works best? Experts agree that it depends on the nature of the assignment. Longer and more complex international assignments benefit from higher-rigor training.[25] Furthermore, because international work assignments tend to be more short-term in nature, ways to enhance the metacognitive aspects of cultural intelligence are necessary.[26] Today, because more managers tend to have more frequent but shorter assignments to international companies, having metacognitive skills is critical. As a result, brief lectures or other low-rigor methods that simply provide information may be useful in helping develop the cognitive aspect but not metacognition. In such cases, high-rigor methods that allow participants to be much more actively engaged with a culture will work well.

When Should Cross-Cultural Training Occur?

Another important aspect of cross-cultural training is the timing of the training. Some multinationals offer **predeparture cross-cultural training**, which provides individuals with learning opportunities prior to their departure.[27] Such training can take the form of 1- to 12-week programs, although two- to three-day programs are also very popular. After such training, the expatriate has a good understanding of expectations, what the local culture looks and feels like, and how to manage any local shocks when they arrive. This approach also makes individuals about to go to another country less anxious about the unknown.

Multinationals will also often opt for **postarrival cross-cultural training**, which occurs after an expatriate has arrived in the foreign country and can address issues in "real time." Armed with local cultural knowledge and training, the expatriate can delve into work issues without worrying about daily living issues.

Recent research provides evidence of the utility of cross-cultural training. For example, a recent study of 114 expatriates showed that both predeparture and postarrival training had positive effects on several aspects of their success.[28] Specifically, in a study in Vietnam, the findings show that both predeparture and postarrival training positively impacted the ability of expatriates to adjust to their work and general environment. Additionally, such training was also effective in enhancing the ability of expatriates to better interact with locals. The researchers also examined the impact of language training. Not surprisingly, expatriates who received training in the local language were better able to adjust to local interaction than others.

The above study shows that both predeparture and postarrival training are important for success in cross-cultural management. While the study shows that it is most effective for MNCs to provide more than one type of training, the findings also show that postarrival training has the most impact on the types of cross-cultural

adjustment. While companies tend to shy away from the more expensive postarrival training, the study suggests that the investment may be worthwhile if it enables expatriates to succeed.

Best practices advise that the optimal time for predeparture training programs is around three to five weeks prior to the international assignment. Training provided too far ahead of time may not be very effective because the expatriate may not activate all learning readiness and may forget the training if it occurs too far ahead of the assignment. Best practices also suggest that postarrival training is best delivered 8 to 12 weeks after arrival. This allows the expatriate to experience cross-cultural interaction and phenomena and to be better ready to gain the most from the training.

Adapting Behavior to the Culture

A final issue that managers need to address is that the training should not focus only on identifying and teaching about differences.[29] Experts agree that this focus on differences is a problem in current cross-cultural training approaches. While identifying and understanding cultural differences is useful and necessary, trainers often don't provide guidance as to how the participants should adapt and react to such cultural differences. It is therefore necessary for the multinational to take the necessary steps to teach cross-cultural sojourners to adapt their behaviors so that they act and react in culturally appropriate ways. Experts also suggest that such training should not be static and limited to web pages or documentation. Training should be integrated with the actual work that the employee is engaging in.

CONCEPT CHECK



1. How should training to manage cultural and regional differences occur?
2. How should training for cross-cultural assignments be implemented?

6.6 Strategies for Expanding Globally

6. What are the main strategies that companies can use to go international?

In the previous sections, you have learned about the need for a serious international management student to appreciate how countries differ and some possible ways to address these differences. Any company involved in business today also needs to understand the global business environment and how it can play a role in this environment. In the final two sections of the chapter, we look at the three main strategies available to companies as they internationalize and learn how companies can use these strategies to enter global markets.

Global Strategy

Companies can choose to pursue one of three main strategies:

- a **global strategy**, whereby all operations and activities are managed fairly similarly worldwide
- a **regional strategy**, whereby activities and operations are adapted to regional requirements
- a **local strategy**, whereby the company's operations are adapted to fit specific countries.

Global strategy

A global strategy is based on the assumption that the world is extremely interconnected and that patterns of consumption and production are fairly homogeneous worldwide.[30] In such cases, the company simply extends its domestic strategy to the global arena.

Global strategies represent a potential solution to reduce costs. Using standardized products and processes in each of the markets it enters allows a company to possibly achieve economies of scale and scope. The global company will scan the world for opportunities and respond by expanding into those areas where there is

potential. Furthermore, it will deploy those activities worldwide depending on where most value is achieved.

A good example of a global strategy is the one pursued by Ford Motor Company.[31] Ford has decided that electric cars will be the vehicles of the future, and it is therefore pursuing a "global electrification strategy," whereby it will use a global platform across many different models and styles. For instance, Ford is now using the "C-platform" to make a variety of vehicles ranging from compact cars (e.g., the Ford Focus) to larger five-passenger cars (e.g., the C-Max). This platform can also be used to build hybrid electric and battery electric cars.



Exhibit 6.7 Electric and Hybrid Vehicles In addition to Ford, many automobile manufacturers have taken a strategic decision to provide electric and hybrid vehicles for the global market. Pictured here is the Toyota Prius hybrid electric vehicle. Toyota takes a regional approach to its global operations. (Credit: Mariordo59/ flickr/ Attribution 2.0 Generic (CC BY 2.0))

Why do some companies pursue global strategies? One major reason is the nature of the industry in which they operate. For instance, the automotive industry lends itself to global approaches because the use of the product and the product being sold are similar worldwide. Thus, if there is the possibility of global markets where global customer needs can be met, a global strategy works well. Additionally, as mentioned earlier, a global strategy also enables cost savings. Because activities are not being adapted to local needs, a company can enjoy the benefits of having the same operations worldwide and enjoying synergistic benefits.

Current discussion of research suggests that few companies are truly global. A recent examination of the Fortune Global 500 companies found that only nine companies were truly global as measured by how sales were globally distributed across a number of countries. These companies include Canon, Coca-Cola, Flextronics, IBM, Intel, LVMH, Nokia, Philips, and Sony.

Regional Strategy

A regional strategy is one in which the company decides that it makes sense to organize its functional activities, such as marketing, finance, etc., around geographical regions that play a critical role in terms of sales. Toyota is an example of a company that has successfully implemented a regional strategy. Because regions such as Europe and North America are sufficiently large but different markets, Toyota has decided that it is worth customizing its operations by regions. In this case, the company has several regional offices that operate independently of Japanese headquarters.

A regional strategy is appropriate if companies find that the benefits from dispersing their activities far outweigh the benefits of coordination. For Toyota, having independent units based on regions makes a lot of sense because each region has specific needs that can better be addressed with a regional rather than a

global approach. For instance, consider that the price of gasoline is significantly higher in Europe than in the United States. Using a regional approach to the design and manufacture of more- or less-fuel-efficient cars makes much more sense than having a "one size fits all" car designed for a global market.

Local Strategy

The local strategy is the one in which a company adapts its products to meet the needs of the local market. For instance, experts argue that despite the perception that customers want global products, significant cultural and national value differences still suggest that some level of customization is necessary. This is especially critical for some functional areas, such as marketing. People across cultures have different purchasing and usage habits. Furthermore, they respond differently to promotional campaigns and other advertising messages. In such cases, a local strategy may be necessary.

An example of a local strategy is McDonald's product offerings in India.[32] Given the taste and vegetarian preference of India as well as the consideration that cows are sacred, the company famous for its hamburgers does not offer any beef or pork products. Rather than offend its customers, McDonald's restaurants in India offer burgers made of potatoes and peas (McAloo Tikki); burgers made of beans, green peas, onions, and carrots (McVeggie); and burgers made of paneer, India's cheese (McSpicy Paneer). The only meats that McDonald's sells at its restaurants in India are chicken (McChicken) and fish. Furthermore, the products are adapted to fit the local preference for spicy foods, and offerings such as the Masala Grill chicken and the McSpicy Chicken.

Despite the attractiveness of a local strategy, it is not without disadvantages. The local strategy is much more costly because it requires companies to duplicate resources and departments around the world. Additionally, because of the differences in local activities and operations, it may be difficult for the company to achieve learning or cost savings across subsidiaries. The nature of some markets, however, may require that a local strategy be adopted.

MANAGERIAL LEADERSHIP



From Regional to Global

Bayer Crop Science is a division of Bayer, a leading global company based in Leverkusen Germany. The Crop Science division's main goal "is to be able to produce enough food, feed, fiber and renewable raw materials for a growing world population on the limited land available."[33] It has been involved in many of the latest innovations in agriculture, such as developing apps for farmers to help them understand their crops, climates, and so on and developing the ability to use drones to assess crop quality.

One of Bayer Crop Science's units is the Global Public and Government Affairs (GPGA) division, which is in charge of monitoring and proactively complying with local government policies. In 2012, Bayer Crop Science had a large number of independent country GPGA divisions that acted independently, thereby limiting collaboration and cooperation. As a result of this regional strategy as described earlier, critical information about policy priorities from different regions was slow to reach headquarters, and Bayer Crop Science was not able to quickly address policy challenges worldwide.

In 2013, Bayer Crop Science hired Lisa Coen to implement a more global strategy in the GPGA division.[34] Her main task was to make the GPGA division a truly global organization. To accomplish her task, she first travelled extensively around the world to meet with the business unit leaders and the public affairs team members. Through this process, she wanted to engage with the key stakeholders to prevent any resistance to change from building up. During these meetings, she discovered that the various local and regional GPGA units had deep knowledge that would greatly help Bayer Crop Science face and manage public policy issues all over the world. The meetings also allowed her to come up with the best strategy to turn the

various regional units into a global unit.

To build a more collaborative organization, Coen had to move from a traditional and hierarchical organization based on regions to a globalized network of units. To demonstrate the need for such a system, Coen invited key individuals to a global meeting to work collectively on public policy issues. Through this exercise, she was able to show the group the critical importance of a network organization. Through team-building exercises, Coen showed how the entire group had to move around to meet with the key people in each region. This interaction allowed the group to commit to a network model that would support and build a global organization.

Discussion Questions

1. Why did Bayer Crop Science decide to move from its original regional organization of units to a more global network of units? What were the advantages and disadvantages of this approach?
2. How did Coen build support for the change? Do you believe this was an appropriate way?
3. What challenges do you anticipate as Coen continues to build a network organization?**

Summary

Companies choose international strategies based on their capabilities and skills as well as on the structure and nature of the industry in which they operate. Companies choose regional strategies if they feel that the regions have differences significant enough to justify such an approach. In contrast, companies elect a global strategy if they believe they have global products that can satisfy global consumer needs.

It is important to note, however, that companies rarely adopt the pure forms of strategy as we've described them. Many companies adopt hybrid structures, where some functional areas may be approached globally while other activities may be approached more regionally or locally.

CONCEPT CHECK

1. How and why do companies take various approaches to global operations?

6.7 The Necessity of Global Markets

7. Why might it be necessary for a company to go international, and how might it accomplish this goal?

In this section, we explore some of the methods companies can use to go international and how they might implement them. As we have seen so many times before, each method for entering international markets has its advantages and disadvantages, and it is up to the international management team to figure out which is most suitable for its company and for the countries in which it operates.

Reasons for Internationalization

Before we get into how companies can go international, let's look at why a company might want to expand internationally in the first place. Because navigating cross-cultural environments is fraught with dangers but holds the possibility of great success, we must understand the compelling reasons to go international.

Trade Facilitation

At a basic level, relying on a domestic market can be problematic. Because of the many factors enhancing globalization, companies of all sizes and types want to take advantage of global markets to expand and achieve sustainable competitive advantage. Despite some slowdown in trade, business-to-consumer e-

commerce is expected to double to $2.2 trillion over the span 2018 to 2021 due to improvements in IT and the use of the web.

Growth Opportunities

Another critical factor that supports internationalization is that emerging markets such as China, India, Brazil, and Malaysia will continue to grow and present companies with tremendous opportunities. Research from the Boston Consulting Group suggests that such emerging markets experienced growth (as measured by GDP growth rate), surpassing more developed economies by 2.2%.[35] Furthermore, this research predicted that economic growth in emerging markets accounted for 68% of worldwide growth in 2013 despite an economic slowdown. Finally, experts also predict that incomes in emerging markets will continue to rise.

How to Go International 1: Exporting

Given that it is critical for companies to go global, there are various means that companies can use to do so. The most basic and cost-effective approach is **exporting**, whereby a company sends its product to an international market and fills the order just as it fills a domestic order. Our earlier example of Dmitrii Dvornikov (who was selling jewelry and table clocks made from Russian semiprecious stones to international customers on Russia's eBay) is a simple example of exporting. However, companies can also become more involved in the process and have dedicated offices in another country to tackle exports. In fact, some companies may find that exporting is so critical that they create a dedicated export department.

Because exporting is one of the easiest ways to go international, it can bring many benefits.[36] Current research suggests that companies that export tend to be 17% more profitable than companies that don't. Additionally, exporting provides the ability for companies to defend their markets by becoming more competitive in other markets. Furthermore, by exploring international markets, a company can acquire critical cross-cultural management skills, thereby increasing the value of the company. Consider the case of DeFeet International, a U.S. maker of socks for cyclists.[37] Despite several major disasters during the company's existence (it burned down in 2006), DeFeet has been able to survive and expand thanks to the global market. The company hired an international marketing manager to get advice on how to develop a market strategy for Europe. Because of its strong research and development, DeFeet International has been able to develop the best socks for cycling. While production still takes place in the U.S., exporting has resulted in distributors in over 35 countries.

Despite the many benefits of exporting, companies are often reluctant to do so. Much of such fear is based on some assumptions about how business is done. For instance, managers often assume that exporting can be too risky, but some argue that selling only to domestic markets is just as risky. Some companies believe that exporting is too cumbersome or that getting paid for exports is too complicated and not worth the time. However, experts believe that exporting is not as complicated and can be easily done through the right channels. Finally, some companies believe that they are too small to export. However, research shows that nearly 30% of all U.S. exporters in 2005 had 19 employees or less.[38] This finding suggests that exporting is a viable strategy, even for small firms. To give you more insights into these assumptions, **Table 6.10** summarizes some of these myths and counterarguments.

Myths About Exporting and Counterarguments	
Myths	**Reality**
Exporting is risky.	Selling domestically is as difficult as exporting to some markets. Additionally, not all markets are necessarily risky.
It is difficult to get paid for exports.	Buying and selling internationally is now fairly routine. There are numerous ways to ensure reliable payment.
Exporting is so complicated.	Exporting requires minimal paperwork. It is now very easy to search for buyers using the internet. There are many intermediaries available to help with exports.
I can't succeed because I don't speak another language.	As mentioned in the chapter, there are many organizations offering help with translation etc. Setting up global websites can be seamless now.
My product won't do well in other markets.	If you do well in the U.S., your product will probably do well in other countries. There are many services available to test the market.

Based on U.S Department of Commerce, "A basic guide to exporting," 11th edition, 2015, https://www.export.gov/article?id=Why-Companies-should-export

Table 6.10

Solving a Disadvantage of Exporting through Licensing and Franchising

Although exporting is an easy way to go international, it has some disadvantages. Exporting does not give much control to the company in terms of how the product is presented in the international market. For instance, if the company decides to use an international intermediary to sell its product abroad, it is at the mercy of that intermediary. Additionally, exporting sometimes requires travelling and other tasks that may take managers away from domestic activities. In the light of such disadvantages, companies will often resort to licensing.

Licensing is a contractual agreement whereby, in exchange for a royalty or fee, a company gives the right to another company to use a trademark, know-how, or other proprietary technology. Similar to exporting, licensing is an easy way for a company to enter an international market quickly and without the need for laying out much capital. A licensor often has some asset that it can offer to the licensee in exchange for a fee. This asset might include a valuable patent, a trademark, technological know-how, or a company name that the licensor provides to the licensee in return for a payment.

A recent study of European firms' entry to the Vietnamese market shows that these companies relied on licensing.[39] For instance, consider Haymarket Media, one of the largest publishers in the United Kingdom. Haymarket enters into simple licensing agreements with the local affiliates to provide generic content to all worldwide licensees. This content is similar in all overseas editions of its magazines. However, through this licensing arrangement, the country affiliate adds local content. In this way, Haymarket has been able to increase sales of existing content by selling it in new global markets.

International franchising takes licensing up a notch. Rather than simply license some specific aspect of the value chain, a company will license the complete business model. The business model usually includes trademarks, business organization structures, technologies and know-how, and training. Similar to licensing,

the franchisor owns a trademark that the franchisee pays a royalty for. Additionally, the franchisee will usually pay for the right to use the business model of the franchisor.

Many fast food companies have relied on franchising agreements to enter the Indian market.[40] As India has experienced economic growth, more people have greater amounts of disposable income. In addition, because more couples are now busy working, they rely more on fast food as a meal option. Companies such as McDonald's, KFC, Domino's Pizza, and Pizza Hut have all entered franchising agreements with local companies to sell their products. This move has proven to be very successful because the franchisors have been able to expand their markets while the franchisees have seen significant profits in the local Indian markets.

Similar to other forms of entry, licensing and franchising have benefits and disadvantages. In terms of benefits, both forms of entry provide the receiving company with an established brand or some other technological know-how that has already proved itself. The recipient of the franchise agreement doesn't need to build a new reputation but can rely on a well-known international competitor. For the franchisor, this often provides a quick way to expand revenue from an existing business model. Additionally, while licensing and franchising are cost effective ways to go international, the companies granting the license or franchise still retain control over their product. If things don't work out as planned, the licensor can end the agreement. For the franchisee, an added benefit is that corporate support is provided to help the company succeed.

Disadvantages of Licensing and Franchising

Both licensing and franchising have disadvantages that can affect both the recipient of the agreement and the grantor of the agreement. For instance, a study of Indian entrepreneurs entering into franchise agreements with fast food companies in the United States reported that the master franchisor had too much control.[41] Furthermore, a franchise agreement can be risky and capital intensive for the local companies. For the licensor or franchisor, the biggest disadvantage is that the company can create a new competitor. While the host country laws may dictate the terms of agreement, local enforcement of these laws may not always be strong. Thus, a local company can therefore use the business model for its own purpose. Furthermore, compared to exporting, the licensor gives up additional control. Once the agreement is signed, it is possible for the licensee to sell the product at a lower price or with lower quality. This has the potential to affect reputation of the licensor.

How to Go International 2: Strategic Alliances

Because of some of the dangers of licensing and franchising, companies can often get even more involved in global operations by engaging in strategic alliances. **International strategic alliances** occur when two or more companies from different countries enter into an agreement to conduct joint business activities. Strategic alliances are often the preferred means of entry in emerging markets because they make it easier to do business in the country. A strategic alliance is a way for a foreign company to bypass barriers imposed by local governments.

A prominent example of one of the most successful strategic alliances is the one entered into by Nissan and Renault in 1999.[42] In this case, both companies were facing situations in which finding an international partner made sense. Nissan had historically low profitability and needed to find a partner. In contrast, Renault had just ended a failed relationship with Volvo and also needed to expand globally. Furthermore, both companies had what the other partner needed. For instance, Nissan had a strong presence in North America, providing a much-needed boost to Renault's global ambition. Nissan also had strong engineering abilities that would benefit Renault. In contrast, Renault had ample cash and superior design capabilities, both of which Nissan needed.

The Nissan-Renault example shows some of the benefits of strategic alliances. Strategic alliances often provide both partners with sorely needed skills or capabilities. Strategic alliances also often provide access to new markets and customers. In terms of going global, a company may not always have the necessary know-how or financial assets to enter an international market. Strategic alliances therefore provide the means for a

company to spring into the international domain. In that context, China remains an attractive destination for many multinationals. China's market presents tremendous potential given the increase in disposable income. A recent study sheds some light on the many aspects of entering alliances in China.[43] **Exhibit 6.8** therefore provides you with some of the main benefits foreign companies expect to gain from strategic alliances.

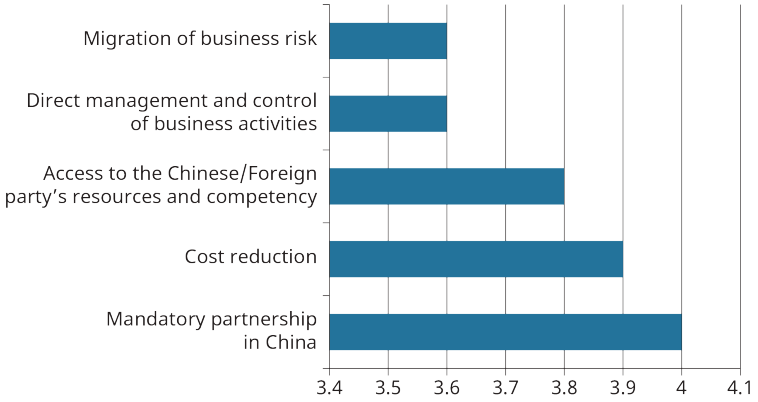

Exhibit 6.8 Reasons to Enter Strategic Alliances Based on PWC, 2015, "Courting China Inc: Expectations, pitfalls, and success factors of Sino-foreign business partnerships in China," http://www.pwccn.com/webmedia/doc/635705701963346674_china_joint_venture.pdf

Strategic alliances also enable companies to share resources to develop new technologies and make technological advances. This issue is acknowledged by the South Korean government, which encourages South Korean small and medium enterprises to enter into strategic alliances with foreign partners as a way to gain access to advanced technology as well as getting management skills to expand internationally. A recent study examined data from South Korea and found that entering strategic alliances also allowed companies to enjoy higher productivity.[44]

Disadvantages of Strategic Alliances

Despite these advantages, strategic alliances are notorious for high failure rates. A major reason is that strategic alliances are very difficult to manage. Additionally, strategic alliances often present partners with the possibility of acting opportunistically. This can occur when a partner tries to access technological know-how that they were not originally privy too. Alliance partners may also decide to refuse to agree to the original terms of the strategic alliance contracts. Finally, strategic alliances inevitably involve ambiguity and uncertainty. Properly managing such ambiguity is also necessary to avoid disadvantages associated with such alliances.

MANAGERIAL LEADERSHIP



McDonald's in India

McDonald's has had significant success in India. In 1996, it opened its first restaurant. Today, it has over 380 restaurants in India. McDonald's has been successful because it adequately examined cultural differences and found ways to address cultural challenges. As mentioned earlier, the practice of Hinduism, the dominant religion in India, results in preferences for vegetarian meals. McDonald's therefore developed many vegetarian menu items while also integrating local foods. It also recognized the very diverse nature of Indian society and offers appropriate regional and local foods in different regions.

To enter the Indian market, McDonald's entered into strategic alliances with two companies that were responsible for different parts of India.[45] However, despite the success, McDonald's is currently embroiled in a business war with one of two individuals who helped McDonald's come to India. In 1996, McDonald's entered into a 50-50 joint venture with Vikram Bakshi of Connaught Place Restaurants Limited. Over the

subsequent decades, Bakshi was able to expand McDonald's significantly in the east and north of India. However, in 2008, McDonald's tried to buy back Bakshi's share for $7 million. Bakshi used evidence from an accounting firm to argue that his share was worth $331 million. In the face of this challenge, McDonald's had Bakshi fired as an alliance partner in 2013. Baskhi has been fighting McDonald's in Indian courts. He sued to be reinstated and to be able to run his stores without interference from McDonald's corporate headquarters. When McDonald's tried to take Bakshi to the London Court of International Arbitration, he was able to get a local Indian court to agree that he was being subjected to "oppression and mismanagement." Although another court has agreed to allow McDonald's to sue Bakshi in London, he is now appealing in another Indian court. This experience has revealed some of the worst fear of multinationals about the dangers of strategic alliances and the need to respect the local courts.

Discussion Questions

1. Why did McDonald's choose to use strategic alliances to enter India? Why not use exporting or other means?
2. Why is McDonald's facing challenges in India? What disadvantages of strategic alliances do these challenges reflect?
3. What can McDonald's do to address Bakshi's concerns?
4. What can McDonald's do about Bakshi's use of local Indian courts? How can multinationals adequately prepare for such situations?**

How to Go International 3: Foreign Direct Investment

Given the difficulties associated with strategic alliances, some companies elect to be wholly vested in the host country. This final form of international entry, which we discussed at the beginning of the chapter, is **foreign direct investment (FDI)**, which occurs when a company invests in another country by constructing facilities and buildings in that country. FDI can also occur through mergers and acquisitions, whereby a multinational company fully acquires a company in another country. Many car companies, such as Toyota, Honda, BMW, and Nissan, have fully operational plants in the United States. For example, many of the BMW SUVs, such as the BMW X3 and X5, are fully built in the BMW plant in Spartanburg, South Carolina.

Why do some companies choose FDI as a means of international entry? For BMW, FDI allows the company to be closer to its customers and to also sell the car as an American car. Additionally, because some countries may impose tariffs on imported products or otherwise discourage imports, building a plant locally allows a company to bypass such restrictions. Furthermore, FDI can also provide access to local expertise or to cheaper costs of labor, both of which can help a company become more competitive through reduced costs.

Disadvantages of FDI

As you might expect, FDI as an entry mode is not without difficulties. While this method gives the company the most control, it is also the most capital intensive. A multinational engaged in FDI is also exposed to the **political risk** of a country, the degree to which political decisions can impact a business's ability to survive in that country. For instance, throughout history, countries such as Venezuela have used governmental decrees to appropriate investment from U.S. oil companies. Finally, it is important to note that FDI also involves additional coordination risks and can drain resources from local operations. A company that engages in FDI must be able to coordinate and integrate foreign and domestic operations.

The Incremental Path to Internationalization: The Uppsala Model

The above sections also provided some insights into how some companies can start small (say, with exporting) and eventually have FDI activities in some countries. One of the most popular ways to understand this development path of internationalization is the **Uppsala model**, which argues that "as firms learn more about a specific market, they become more committed by investing more resources into that market."[46] In this

model, companies adopt an incremental approach to internationalizing. First, they develop a solid domestic market base. After they have a strong domestic foundation, they start exploring international markets and eventually export products to markets that they feel have close psychic distance. **Psychic distance** refers to the many differences that exist between countries because of language, cultural characteristics, social institutions, and business practices. Countries with close psychic distance are similar to each other in all these variables; those with greater psychic distance are less similar. As a firm continues to gain international experience, it will start exporting to countries with greater psychic distance. As the firm gains even more international experience and knowledge of international markets, it will eventually want to have production facilities in the overseas market.[47]

The Uppsala model has been criticized on many fronts. Experts argue that this approach may oversimplify a very complex process. It is also criticized as being too deterministic because some companies may skip stages. The latter criticism is valid when we consider the case of **born globals**, companies that operate internationally from the day they are created.

The All-In Approach to Internalization: Born Globals

Born globals are considered key to most countries' economic development. A recent report suggests that born globals were significant contributors to exports in countries such as Poland and Australia. Additionally, the Organisation for Economic Co-operation and Development (OECD), a leading international organization comprising many of the world's leading economies, has argued that born globals were key engines that tackled the economic downturn that occurred after the financial crisis of 2007. It is therefore critical for the international management student to understand born globals.

Born globals have been made possible because of the many factors we discussed earlier that are making the world more global: the rapid development and decreasing costs of many types of information technologies have allowed companies to go international from the day they are created. Consider the case of M-PESA, the world's leading mobile-money company, created in 2007 in Kenya.[48] Because of M-PESA, it is now easier to pay for a taxi ride using your mobile phone in Nairobi, Kenya, than in New York. M-PESA was created by Safaricom, Kenya's largest mobile-network operator. A customer can sign up for the service at one of the 40,000 agents throughout Kenya and place money in the account. Money can then be transferred to others by using a mobile phone. This has proved to be very useful because so many people work in Kenya's major cities and need to transfer money to their family, who often life far away in rural areas. The mobile-money service provides a safe and convenient way to move money around in unsafe environments. The development in IT has also allowed M-PESA to quickly expand globally. Today it has 30 million users in 10 countries.[49]

Current research suggests that born globals are unique in many ways.[50] When compared to other start-ups, born globals tend to have higher employment and job growth rates. Born globals also serve a wider global market than domestic start-ups. Additionally, while born globals tend to experience similar internationalization patterns of smaller entrepreneurial firms, they have much more aggressive learning strategies as a result of becoming global much faster than others.[51]

Given the critical importance of born globals, what are the factors that contribute to their success? Current research suggests that a number of factors, such as marketing competence, effective pricing, advertising and distribution capabilities, product quality, and so on, all contribute to the success of such companies.[52] Studies also show that prior experience of managers in combining resources from different countries and having a global vision are also important. To give you more insights, **Table 6.11** discusses the success factors for born globals based on several studies.

Success Factors of Born Globals	
Study Sample	**Key Success Factors**
21 British firms	• Product uniqueness • New product development ability • Ability to meet customer specification • Company reputation
Companies based in U.S. and Denmark	• Marketing competence • Control of marketing processes • Effective pricing • Advertising and distribution • Product quality and differentiation
New ventures in Irish shellfish sector	• Maintaining closer relationship with international customers • Product differentiation • Proactive personality and global mindset of company founder
Irish low-technology International New Ventures	• Dynamic capability - ability for firms to constantly develop new capabilities to identify opportunities and respond
Polish born globals	• Product quality • Product pricing

Based on studies reviewed in Lidia Danik and Izabela Kowalik, "Success factors and development barriers perceived by the Polish born global companies. Empirical study results," *Journal for East European Management Studies,* 2015, Vol. 20, pp. 360-390.

Table 6.11

Summary

In the above sections, you have learned about the different ways in which a company can go international. Some companies have minimal engagement and only export. Others are fully vested and build production plants overseas. Yet others choose to go global from inception. Each entry mode has its benefits and costs, advantages and disadvantages. How do companies choose among these entry types?

The primary factors in the internalization decision are how much control the company wants to have over operations and how much of the company's resources (physical, financial, natural, human) it wants to expend to go international. For example, if a company doesn't want to invest or spend too much to access global markets but still wants to explore them, it can simply export. But with this method, the company has less control over operations, such as how the product is marketed and sold. However, if companies want to control all activities and if they have the resources, they can get involved in FDI. In such cases, the companies have significant control but at much higher costs.

A recent study of banks provides further insight into this issue.[53] For instance, the more a bank required local resources in the form of local reputation or the availability of a local branch network to offer services, the more likely the company was to use joint ventures or acquisitions as forms of international entry. If a bank wanted

to have greater control in terms of being able to manage its activities to achieve its goals, it would be more likely to acquire local firms. In some cases, banks needed this degree of control so that they could coordinate the activities to achieve economies of scale.

To become born globals, companies need to understand whether they have many of the success factors discussed in **Table 6.11**. Furthermore, all companies going international face risks, such as the barriers to export initiation (such as insufficient finances and knowledge of international market) and other complexities associated with transferring money across borders (fluctuation in exchange rates, payment delays, etc.).[54] Companies also face political risk in terms of foreign government intervention in the form of tariffs or foreign exchange controls. Companies need to determine whether they can work around these barriers.

CONCEPT CHECK



1. What are the factors and approaches that organizations can take when deciding to go global?
2. Explain the term *born global* and why it is important for companies to take this approach.

Key Terms

Born globals Companies that operate internationally from the day that they are created.
Christianity Faith based on the life, teachings, death, and resurrection of Jesus.
Clusters Representing countries that share similar cultural characteristics.
Cultural intelligence Refers to the individuals' capabilities to function and manage effectively in culturally diverse settings.
Cultural paradox Insights from an understanding of culture may not necessarily coincide with reality in that culture.
Cultural stereotyping Occurs when one assumes that all people within a culture act, think, and behave the same way.
DHL Global Connected Index Index tracking the flow of capital, information, trade, and human resources and representing the degree of globalization.
E-commerce Buying and selling of products using the Internet.
Education Socializing experiences that prepare individuals to act in society.
Emerging market multinationals Influential companies from emerging markets that are competing head-on with established multinationals and rewriting the rules of competition by using new business models.
Emerging markets Those markets in countries that present tremendous potential for multinationals.
Expatriate **F**oreign employee who moves and works in another country for an extended period of time.
Exporting International entry mode where a company sends a product to an international market and fills the order like a domestic order.
Foreign direct investment (FDI) Involves a company investing in another country through the construction of facilities and buildings in another country.
Foreign direct investment (FDI) Refers to deliberate efforts of a country or company to invest in another country through the form of ownership positions in companies in another country.
Global strategy Where all operations and activities are managed fairly similarly worldwide.
Globalization Worldwide phenomenon whereby the countries of the world are becoming more interconnected and where trade barriers are disappearing.
GLOBE project More recent cultural project involving 170 researchers who collected data on 17,000 managers from 62 countries around the world.
High-rigor cross-cultural training Methods of training where participants are much more actively engaged in the training process and can learn some tacit aspects of cross-cultural differences.
Hinduism Represented by all those who honor the ancient scriptures called the Vedas.
Hofstede model of national culture Project involving survey of over 88,000 employees in IBM subsidiaries from 72 countries.
Immigration Movement of people from their home country to other countries; will continue to grow worldwide.
Individualism Degree to which a society focuses on the relationship of the individual to the group.
International franchising Where a company will license the complete business model.
International strategic alliances Two or more companies from different countries enter into an agreement to conduct joint business activities.
Islam Religion whose essence is described in the Qur'an as the submission to the will of Allah (God).
Licensing Contractual agreement whereby a company is given the right to another company's trademarks, know-how, and other intangible assets in return for a royalty or a fee.
Local strategy Company's operations are adapted to fit some specific countries.
Low-rigor cross-cultural training Training where individuals are exposed to critical information to help them understand the realities of a different culture but are not actively engaged in their learning.
Masculinity **D**egree to which a society emphasizes traditional masculine qualities, such as advancement and earnings.
Political risk Degree to which political decisions can impact a business's ability to survive in a country.

Postarrival cross-cultural training Training provided after the expatriate has arrived to the intended destination.
Power distance Refers to the degree to which societies accept power differences and authority in society.
Predeparture cross-cultural training Learning opportunities provided prior to departure.
Regional strategy Where the multinational adapts activities and operations to regional requirements.
Religion Shared set of beliefs, activities, and institutions based on faith in supernatural forces.
Social institution Complex of positions, roles, norms, and values lodged in particular types of social structures and organizing relatively stable patterns of human resources with respect to fundamental problems in . . . sustaining viable societal structures within a given environment.
Social stratification Degree to which social benefits are unequally distributed; those patterns are perpetuated for life.
Tariffs Extra charges that are added to the price of international products in the form of additional taxes or higher prices as a way to give domestic companies a price advantage while also protecting these companies from foreign competition.
Trade agreements Popular policy instruments that countries agree on to eliminate cross-border barriers to trade and to promote global integration.
Uncertainty avoidance Refers to the degree to which people in a society are comfortable with uncertainty and unpredictable situations.
Uppsala model of internationalization Model that argues that as firms learn more about a specific market, they become more committed by investing more resources into that market.

Summary of Learning Outcomes

6.1 Importance of International Management

1. Why is it important to understand and appreciate the importance of international management in today's world?

Any serious management student needs to understand and appreciate the importance of international management in today's global business environment. Whether you work for a domestic company or a foreign company, you will likely need to interact with someone from another country or do business in another country. Understanding international management is therefore critical to address future challenges.

In this section, you learned about the many factors contributing to making globalization a reality: the growth of trade between countries, the growing importance of foreign direct investment, the growing competition from emerging market multinationals, and the globalization-fueling pervasiveness of the Internet. These factors all contribute to making the business world more global.

6.2 Hofstede's Cultural Framework

2. What is culture, and how can culture be understood through Hofstede's cultural framework?

Given the importance of globalization, any serious international management students will need to be able to understand the cultural aspects of a society in which they may find themselves and will need to learn how to adapt to various cultural conditions. The most popular cultural framework, the Hofstede scheme, was developed by Geert Hofstede, a Dutch social scientist who surveyed over 88,000 employees in 72 countries in which IBM had subsidiaries. He developed this cultural model primarily on the basis of differences in values and beliefs regarding work goals. This effort resulted in four main dimensions: power distance (the degree to which societies accept power differences and authority in society), individualism (the degree to which a society focuses on the relationship of the individual to the group), uncertainty avoidance (the degree to which people in a society are comfortable with uncertainty and unpredictable situations), and masculinity (degree to which a society emphasizes traditional masculine qualities such as advancement and earnings).

6.3 The GLOBE Framework

3. How are regions of the world categorized using the GLOBE framework, and how does this categorization enhance understanding of cross-cultural leadership?

The GLOBE project cultural framework is a much more recent effort that involved 170 researchers who collected data on 17,000 managers from 62 countries around the world. The focus of the GLOBE project was to understand how national cultures have preferences for different leadership styles. One of the strengths of the GLOBE project is that it clusters societies that share similar characteristics. The seven important clusters of the GLOBE project are the Anglo cluster, the Confucian Asia cluster, the Germanic Europe cluster, the Latin America cluster, the Middle East cluster, the Nordic Europe cluster, and the Sub-Saharan cluster. Each cluster rates differently the styles of leadership that the GLOBE researchers considered. The six leadership profiles are charismatic types (degree to which the leader can inspire and motivate others), participative type (degree to which leaders involve others in decision making), humane-oriented type (degree to which the leader shows compassion and generosity), autonomous (degree to which the leader reflects independent and individualistic leadership), and self-protective (degree to which the leader is self-centered and uses a face-saving approach). The various clusters show preferences for specific leadership styles that are consistent with the cultural aspects emphasized in each cluster.

6.4 Cultural Stereotyping and Social Institutions

4. Why is an understanding of cultural stereotyping important, and what can students do to prepare for cultural stereotyping by looking at social institutions?

While the Hofstede and GLOBE culture frameworks are certainly useful and can provide a solid basis for understanding cultural differences, relying solely on cultural dimensions can lead to problems when managers are confronted with cultural paradoxes (when reality doesn't coincide with expectations based on cultural dimensions) and cultural stereotyping (when it is assumed that everyone within the same culture acts and behaves similarly).

To broaden your understanding of cultural differences, you must also take into account a country's social institutions.

While there are a large number of social institutions that can impact international business, we examined three main types of social institutions that affect how people act and behave: social stratification (degree to which social benefits are unequally distributed and those patterns are perpetuated for life), education (the socializing experiences which prepare individuals to act in society), and religion (the shared set of beliefs, activities, and institutions based on faith in supernatural forces).

6.5 Cross-Cultural Assignments

5. What steps can you undertake to be better prepared for cross-cultural assignments?

While the above sections provided you with many diagnostic tools to understand how to evaluate cross-cultural differences, this section presented you with the ways to prepare for cross-cultural assignments. The goal of any training is to increase cultural intelligence, the ability to function and manage effectively in culturally diverse settings. To understand what companies can do to increase cultural intelligence, you learned about various types of training: low-rigor training (where individuals are exposed to critical information but are not necessarily actively engaged in their learning) and high-rigor training (methods of training where participants are much more actively engaged in the training process). You also learned that multinationals can also provide training before someone goes on an international assignment or while someone is already on the assignment.

6.6 Strategies for Expanding Globally

6. What are the main strategies that companies can use to go international?

As companies explore expanding into international markets, they adopt one of three main strategies, each of which has its advantages and disadvantages depending on the company's and country's characteristics. The three strategies are 1) the global strategy, in which all operations and activities are managed fairly similarly worldwide; 2) the regional strategy, in which the multinational adapts activities and operations to regional requirements; and 3) the local strategy, in which the company's operations are adapted to fit some specific countries.

6.7 The Necessity of Global Markets

7. Why might it be necessary for a company to go international, and how might it accomplish this goal?

In the final section of the chapter, you first read about the need for companies to go international and learned that some markets present strong potential while others have floundered.

Companies can go international in many ways: exporting (an entry mode where a company sends a product to an international market and fills the order like a domestic order), licensing and franchising (a contractual agreement whereby a company is given the right to another company's trademarks, know-how, and other intangible assets in return for a royalty or a fee), strategic alliances (where two or more companies from different countries enter into an agreement to conduct joint business activities), and foreign direct investment (which involves a company investing in another country through the construction of facilities and buildings in another country).

With each of these methods of entry, there is a trade-off between the cost of a means of entry and the amount of control a company has over its operations. For example, exporting is usually the cheapest way to go international but offers the company the least amount of control. Born globals do not have to think about how or when to go global because they are international from the day they are created.

Chapter Review Questions

1. Why is international management a critical area that all management students should be aware of?
2. Briefly describe the main cultural dimensions of Hofstede's framework. Where does the U.S. stand on each of the dimensions?
3. What is power distance? What are the implications of power distance for how management is conducted in different societies?
4. How is the GLOBE project different from the Hofstede project of cultural dimensions? What are the main findings of the study?
5. What are country clusters? Pick any three clusters and discuss some of the leadership preferences for each cluster.
6. Compare and contrast low-rigor versus high-rigor cross-cultural training. Provide some examples of each type of training.
7. What is predeparture cross-cultural training? What is postarrival cross-cultural training? Which method works best and why?
8. What is a global strategy? When do companies prefer a global strategy?
9. Compare and contrast a global, regional, and local strategy. Discuss some advantages and disadvantages of each method.
10. What are the various means available to companies to go international? When is an exporting strategy most appropriate?

Management Skills Application Exercises

1. Your manager is currently considering negotiations in China, and given your international management knowledge, you are asked for advice. How would you approach preparing to advise her? What type of information will you provide to her?
2. You have a new product, and you are considering exporting the product. Visit the government's export

website at https://www.export.gov/article?id=Why-Companies-should-export. What are some of the key issues to take into consideration when exporting?
3. You are in charge of HR in your company, and the company will soon need to send an expatriate to Japan. You will need to design a training program to better prepare your employee. What type of training program will you provide? What essential elements will the program include?
4. You are considering investing in Saudi Arabia and know that the business culture there is influenced by religion. Using your knowledge of Islam, what should you expect? How can you better prepare for the investment?
5. You have designed a new surfboard that presents significant advantages over current models. How can you determine whether you are ready to launch your company as a born global?

Managerial Decision Exercises

1. You are the CEO of a company that produces high-end laptops for gaming. You have heard that there is interest in your product from international customers. You need to decide how to enter the international market. What issues do you take into consideration when deciding among the different means of entry? Which approach do you think would work best?
2. Visit Hofstede's cultural dimensions website at https://www.hofstede-insights.com/models/national-culture/. Pick two countries and compare them with the United States on the cultural dimensions. How would you manage cultural differences in these countries?
3. Your company is interested in exploring international expansion into Africa. Visit the African Union's website at https://au.int/en/. What are some of the countries included in the African Union? How easy will it be to approach entering these markets?
4. Your company is interested in exploring investments in several sectors in Zimbabwe. Because of political instability, you are obviously very reluctant given the risks of doing business in that country. Using data from https://www.marsh.com/us/campaigns/political-risk-map-2017.html, discuss the concept of political risk. When can you decide that investing in Zimbabwe is a good idea?
5. You will be sending one of your employees to several new countries for short-term assignments. You need to decide between low-rigor cross-cultural training and high-rigor cross-cultural training. Which method would work best? How would you decide between the two, and what elements would your training involve?

Critical Thinking Case

SAP and the American CEO of a German Multinational

SAP is a German multinational specializing in enterprise application software. The company was founded by five engineers, and the company is now the world's leading business software maker. Through its software, SAP helps its customers streamline production processes. SAP also provides forecasting services to its customers to help them predict customer trends. It currently has over 87,000 employees in 130 countries assisting over 335,000 customers worldwide.

For the first time in its history, the company is currently headed by an American, Bill McDermott. McDermott's training was in sales, and that provided him with significant expertise to become SAP's current CEO. In 2010, SAP was facing declining revenue worldwide and needed a turnaround. Initially, McDermott was co-CEO with Jim Hagemann Snabe, a Danish executive who was one of the company's cofounders. The arrangement worked well, and when Snabe retired in 2014, McDermott became CEO.

McDermott's success came from the many changes he instituted to better adapt to cultural differences. For instance, he quickly discovered that sales were not very effective in the United States because the salespeople were more interested in focusing on the engineering aspects of SAP's products at the expense of listening to American customers. Such experiences led to the development of more customer-focused innovation and a more empathetic approach to customer needs, things McDermott strongly believes in.

In visiting his German counterparts, McDermott also saw other potential sources of cross-cultural conflict. For instance, he saw that presentations in the United States were much more effective if the presentation quickly engaged the audience and got them excited. In contrast, a German audience preferred a more disciplined, fact-based presentation. McDermott also discovered key differences between the way U.S. companies are managed in comparison to German companies. For example, he found that while U.S. public companies are pressured by quarterly results, SAP was much more interested in 30-year cycles as opposed to 90-day stock price movements.

McDermott's success at managing cross-cultural differences is no surprise. When he was a teenager, he purchased a distressed deli shop in Long Island. Long Island was already a melting pot of immigrants, and he learned how to deal with a diverse group of customers. When he was first hired at 27 to sell Xerox copy machines, he found that American customers do not have a long time for a sales pitch. He learned to be quick and to the point. In contrast, in Asia, he found that you had to focus on developing relationships rather than focus on the product. At the age of 29, he was asked to turn around business in Puerto Rico. There he found employee morale to be very low because of cost-cutting measures. Rather than blindly implementing American management, he listened to the local employees and implemented many measures to improve operations. For instance, he worked to improve customer service. Most importantly, he reinstated a Christmas party that had been canceled as a cost-cutting measure. This lifted morale and led to the turnaround.

McDermott has many important lessons for aspiring cross-cultural leaders. He advises that leaders be respectful of cross-cultural differences. Additionally, because SAP has one global vision, he can have all employees focus on that vision. He therefore also suggests that leaders and managers adopt a compelling vision that can be readily shared with all employees. He also believes that the customer experience is what is critical. Finally, he recommends that the savvy manager be human and empathetic and show humility.

Critical Thinking Questions

1. What are some of the sources of McDermott's excellence at managing cross-cultural differences? How did his experience managing a deli store at a young age help him develop cross-cultural management skills?
2. What are some of the cross-cultural differences he discovered? Using your knowledge of culture, explain some of these differences.
3. What is your assessment of his lessons for cross-cultural managers? Relate these lessons to the GLOBE findings of the effective global leader.

Sources: Geoff Colvin, " A CEO's plan to defy disruption," *Fortune,* November 2014, pp. 36; Michal Lev-Ram, "Inside SAP's radical make-over," Fortune, April 9th, 2012, Issue 5, pp. 35-38; Bill McDermott, "SAP's CEO on being the American head of a German multinational," *Harvard Business Review,* 2016, November, https://hbr.org/2016/11/saps-ceo-on-being-the-american-head-of-a-german-multinational; SAP Corporate Website https://www.sap.com/index.html.



7

Entrepreneurship

Exhibit 7.1 (Credit: Christian Heilmann / flickr / Attribution 2.0 Generic (CC BY 2.0))

Introduction

Learning Outcomes

After reading this chapter, you should be able to answer these questions:

1. Why do people become entrepreneurs, and what are the different types of entrepreneurs?
2. What characteristics do successful entrepreneurs share?
3. How do small businesses contribute to the U.S. economy?
4. What are the first steps to take if you are starting your own business?
5. Why does managing a small business present special challenges for the owner?
6. What are the advantages and disadvantages facing owners of small businesses?
7. How does the Small Business Administration help small businesses?
8. What trends are shaping entrepreneurship and small-business ownership?

EXPLORING MANAGERIAL CAREERS

Natalie Tessler, Spa Space

Natalie Tessler has always had an entrepreneurial spirit. After she graduated from New York University's law school, she began working as a tax attorney for a large firm in Chicago. But Tessler soon realized that this left her feeling unfulfilled. She didn't want to practice law, and she didn't want to work for someone else. "I wanted to wake up and be excited for my day," Tessler said. Not until one night, though, when she was having dinner with a friend who recently had begun a writing career, did she realize it was time. "I was listening to her talk about how much she loved her job. Her passion and excitement—I wanted that. I wanted something that grabbed me and propelled me through the day—and being a lawyer wasn't it."

She began searching for what "it" was. She had a tremendous passion and talent for hospitality, entertaining others, and presentation. Seeking an outlet for that flair, she found the spa industry, and the idea for Spa Space was born.

"People think that, owning a spa, I'm able to live this glamorous lifestyle," she laughs. "Owning a spa is nothing like going to one—my nails always are broken from fixing equipment; my back is usually in pain from sitting hunched over a computer trying to figure out the budget or our next marketing promotion." Tessler is a true entrepreneur, embodying the spirit and drive necessary to see her vision become a reality.

Tessler wanted to design a spa that focused on something new: creating a comfortable, personalized environment of indulgence while not neglecting the medical technology of proper skin care. "My father's a dermatologist, so we discussed the importance of making this more than a spa where you can get a frou-frou, smell-good treatment that might actually harm your skin. We both thought it was important to create an experience that is as beneficial for people's skin as it is for their emotional well-being." To address this need, Spa Space has a medical advisory board that helps with product selection, treatment design, and staff training.

Armed with a vision and a plan, Tessler turned her sights toward making it a reality. Spa Space opened in 2001 and has received a great deal of national recognition for its service excellence, unique treatments and products, and its fresh approach to appealing to both men and women. But it hasn't always been smooth sailing for Spa Space. Tessler had to steer the business through several obstacles, including the 9/11 tragedy just three months after the spa's grand opening, and then the Great Recession. Tessler learned to adapt her strategy by refining her target market and the services Spa Space offered. Her resiliency enabled the company to not only survive difficult economic periods, but to thrive and grow 17 years later into what the press recognizes as Chicago's best spa.

Tessler recently turned the reins over to Ilana Alberico, another entrepreneur and founder of Innovative Spa Management, a company that has been named twice to *Inc.* magazine's list of fastest growing companies. When Alberico met Natalie Tessler and learned about her vision, she was inspired to invest in Spa Space. "Natalie's vision still resonates . . . I'm inspired to champion her vision into the future."

Sources: "Our Team," https://spaspace.com, accessed February 1, 2018; Jennifer Keishin Armstrong, "Spa Reviews: Spa Space in Chicago," *Day Spa* magazine, http://www.dayspamagazine.com, accessed February 1, 2018; "About Us," https://ismspa.com, accessed February 1, 2018.

Typical of many who catch the entrepreneurial bug, Natalie Tessler had a vision and pursued it single-mindedly. She is just one of thousands of entrepreneurs from all age groups and backgrounds. Even kids are starting businesses and high-tech firms. College graduates are shunning the corporate world to head out on their own. Downsized employees, midcareer executives, and retirees who have worked for others all their lives are forming the companies they have always wanted to own.

Companies started by entrepreneurs and small-business owners make significant contributions to the U.S. and global economies. Hotbeds of innovation, these small businesses take leadership roles in technological change and the development of new goods and services. Just how important are small businesses to our economy? **Table 7.1** provides insight into the role of small business in today's economy.

You may be one of the millions of Americans who's considering joining the ranks of business owners. As you read this chapter, you'll learn why entrepreneurship continues to be one of the hottest areas of business activity. Then you'll get the information and tools you need to help you decide whether owning your own company is the right career path for you. Next you'll discover what characteristics you'll need to become a successful entrepreneur. Then we'll look at the importance of small businesses in the economy, guidelines for starting and managing a small business, the many reasons small businesses continue to thrive in the United States, and the role of the Small Business Administration. Finally, the chapter explores the trends that shape entrepreneurship and small-business ownership today.

7.1 Entrepreneurship

1. Why do people become entrepreneurs, and what are the different types of entrepreneurs?

Brothers Fernando and Santiago Aguerre exhibited entrepreneurial tendencies at an early age. At 8 and 9 years old respectively, they sold strawberries and radishes from a vacant lot near their parents' home in Plata del Mar on the Atlantic coast of Argentina. At 11 and 12, they provided a surfboard repair service from their garage. As teenagers, Fer and Santi, as they call each other, opened Argentina's first surf shop, which led to their most ambitious entrepreneurial venture of all.

The flat-footed brothers found that traipsing across hot sand in flip-flops was uncomfortable, so in 1984 they sank their $4,000 savings into manufacturing their own line of beach sandals. Now offering sandals and footwear for women, men, and children, as well as clothing for men, Reef sandals have become the world's hottest beach footwear, with a presence in nearly every surf shop in the United States.[1]

The Economic Impact of Small Business
Most U.S. Businesses Are Small:
• 80% (approximately 23.8 million) of the nearly 29.7 million businesses have no employees (businesses run by individuals or small groups of partners, such as married couples). • 89% (approximately 5.2 million) of the nearly 5.8 million businesses with employees have fewer than 20 employees. • 99.6% (approximately 5.7 million) of all businesses have 0–99 employees—98% have 0–20 workers. • Approximately 5.8 million businesses have fewer than 500 employees. • Only about 19,000 businesses in the United States have more than 500 employees. • Companies with fewer than 50 employees pay more than 20% of America's payroll. • Companies with fewer than 500 employees pay more than 41% of America's payroll. • 32.5 million people (1 employee in 4) work for businesses with fewer than 50 employees. • These businesses also pay tens of millions of owners, not included in employment statistics.

Table 7.1 Source: "Firm Size Data: 2014," https://www.sba.gov, accessed February 1, 2018.

CATCHING THE ENTREPRENEURIAL SPIRIT



Young Entrepreneur Living the Dream

Jack Bonneau is the quintessential entrepreneur. In the three years he has been in business, he has expanded his product line, opened multiple locations, established strategic partnerships, and secured sponsorship from several national brands. His business has garnered publicity from *The New York Times, The Denver Post, The Today Show*, *Good Morning America*, and numerous other media. He has shared his business success on several stages, speaking at TechStars and the Aspen Ideas Festival, and recently delivered the closing keynote speech at a national STEM conference. He even landed a gig on *Shark Tank*.

Jack Bonneau is smart, charismatic, an excellent spokesperson, and persistent in his mission. And he is only 11 years old—which also makes him very adorable.

Jack's business was born from a need that most kids have: a desire for toys. He asked his dad, Steve Bonneau, for a LEGO Star Wars Death Star. The problem was that it cost $400. Jack's dad said he could have

it but only if he paid for it himself. This led Jack to do what a lot of kids do to earn some extra cash. He opened a lemonade stand. But he quickly learned that this would never help him realize his dream, so, with the advice and help of his father, he decided to open a lemonade stand at a local farmers market. "There were lots of people who wanted to buy great lemonade from an eight-year-old," says Jack. In no time, Jack had earned enough to buy his LEGO Death Star. "I had sales of around $2,000, and my total profit was $900," Jack said.

Jack realized that he was on to something. Adults love to buy things from cute kids. What if he could make even more money by opening more locations? Jack developed an expansion plan to open three new "Jack Stands" the following spring. Realizing that he would need more working capital, he secured a $5,000 loan from Young Americas Bank, a bank in Denver that specializes in loans to children. Jack made $25,000 in 2015.

The following year, Jack wanted to expand operations, so he secured a second loan for $12,000. He opened stands in several more locations, including shopping malls during the holiday season, selling apple cider and hot chocolate instead of lemonade. He also added additional shop space and recruited other young entrepreneurial kids to sell their products in his space, changing the name to Jack's Stands and Marketplace. One of his first partnerships was Sweet Bee Sisters, a lip balm and lotion company founded by Lily, Chloe, and Sophie Warren. He also worked with 18 other young entrepreneurs who sell a range of products from organic dog treats to scarves and headbands.

Jack's strategy worked, and the business brought in more than $100,000 last year. This year, he became the spokesperson for Santa Cruz Organic Lemonade, and he's now looking at expanding into other cities such as Detroit and New Orleans.

Even though Jack is only 11 years old, he has already mastered financial literacy, customer service, marketing and sales, social skills, and other sound business practices—all the qualities of a successful entrepreneur.

Critical Thinking Questions

1. What do you think enabled Jack Bonneau to start and grow a successful business at such a young age?
2. What personal characteristics and values will Jack need to continue running his business while also attending school full-time?

Sources: "About Jack's Stands & Marketplaces," https://www.jackstands.com, accessed February 1, 2018; Peter Gasca, "This 11-Year-Old Founder's Advice Is As Profound as Any You Could Receive," *Inc.,* https://www.inc.com, July 27, 2017; Claire Martin, "Some Kids Sell Lemonade. He Starts a Chain," *The New York Times,* https://www.nytimes.com, February 26, 2016.

Christy Glass Lowe, who monitors surf apparel for USBX Advisory Services LLC, notes, "They [Reef] built a brand from nothing and now they're the dominant market share leader."

The Aguerres, who currently live two blocks from each other in La Jolla, California, sold Reef to VF Corporation for more than $100 million in 2005. In selling Reef, "We've finally found our freedom," Fernando says. "We traded money for time," adds Santiago. Fernando remains active with surfing organizations, serving as president of the International Surfing Association, where he became known as "Ambassador of the Wave" for his efforts in getting all 90 worldwide members of the International Olympic Committee to unanimously vote in favor of including surfing in the 2020 Olympic Games.[2] He has also been named "Waterman of the Year" by the Surf Industry Manufacturers Association two times in 24 years.[3] Santi raises funds for his favorite not-for-profit, SurfAid. Both brothers are enjoying serving an industry that has served them so well.

The United States is blessed with a wealth of entrepreneurs such as the Aguerres who want to start a **small business**. According to research by the Small Business Administration, two-thirds of college students intend to

be entrepreneurs at some point in their careers, aspiring to become the next Bill Gates or Jeff Bezos, founder of Amazon.com. But before you put out any money or expend energy and time, you'd be wise to check out **Table 7.2** for some preliminary advice.

The desire to be one's own boss cuts across all age, gender, and ethnic lines. Results of a recent U.S. Census Bureau survey of business owners show that minority groups and women are becoming business owners at a much higher rate than the national average. **Exhibit 7.4** illustrates these minority-owned business demographics.

Why has entrepreneurship remained such a strong part of the foundation of the U.S. business system for so many years? Because today's global economy rewards innovative, flexible companies that can respond quickly to changes in the business environment. Such companies are started by **entrepreneurs**, people with vision,

drive, and creativity, who are willing to take the risk of starting and managing a business to make a profit.

Are You Ready to Be an Entrepreneur?
Here are some questions would-be entrepreneurs should ask themselves: 1. What is new and novel about your idea? Are you solving a problem or unmet need? 2. Are there similar products/services out there? If so, what makes yours better? 3. Who is your target market? How many people would use your product or service? 4. Have you talked with potential customers to get their feedback? Would they buy your product/service? 5. What about production costs? How much do you think the market will pay? 6. How defensible is the concept? Is there good intellectual property? 7. Is this innovation strategic to my business? 8. Is the innovation easy to communicate? 9. How might this product evolve over time? Would it be possible to expand it into a product line? Can it be updated/enhanced in future versions? 10. Where would someone buy this product/service? 11. How will the product/service be marketed? What are the costs to sell and market it? 12. What are the challenges involved in developing this product/service?

Table 7.2 Sources: Jess Ekstrom, "5 Questions to Ask Yourself Before You Start a Business," *Entrepreneur,* https://www.entrepreneur.com, accessed February 1, 2018; "Resources," http://www.marketsmarter.com, accessed February 1, 2018; Monique Reece, *Real-Time Marketing for Business Growth: How to Use Social Media, Measure Marketing, and Create a Culture of Execution* (Upper Saddle River, NJ: FT Press/Pearson, 2010); Mike Collins, "Before You Start–Innovator's Inventory," *The Wall Street Journal,* May 9, 2005, p. R4.

Statistics for Minority-Owned Businesses
• The number of Hispanic-owned businesses almost tripled between 1997 (1.2 million) and 2012 (3.3 million). • The percentage of U.S. businesses with 1 to 50 employees owned by African Americans increased by 50% between 1996 and 2015. • Almost a million firms with employees are minority owned: 53% are Asian American owned, 11% are African American owned, and almost a third are Hispanic owned. • 19% of all companies with employees are owned by women.

Table 7.3 Sources: Robert Bernstein, "Hispanic-Owned Businesses on the Upswing," International Trade Management Division, U.S. Census, https://www.census.gov, December 1, 2016; The Kauffman Index of Main Street Entrepreneurship, https://www.kauffman.org, November 2016.

Entrepreneur or Small-Business Owner?

The term *entrepreneur* is often used in a broad sense to include most small-business owners. The two groups share some of the same characteristics, and we'll see that some of the reasons for becoming an entrepreneur or a small-business owner are very similar. But there is a difference between entrepreneurship and small-business management. Entrepreneurship involves taking a risk, either to create a new business or to greatly change the scope and direction of an existing one. Entrepreneurs typically are innovators who start companies to pursue their ideas for a new product or service. They are visionaries who spot trends.

Although entrepreneurs may be small-business owners, not all small-business owners are entrepreneurs. Small-business owners are managers or people with technical expertise who started a business or bought an existing business and made a conscious decision to stay small. For example, the proprietor of your local

independent bookstore is a small-business owner. Jeff Bezos, founder of Amazon.com, also sells books. But Bezos is an entrepreneur: He developed a new model—web-based book retailing—that revolutionized the bookselling world and then moved on to change retailing in general. Entrepreneurs are less likely to accept the status quo, and they generally take a longer-term view than the small-business owner.

Types of Entrepreneurs

Entrepreneurs fall into several categories: classic entrepreneurs, multipreneurs, and intrapreneurs.

Classic Entrepreneurs

Classic entrepreneurs are risk-takers who start their own companies based on innovative ideas. Some classic entrepreneurs are *micropreneurs* who start small and plan to stay small. They often start businesses just for personal satisfaction and the lifestyle. Miho Inagi is a good example of a micropreneur. On a visit to New York with college friends in 1998, Inagi fell in love with the city's bagels. "I just didn't think anything like a bagel could taste so good," she said. Her passion for bagels led the young office assistant to quit her job and pursue her dream of one day opening her own bagel shop in Tokyo. Although her parents tried to talk her out of it, and bagels were virtually unknown in Japan, nothing deterred her. Other trips to New York followed, including an unpaid six-month apprenticeship at Ess-a-Bagel, where Inagi took orders, cleared trays, and swept floors. On weekends, owner Florence Wilpon let her make dough.

In August 2004, using $20,000 of her own savings and a $30,000 loan from her parents, Inagi finally opened tiny Maruichi Bagel. The timing was fortuitous, as Japan was about to experience a bagel boom. After a slow start, a favorable review on a local bagel website brought customers flocking for what are considered the best bagels in Tokyo. Inagi earns only about $2,300 a month after expenses, the same amount she was making as a company employee. "Before I opened this store I had no goals," she says, "but now I feel so satisfied."[4]

In contrast, *growth-oriented entrepreneurs* want their business to grow into a major corporation. Most high-tech companies are formed by growth-oriented entrepreneurs. Jeff Bezos recognized that with Internet technology he could compete with large chains of traditional book retailers. Bezos's goal was to build his company into a high-growth enterprise—and he chose a name that reflected his strategy: Amazon.com. Once his company succeeded in the book sector, Bezos applied his online retailing model to other product lines, from toys and house and garden items to tools, apparel, music, and services. In partnership with other retailers, Bezos is well on his way to making Amazon's vision "to be Earth's most customer-centric company; to build a place where people can come to find and discover anything they might want to buy online."—a reality.[5]

Multipreneurs

Then there are *multipreneurs,* entrepreneurs who start a series of companies. They thrive on the challenge of building a business and watching it grow. In fact, over half of the chief executives at *Inc.* 500 companies say they would start another company if they sold their current one. Brothers Jeff and Rich Sloan are a good example of multipreneurs, having turned numerous improbable ideas into successful companies. Over the past 20-plus years, they have renovated houses, owned a horse breeding and marketing business, invented a device to prevent car batteries from dying, and so on. Their latest venture, a multimedia company called StartupNation, helps individuals realize their entrepreneurial dreams. And the brothers know what company they want to start next: yours.[6]



Exhibit 7.2 If there is one person responsible for the mainstream success of solar energy and electric vehicles in the past 10 years, it's Elon Musk, co-founder and CEO of Tesla. Since the 2000s when he founded Tesla, launching innovation in solar technology, and commercial space exploration with SpaceX, Musk has pioneered countless innovations and has challenged traditional automobile, trucking, and energy companies to challenge and rethink their businesses. *What entrepreneurial type best describes Elon Musk?* (Credit: Steve Jurvetson/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))

Intrapreneurs

Some entrepreneurs don't own their own companies but apply their creativity, vision, and risk-taking within a large corporation. Called **intrapreneurs**, these employees enjoy the freedom to nurture their ideas and develop new products, while their employers provide regular salaries and financial backing. Intrapreneurs have a high degree of autonomy to run their own minicompanies within the larger enterprise. They share many of the same personality traits as classic entrepreneurs, but they take less personal risk. According to Gifford Pinchot, who coined the term *intrapreneur* in his book of the same name, large companies provide seed funds that finance in-house entrepreneurial efforts. These include Intel, IBM, Texas Instruments (a pioneering intrapreneurial company), Salesforce.com, and Xerox.

Why Become an Entrepreneur?

As the examples in this chapter show, entrepreneurs are found in all industries and have different motives for starting companies. The most common reason cited by CEOs of the *Inc.* 500, the magazine's annual list of fastest-growing private companies, is the challenge of building a business, followed by the desire to control their own destiny. Other reasons include financial independence and the frustration of working for someone else. Two important motives mentioned in other surveys are a feeling of personal satisfaction with their work, and creating the lifestyle that they want. Do entrepreneurs feel that going into business for themselves was worth it? The answer is a resounding yes. Most say they would do it again.

CONCEPT CHECK

1. Describe several types of entrepreneurs.
2. What differentiates an entrepreneur from a small-business owner?
3. What are some major factors that motivate entrepreneurs to start businesses?

7.2 Characteristics of Successful Entrepreneurs

2. What characteristics do successful entrepreneurs share?

Do you have what it takes to become an entrepreneur? Having a great concept is not enough. An entrepreneur must be able to develop and manage the company that implements his or her idea. Being an entrepreneur requires special drive, perseverance, passion, and a spirit of adventure, in addition to managerial and technical ability. Entrepreneurs *are* the company; they tend to work longer hours, take fewer vacations, and cannot leave problems at the office at the end of the day. They also share other common characteristics as described in the next section.

The Entrepreneurial Personality

Studies of the entrepreneurial personality find that entrepreneurs share certain key traits. Most entrepreneurs are

- *Ambitious:* They are competitive and have a high need for achievement.
- *Independent:* They are individualists and self-starters who prefer to lead rather than follow.
- *Self-confident:* They understand the challenges of starting and operating a business and are decisive and confident in their ability to solve problems.
- *Risk-takers:* Although they are not averse to risk, most successful entrepreneurs favor business opportunities that carry a moderate degree of risk where they can better control the outcome over highly risky ventures where luck plays a large role.
- *Visionary:* Their ability to spot trends and act on them sets entrepreneurs apart from small-business owners and managers.
- *Creative:* To compete with larger firms, entrepreneurs need to have creative product designs, bold marketing strategies, and innovative solutions to managerial problems.
- *Energetic:* Starting and operating a business takes long hours. Even so, some entrepreneurs start their companies while still employed full-time elsewhere.
- *Passionate.* Entrepreneurs love their work, as Miho Inagi demonstrated by opening a bagel shop in Tokyo despite the odds against it being a success.
- *Committed.* Because they are so committed to their companies, entrepreneurs are willing to make personal sacrifices to achieve their goals.

ETHICS IN PRACTICE



Ethical Choices Transform Family Business into International Brand

Ever since Apollonia Poilâne was a young girl growing up in Paris, she always knew what she wanted to do when she grew up: take over the family business. But she didn't anticipate how quickly this would happen. When her father—Lionel Poilâne—and her mother died in a helicopter crash in 2002, France lost its most celebrated baker, and Apollonia stepped into the role. She was just 18 years old at the time with plans to matriculate to Harvard in the fall, but the moment her parents had prepared her for had come. As her Harvard admissions essay said, "The work of several generations is at stake."

With organization and determination, Apollonia managed one of the best French bakeries in the world—based in Paris—from her apartment in Cambridge, Massachusetts. She would usually wake up an extra two hours before classes to make sure she would get all the phone calls done for work. "After classes I check on any business regarding the company and then do my homework," she says. "Before I go to bed I call my production manager in Paris to check the quality of the bread." Because the name Poilâne has earned a place with a very small group of prestige bakers, the 18-year-old was determined to continue the

tradition of customer satisfaction and quality her grandfather established in 1932. When her grandfather suffered a stroke in 1973, his 28-year-old son, Lionel, poured his heart into the business and made the family bread into the global brand it is today. Lionel opened two more bakeries in Paris and another in London. He developed and nurtured a worldwide network of retailers and celebrities where bread is shipped daily via FedEx to upscale restaurants and wealthy clients around the world.

Experimenting with sourdough is what distinguished Poilâne's products from bread produced by Paris's other bakers, and it has remained the company's signature product. It is baked with a "P" carved into the crust, a throwback to the days when the use of communal ovens forced bakers to identify their loaves, and it also ensures that the loaf doesn't burst while it's baking. Today, Poilâne also sells croissants, pastries, and a few specialty breads, but the company's signature item is still the four-pound *miche*, a wheel of sourdough, a country bread, *pain Poilâne*.

"Apollonia is definitely passionate about her job," says Juliette Sarrazin, manager of the successful Poilâne Bakery in London. "She really believes in the work of her father and the company, and she is looking at the future, which is very good."

Apollonia's work ethic and passion fueled her drive even when she was a student. Each day presented a juggling act of new problems to solve in Paris while other Harvard students slept. As Apollonia told a student reporter from *The Harvard Crimson* writing a story about her, "The one or two hours you spend procrastinating I spend working. It's nothing demanding at all. It was always my dream to run the company."

Her dedication paid off, and Apollonia retained control of important decisions, strategy, and business goals, describing herself as the "commander of the ship," determining the company's overall direction. Today, Poilâne is an $18 million business that employs 160 people. Poilâne runs three restaurants called Cuisine de Bar in Paris and in London, serving casual meals such as soups, salads, and open-faced *tartines*. The company ships more than 200,000 loaves a year to clients in 20 countries, including the United States, Japan, and Saudi Arabia. "More people understand what makes the quality of the bread, what my father spent years studying, so I am thrilled about that," says Apollonia.

Critical Thinking Questions

1. What type of entrepreneur is Apollonia Poilâne?
2. What personal ethics drove Apollonia's decision to take over the family business?

Sources: "About Us," https://www.poilane.com, accessed February 1, 2018; Meg Bortin, "Apollonia Poilâne Builds on Her Family's Legacy," *The New York Times,* https://www.nytimes.com, accessed February 1, 2018; Lauren Collins, "Bread Winner: A Daughter Upholds the Traditions of France's Premier Baking Dynasty," *The New Yorker,* https://www.newyorker.com, December 3, 2012; Gregory Katz, "Her Daily Bread," *American Way* magazine, July 15, 2005, p. 34; Clarel Antoine, "No Time to Loaf Around," *Harvard Crimson,* http://www.thecrimson.com, October 16, 2003.

Most entrepreneurs combine many of the above characteristics. Sarah Levy, 23, loved her job as a restaurant pastry chef but not the low pay, high stress, and long hours of a commercial kitchen. So she found a new one—in her parents' home—and launched Sarah's Pastries and Candies. Part-time staffers help her fill pastry and candy orders to the soothing sounds of music videos playing in the background. Cornell University graduate Conor McDonough started his own web design firm, OffThePathMedia.com, after becoming disillusioned with the rigid structure of his job. "There wasn't enough room for my own expression," he says. "Freelancing keeps me on my toes," says busy graphic artist Ana Sanchez. "It forces me to do my best work because I know my next job depends on my performance."[7]



Exhibit 7.3 Celebrity Ashton Kutcher is more than just a pretty face. The actor-mogul is an active investor in technology-based start-ups such as Airbnb, Skype, and Foursquare with an empire estimated at $200 million dollars. *What personality traits are common to successful young entrepreneurs such as Kutcher?* (Credit: TechCrunch/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))

Managerial Ability and Technical Knowledge

A person with all the characteristics of an entrepreneur might still lack the necessary business skills to run a successful company. Entrepreneurs need the technical knowledge to carry out their ideas and the managerial ability to organize a company, develop operating strategies, obtain financing, and supervise day-to-day activities. Jim Crane, who built Eagle Global Logistics from a start-up into a $250 million company, addressed a group at a meeting saying, "I have never run a $250 million company before so you guys are going to have to start running this business."[8]

Good interpersonal and communication skills are important in dealing with employees, customers, and other business associates such as bankers, accountants, and attorneys. As we will discuss later in the chapter, entrepreneurs believe they can learn these much-needed skills. When Jim Steiner started his toner cartridge remanufacturing business, Quality Imaging Products, his initial investment was $400. He spent $200 on a consultant to teach him the business and $200 on materials to rebuild his first printer cartridges. He made sales calls from 8.00 a.m. to noon and made deliveries to customers from noon until 5:00 p.m. After a quick dinner, he moved to the garage, where he filled copier cartridges until midnight, when he collapsed into bed, sometimes covered with carbon soot. And this was not something he did for a couple of months until he got the business off the ground—this was his life for 18 months.[9] But entrepreneurs usually soon learn that they can't do it all themselves. Often they choose to focus on what they do best and hire others to do the rest.

CONCEPT CHECK

1. Describe the personality traits and skills characteristic of successful entrepreneurs.
2. What does it mean when we say that an entrepreneur should work on the business, not in it?

7.3 Small Business

3. How do small businesses contribute to the U.S. economy?

Although large corporations dominated the business scene for many decades, in recent years small businesses have once again come to the forefront. Downsizings that accompany economic downturns have caused many people to look toward smaller companies for employment, and they have plenty to choose from.

Small businesses play an important role in the U.S. economy, representing about half of U.S. economic output, employing about half the private sector workforce, and giving individuals from all walks of life a chance to succeed.

What Is a Small Business?

How many small businesses are there in the United States? Estimates range from 5 million to over 22 million, depending on the size limits government agencies and other groups use to define a small business or the number of businesses with or without employees. The Small Business Administration (SBA) established size standards to define whether a business entity is small and therefore eligible for government programs and preferences that are reserved for "small businesses." Size standards are based on the types of economic activity or industry, generally matched to the North American Industry Classification System (NAICS).[10]

Small businesses are defined in many ways. Statistics for small businesses vary based on criteria such as new/start-up businesses, the number of employees, total revenue, length of time in business, nonemployees, businesses with employees, geographic location, and so on. Due to the complexity and need for consistent statistics and reporting for small businesses, several organizations are now working together to combine comprehensive data sources to get a clear and accurate picture of small businesses in the United States. **Table 7.4** provides a more detailed look at small-business owners.

Snapshot of Small-Business Owners
• Start-up activity has risen sharply over the last three years, from an all-time low of minus 0.87% in 2013 to positive 0.48% in 2016. • Between 1996 and 2011, the rate of business ownership dropped for both men and women; however, business ownership has increased every year since 2014. • The Kauffman Index of Startup Activity, an early indicator of new entrepreneurship in the United States, rose again slightly in 2016 following sharp increases two years in a row. • New entrepreneurs who started businesses to pursue opportunity rather than from necessity reached 86.3%, more than 12 percentage points higher than in 2009 at the height of the Great Recession. • For the first time, Main Street entrepreneurship activity was higher in 2016 than before the onset of the Great Recession. This increase was driven by a jump in business survival rates, which reached a three-decade high of 48.7%. Nearly half of new businesses are making it to their fifth year of operation. • 47% of U.S. businesses have been in business for 11 or more years. • In 2016, about 25% of all employing firms had revenues over $1 million, but 2% had revenues under $10,000.

Table 7.4 Sources: "The Kauffman Index: Main Street Entrepreneurship: National Trends," http://www.kauffman.org, November 2016; "Kauffman Index of Startup Activity, 2016 (calculations based from CPS, BDS, and BED)," http://www.kauffman.org; "America's Entrepreneurs: September 2016," https://www.census.gov; "Nearly 1 in 10 Businesses with Employees Are New, According to Inaugural Annual Survey of Entrepreneurs," https://www.census.gov, September 1, 2016.

One of the best sources to track U.S. entrepreneurial growth activity is the Ewing Marion Kauffman Foundation. The Kauffman Foundation is among the largest private foundations in the country, with an asset base of approximately $2 billion, and focuses on projects that encourage entrepreneurship and support education through grants and research activities. They distributed over $17 million in grants in 2013.[11]

The Kauffman Foundation supports new business creation in the United States through two research programs. The annual Kauffman Index of Entrepreneurship series measures and interprets indicators of U.S. entrepreneurial activity at the national, state, and metropolitan level. The foundation also contributes to the cost of the Annual Survey of Entrepreneurs (ASE), which is a public–private partnership between the foundation, the U.S. Census Bureau, and the Minority Business Development Agency. The ASE provides annual

data on select economic and demographic characteristics of employer businesses and their owners by gender, ethnicity, race, and veteran status.[12] The Kauffman Index of Entrepreneurship series is an umbrella of annual reports that measures how people and businesses contribute to America's overall economy. What is unique about the Kauffman reports is that the indexes don't focus on only inputs (as most small-business reporting has been done in the past); it reports primarily on entrepreneurial outputs—the actual results of entrepreneurial activity, such as new companies, business density, and growth rates. The reports also include comprehensive, interactive data visualizations that enable users to slice and dice a myriad of data nationally, at the state level, and for the 40 largest metropolitan areas.[13]

The Kauffman Index series consists of three in-depth studies—Start-up Activity, Main Street Entrepreneurship, and Growth Entrepreneurship.

- The Kauffman Index of Startup Activity is an early indicator of new entrepreneurship in the United States. It focuses on new business creation activity and people engaging in business start-up activity, using three components: the rate of new entrepreneurs, the opportunity share of new entrepreneurs, and start-up density.
- The Kauffman Index of Main Street Entrepreneurship measures established small-business activity—focusing on U.S. businesses more than five years old with less than 50 employees from 1997 to 2016. Established in 2015, it takes into account three components of local, small-business activity: the rate of businesses owners in the economy, the five-year survival rate of businesses, and the established small-business density.
- The Kauffman Growth Entrepreneurship Index is a composite measure of entrepreneurial business growth in the United States that captures growth entrepreneurship in all industries and measures business growth from both revenue and job perspectives. Established in 2016, it includes three component measures of business growth: rate of start-up growth, share of scale-ups, and high-growth company density.

Data sources for the Kauffman Index calculations are based on Current Population Survey (CPS), with sample sizes of more than 900,000 observations, and the Business Dynamics Statistics (BDS), which covers approximately 5 million businesses. The Growth Entrepreneurship Index also includes *Inc.* 500/5000 data).

Small businesses in the United States can be found in almost every industry, including services, retail, construction, wholesale, manufacturing, finance and insurance, agriculture and mining, transportation, and warehousing. Established small businesses are defined as companies that have been in business at least five years and employ at least one, but less than 50, employees. **Table 7.5** provides the number of employees by the size of established business. More than half of small businesses have between one and four employees.

Number of Employees, by Percentage of Established Small Businesses

Established small businesses are defined as businesses over the age of five employing at least one, but less than 50, employees.

Number of Employees	Percentage of Businesses
1–4 employees	53.07%
5–9 employees	23.23%

Table 7.5 Source: Kauffman Foundation calculations from Business Dynamics Statistics, yearly measures. November 2016.

Number of Employees, by Percentage of Established Small Businesses	
Established small businesses are defined as businesses over the age of five employing at least one, but less than 50, employees.	
Number of Employees	**Percentage of Businesses**
10–19 employees	14.36%
20–49 employees	9.33%

Table 7.5 Source: Kauffman Foundation calculations from Business Dynamics Statistics, yearly measures. November 2016.

CONCEPT CHECK

1. What are three ways small businesses can be defined?
2. What social and economic factors have prompted the rise in small business?

7.4 Start Your Own Business

4. What are the first steps to take if you are starting your own business?

You have decided that you'd like to go into business for yourself. What is the best way to go about it? Start from scratch? Buy an existing business? Or buy a franchise? About 75 percent of business start-ups involve brand-new organizations, with the remaining 25 percent representing purchased companies or franchises. Franchising may have been discussed elsewhere in your course, so we'll cover the other two options in this section.

Getting Started

The first step in starting your own business is a self-assessment to determine whether you have the personal traits you need to succeed and, if so, what type of business would be best for you. Table 7.6 provides a checklist to consider before starting your business.

Finding the Idea

Entrepreneurs get ideas for their businesses from many sources. It is not surprising that about 80 percent of *Inc.* 500 executives got the idea for their company while working in the same or a related industry. Starting a firm in a field where you have experience improves your chances of success. Other sources of inspiration are personal experiences as a consumer; hobbies and personal interests; suggestions from customers, family, and

friends; industry conferences; and college courses or other education.

Checklist for Starting a Business
Before you start your own small business, consider the following checklist: • Identify your reasons • Self-analysis • Personal skills and experience • Finding a niche • Conduct market research • Plan your start-up: write a business plan • Finances: how to fund your business

Table 7.6 Source: "10 Steps to Start Your Business," https://www.sba.gov, accessed February 2, 2018.

An excellent way to keep up with small-business trends is by reading entrepreneurship and small-business magazines and visiting their websites. With articles on everything from idea generation to selling a business, they provide an invaluable resource and profile some of the young entrepreneurs and their successful business ventures (**Table 7.7**).[14]

Successful Entrepreneurs	
Name and Age	**Company and Description**
Philip Kimmey, 27	Kimmey's dog-sitting and dog-walking network, Rover.com, raised almost $100 million in venture capital and was valued at $300 million in 2017.
Max Mankin, 27	Mankin cofounded Modern Electron and raised $10 million in venture capital to create "advanced thermionic energy converters" that will generate "cheap, scalable, and reliable electricity." Modern Electron will turn every home into a power station.
Alexandra Cristin White, 28	In her early 20s, White founded Glam Seamless, which sells tape-in hair extensions. In 2016, her self-funded company grossed $2.5 million.
Steph Korey, 29; Jen Rubio, 29	Korey and Rubio founded Away, selling "first-class luggage at a coach price" in 2015. They raised $31 million in funding and grossed $12 million in sales in 2016.
Allen Gannet, 26	Gannet founded TrackMaven, a web-marketing analytics company, in 2012; by 2016, his company was grossing $6.7 million a year.

Table 7.7 (Attribution: Copyright Rice University, OpenStax, under CC-BY 4. license)

Successful Entrepreneurs	
Name and Age	**Company and Description**
Jake Kassan, 25; Kramer LaPlante, 25	Kassan and Kramer launched their company, MVMT, through Indiegogo, raising $300,000, and in 2016 grossed $60 million, selling primarily watches and sunglasses.
Brian Streem, 29	Streem's company, Aerobo, provides drone services to the film industry, selling "professional aerial filming and drone cinematography." Aerobo grossed $1 million in 2016, its first full year of business.
Natalya Bailey, 30; Louis Perna, 29	Accion Systems began in 2014, raised $10 million in venture funding, and grossed $4.5 million in 2016, making tiny propulsion systems for satellites.
Jessy Dover, 29	Dover is the cofounder of Dagne Dover, a company making storage-efficient handbags for professional women. She and her cofounders grossed $4.5 million in 2016 and debuted on Nordstrom.com in 2017.

Table 7.7 (Attribution: Copyright Rice University, OpenStax, under CC-BY 4. license)

These dynamic individuals, who are already so successful in their 20s and 30s, came up with unique ideas and concepts and found the right niche for their businesses.

Interesting ideas are all around you. Many successful businesses get started because someone identifies a need and then finds a way to fill it. Do you have a problem that you need to solve? Or a product that doesn't work as well as you'd like? Raising questions about the way things are done and seeing opportunity in adversity are great ways to generate ideas.

Choosing a Form of Business Organization

A key decision for a person starting a new business is whether it will be a sole proprietorship, partnership, corporation, or limited liability company. As discussed earlier, each type of business organization has advantages and disadvantages. The choice depends on the type of business, number of employees, capital requirements, tax considerations, and level of risk involved.

Developing the Business Plan

Once you have the basic concept for a product or service, you must develop a plan to create the business. This planning process, culminating in a sound **business plan**, is one of the most important steps in starting a business. It can help to attract appropriate loan financing, minimize the risks involved, and be a critical determinant in whether a firm succeeds or fails. Many people do not venture out on their own because they are overwhelmed with doubts and concerns. A comprehensive business plan lets you run various "what if" analyses and evaluate your business without any financial outlay or risk. You can also develop strategies to overcome problems well before starting the business.

Taking the time to develop a good business plan pays off. A venture that seems sound at the idea stage may

not look so good on paper. A well-prepared, comprehensive, written business plan forces entrepreneurs to take an objective and critical look at their business venture and analyze their concept carefully; make decisions about marketing, sales, operations, production, staffing, budgeting and financing; and set goals that will help them manage and monitor its growth and performance.



Exhibit 7.4 Each year, a variety of organizations hold business plan competitions to engage the growing number of college students starting their own businesses. The University of Essex and the iLearn entrepreneurship curriculum developed by the University of Texas in Austin, which partnered with Trisakti University in Jakarta, Indonesia, and the U.S. embassy to help run an entrepreneurship course and competition are examples of such competitions. Seven students from "iLearn: Entrepreneurship" were selected as finalists to pitch their business plans to a panel of Indonesian business leaders and embassy representatives. The winning business plan, which was an ecotourism concept, earned $1,000 in seed money. *What research goes into a winning business plan?* (Credit: University of Essex /flickr/ Attribution 2.0 Generic (CC BY 2.0))

The business plan also serves as the initial operating plan for the business. Writing a good business plan takes time. But many businesspeople neglect this critical planning tool in their eagerness to begin doing business, getting caught up in the day-to-day operations instead.

The key features of a business plan are a general description of the company, the qualifications of the owner(s), a description of the products or services, an analysis of the market (demand, customers, competition), sales and distribution channels, and a financial plan. The sections should work together to demonstrate why the business will be successful, while focusing on the uniqueness of the business and why it will attract customers. **Table 7.8** describes the essential elements of a business plan.

A common use of a business plan is to persuade lenders and investors to finance the venture. The detailed information in the plan helps them assess whether to invest. Even though a business plan may take months to write, it must capture potential investors' interest within minutes. For that reason, the basic business plan should be written with a particular reader in mind. Then you can fine-tune and tailor it to fit the investment goals of the investor(s) you plan to approach.

Key Elements of a Business Plan
Executive summary provides an overview of the total business plan. Written after the other sections are completed, it highlights significant points and, ideally, creates enough excitement to motivate the reader to continue reading.
Vision and mission statement concisely describe the intended strategy and business philosophy for making the vision happen. Company values can also be included in this section.
Company overview explains the type of company, such as manufacturing, retail, or service; provides background information on the company if it already exists; and describes the proposed form of organization—sole proprietorship, partnership, or corporation. This section should include company name and location, company objectives, nature and primary product or service of the business, current status (start-up, buyout, or expansion) and history (if applicable), and legal form of organization.
Product and/or service plan describes the product and/or service and points out any unique features, as well as explains why people will buy the product or service. This section should offer the following descriptions: product and/or service; features and benefits of the product or service that provide a competitive advantage; available legal protection—patents, copyrights, and trademarks.
Marketing plan shows who the firm's customers will be and what type of competition it will face; outlines the marketing strategy and specifies the firm's competitive edge; and describes the strengths, weaknesses, opportunities, and threats of the business. This section should offer the following descriptions: analysis of target market and profile of target customer; methods of identifying, attracting, and retaining customers; a concise description of the value proposition; selling approach, type of sales force, and distribution channels; types of marketing and sales promotions, advertising, and projected marketing budget; product and/or service pricing strategy; and credit and pricing policies.
Management plan identifies the key players—active investors, management team, board members, and advisors— citing the experience and competence they possess. This section should offer the following descriptions: management team, outside investors and/or directors and their qualifications, outside resource people and their qualifications, and plans for recruiting and training employees.
Operating plan explains the type of manufacturing or operating system to be used and describes the facilities, labor, raw materials, and product-processing requirements. This section should offer the following descriptions: operating or manufacturing methods, operating facilities (location, space, and equipment), quality-control methods, procedures to control inventory and operations, sources of supply, and purchasing procedures.

Table 7.8 Sources: "7 Elements of a Business Plan," https://quickbooks.intuit.com, accessed February 2, 2018; David Ciccarelli, "Write a Winning Business Plan with These 8 Key Elements," *Entrepreneur,* https://www.entrepreneur.com, accessed February 2, 2018; Patrick Hull, "10 Essential Business Plan Components," *Forbes,* https://www.forbes.com, accessed February 2, 2018; Justin G. Longenecker, J. William Petty, Leslie E. Palich, and Frank Hoy, *Small Business Management: Launching & Growing Entrepreneurial Ventures,* 18th edition (Mason, OH: Cengage, 2017); Monique Reece, *Real-Time Marketing for Business Growth: How to Use Social Media, Measure Marketing, and Create a Culture of Execution* (Upper Saddle River, NJ: FT Press/Pearson, 2010).

Key Elements of a Business Plan
Financial plan specifies financial needs and contemplated sources of financing, as well as presents projections of revenues, costs, and profits. This section should offer the following descriptions: historical financial statements for the last 3–5 years or as available; pro forma financial statements for 3–5 years, including income statements, balance sheets, cash flow statements, and cash budgets (monthly for first year and quarterly for second year); financial assumptions; breakeven analysis of profits and cash flows; and planned sources of financing.
Appendix of supporting documents provides materials supplementary to the plan. This section should offer the following descriptions: management team biographies; the company's values; information about the company culture (if it's unique and contributes to employee retention); and any other important data that support the information in the business plan, such as detailed competitive analysis, customer testimonials, and research summaries.

Table 7.8 Sources: "7 Elements of a Business Plan," https://quickbooks.intuit.com, accessed February 2, 2018; David Ciccarelli, "Write a Winning Business Plan with These 8 Key Elements," *Entrepreneur,* https://www.entrepreneur.com, accessed February 2, 2018; Patrick Hull, "10 Essential Business Plan Components," *Forbes,* https://www.forbes.com, accessed February 2, 2018; Justin G. Longenecker, J. William Petty, Leslie E. Palich, and Frank Hoy, *Small Business Management: Launching & Growing Entrepreneurial Ventures,* 18th edition (Mason, OH: Cengage, 2017); Monique Reece, *Real-Time Marketing for Business Growth: How to Use Social Media, Measure Marketing, and Create a Culture of Execution* (Upper Saddle River, NJ: FT Press/Pearson, 2010).

But don't think you can set aside your business plan once you obtain financing and begin operating your company. Entrepreneurs who think their business plan is only for raising money make a big mistake. Business plans should be dynamic documents, reviewed and updated on a regular basis—monthly, quarterly, or annually, depending on how the business progresses and the particular industry changes.

Owners should adjust their sales and profit projections up or down as they analyze their markets and operating results. Reviewing your plan on a constant basis will help you identify strengths and weaknesses in your marketing and management strategies and help you evaluate possible opportunities for expansion in light of both your original mission and goals, current market trends, and business results. The Small Business Administration (SBA) offers sample business plans and online guidance for business plan preparation under the "Business Guide" tab at **https://www.sba.gov**.

Financing the Business

Once the business plan is complete, the next step is to obtain financing to set up your company. The funding required depends on the type of business and the entrepreneur's own investment. Businesses started by lifestyle entrepreneurs require less financing than growth-oriented businesses, and manufacturing and high-tech companies generally require a large initial investment.

Who provides start-up funding for small companies? Like Miho Inagi and her Tokyo bagel shop, 94 percent of business owners raise start-up funds from personal accounts, family, and friends. Personal assets and money from family and friends are important for new firms, whereas funding from financial institutions may become more important as companies grow. Three-quarters of *Inc.* 500 companies have been funded on $100,000 or less.[15]

The two forms of business financing are **debt**, borrowed funds that must be repaid with interest over a stated time period, and **equity**, funds raised through the sale of stock (i.e., ownership) in the business. Those who provide equity funds get a share of the business's profits. Because lenders usually limit debt financing to no more than a quarter to a third of the firm's total needs, equity financing often amounts to about 65 to 75 percent of total start-up financing.



Exhibit 7.5 FUBU started when a young entrepreneur from Hollis, Queens, began making tie-top skullcaps at home with some friends. With funding from a $100,000 mortgage and a later investment from the Samsung Corporation, CEO Daymond John, turned his home into a successful sportswear company. The FUBU brand tops the list for today's fashionistas who don everything from FUBU's classic Fat Albert line to swanky FUBU suits and tuxedos. *How do start-ups obtain funding?* (Credit: U.S. Embasy Nairobi/ flickr/ Attribution 2.0 Generic (CC BY 2.0))

One way to finance a start-up company is bootstrapping, which is basically funding the operation with your own resources. If the resources needed are not available to an individual, there are other options. Two sources of equity financing for young companies are angel investors and venture-capital firms. **Angel investors** are individual investors or groups of experienced investors who provide financing for start-up businesses by investing their own money, often referred to as "seed capital." This gives the investors more flexibility on what they can and will invest in, but because it is their own money, angels are careful. Angel investors often invest early in a company's development, and they want to see an idea they understand and can have confidence in.

Table 7.9 offers some guidelines on how to attract angel financing.

Making a Heavenly Deal
You need financing for your start-up business. How do you get angels interested in investing in your business venture? • Show them something they understand, ideally a business from an industry they've been associated with. • Know your business details: Information important to potential investors includes annual sales, gross profit, profit margin, and expenses. • Be able to describe your business—what it does and who it sells to—in less than a minute. Limit PowerPoint presentations to 10 slides. • Angels can always leave their money in the bank, so an investment must interest them. It should be something they're passionate about. And timing is important—knowing when to reach out to an angel can make a huge difference. • They need to see management they trust, respect, and like. Present a competent management team with a strong, experienced leader who can explain the business and answer questions from potential investors with specifics. • Angels prefer something they can bring added value to. Those who invest could be involved with your company for a long time or perhaps take a seat on your board of directors. • They are more partial to deals that don't require huge sums of money or additional infusions of angel cash. • Emphasize the likely exits for investors and know who the competition is, why your solution is better, and how you are going to gain market share with an infusion of cash.

Table 7.9 Sources: Guy Kawasaki, "The Art of Raising Angel Capital," https://guykawasaki.com, accessed February 2, 2018; Murray Newlands, "How to Raise an Angel Funding Round," *Forbes,* https://www.forbes.com, March 16, 2017; Melinda Emerson, "5 Tips for Attracting Angel Investors," *Small Business Trends,* https://smallbiztrends.com, July 26, 2016; Nicole Fallon, "5 Tips for Attracting Angel Investors," *Business News Daily,* https://www.businessnewsdaily.com, January 2, 2014; Stacy Zhao, "9 Tips for Winning over Angels," *Inc.,* https://www.inc.com, June 15, 2005; Rhonda Abrams, "What Does It Take to Impress an Angel Investor?" *Inc.,* https://www.inc.com, March 29, 2001.

Venture capital is financing obtained from *venture capitalists,* investment firms that specialize in financing small, high-growth companies. Venture capitalists receive an ownership interest and a voice in management in return for their money. They typically invest at a later stage than angel investors. We'll discuss venture capital in greater detail when discussing financing the enterprise.

Buying a Small Business

Another route to small-business ownership is buying an existing business. Although this approach is less risky, many of the same steps for starting a business from scratch apply to buying an existing company. It still requires careful and thorough analysis. The potential buyer must answer several important questions: Why is the owner selling? Does he or she want to retire or move on to a new challenge, or are there problems with the business? Is the business operating at a profit? If not, can this be corrected? On what basis has the owner valued the company, and is it a fair price? What are the owner's plans after selling the company? Will he or she be available to provide assistance through the change of ownership of the business? And depending on the type of business it is, will customers be more loyal to the owner than to the product or service being offered? Customers could leave the firm if the current owner decides to open a similar business. To protect against this, many purchasers include a *noncompete clause* in the contract of sale, which generally means that the owner of the company being sold may not be allowed to compete in the same industry of the acquired business for a specific amount of time.

You should prepare a business plan that thoroughly analyzes all aspects of the business. Get answers to all your questions, and determine, via the business plan, whether the business is a sound one. Then you must negotiate the price and other terms of purchase and obtain appropriate financing. This can be a complicated process and may require the use of a consultant or business broker.

Risky Business

Running your own business may not be as easy as it sounds. Despite the many advantages of being your own boss, the risks are great as well. Over a period of five years, nearly 50% percent of small businesses fail according to the Kauffman Foundation.[16]

Businesses close down for many reasons—and not all are failures. Some businesses that close are financially successful and close for nonfinancial reasons. But the causes of business failure can be interrelated. For example, low sales and high expenses are often directly related to poor management. Some common causes of business closure are:

- Economic factors—business downturns and high interest rates
- Financial causes—inadequate capital, low cash balances, and high expenses
- Lack of experience—inadequate business knowledge, management experience, and technical expertise
- Personal reasons—the owners may decide to sell the business or move on to other opportunities

Inadequate early planning is often at the core of later business problems. As described earlier, a thorough feasibility analysis, from market assessment to financing, is critical to business success. Yet even with the best plans, business conditions change and unexpected challenges arise. An entrepreneur may start a company based on a terrific new product only to find that a larger firm with more marketing, financing, and distribution clout introduces a similar item.

The stress of managing a business can also take its toll. The business can consume your whole life. Owners may find themselves in over their heads and unable to cope with the pressures of business operations, from the long hours to being the main decision maker. Even successful businesses have to deal with ongoing challenges. Growing too quickly can cause as many problems as sluggish sales. Growth can strain a company's finances when additional capital is required to fund expanding operations, from hiring additional staff to purchasing more raw material or equipment. Successful business owners must respond quickly and develop plans to manage its growth.

So, how do you know when it is time to quit? "Never give up" may be a good motivational catchphrase, but it is not always good advice for a small-business owner. Yet, some small-business owners keep going no matter what the cost. For example, Ian White's company was trying to market a new kind of city map. White maxed out 11 credit cards and ran up more than $100,000 in debt after starting his company. He ultimately declared personal bankruptcy and was forced to find a job so that he could pay his bills. Maria Martz didn't realize her small business would become a casualty until she saw her tax return showing her company's losses in black and white—for the second year in a row. It convinced her that enough was enough and she gave up her gift-basket business to become a full-time homemaker. But once the decision is made, it may be tough to stick to. "I got calls from people asking how come I wasn't in business anymore. It was tempting to say I'd make their basket but I had to tell myself it is finished now."[17]

CONCEPT CHECK



1. How can potential business owners find new business ideas?
2. Why is it important to develop a business plan? What should such a plan include?
3. What financing options do small-business owners have? What risks do they face?

7.5 Managing a Small Business

5. Why does managing a small business present special challenges for the owner?

Managing a small business is quite a challenge. Whether you start a business from scratch or buy an existing one, you must be able to keep it going. The small-business owner must be ready to solve problems as they arise and move quickly if market conditions change.

MANAGING CHANGE



Learning How to Pivot

Most small business owners either use, or at least know of, the iconic email service MailChimp, a company that is growing by more than $120 million every year and is on track to bring in $525 million over the coming year. But Ben Chestnut, the CEO and cofounder, says it took MailChimp several years to figure out what it did well.

When Chestnut was laid off from his job at the Cox Media Group in Atlanta, he founded Rocket Science Group, a web design firm. Cofounder Dan Kurzius (who taught himself to code) joined Chestnut, and they began to focus their sales efforts on tech companies. But when the tech bubble burst, they pivoted to focus on selling to airline and travel companies. Then 9/11 hit, and they needed to change focus again, this time on the real estate market. However, both Chestnut and Kurzius discovered they didn't enjoy sales (and they weren't very good at it), nor did they like the bureaucracy of working with large companies. "The only companies we could relate to were small businesses, and they always asked for email marketing."

This insight helped Chestnut to recall a product feature the Rocket Science Group had previously developed for an email greeting card project. So Chestnut and Kurzius evaluated the marketing software and began to test it with small businesses. "Our day jobs felt like going to these big organizations and pitching to them, and it was miserable," Chestnut says. "But we really loved our nighttime jobs, which were helping the small businesses use this email marketing app." Their passion, along with market feedback, led to their decision to completely focus on email marketing for small businesses. But it wasn't until almost 2009 that MailChimp found its sweet spot. The founders initially wanted to give away one product that collected subscribers and then charge for another, which was sending emails, but it would have been very difficult to divide the product into two pieces. That's when they landed on the Freemium idea. "Let's just make the whole thing free," said Chestnut.

The idea was that if they made it cheap and easy for small businesses to try MailChimp, their business would grow and they would be happy to pay for MailChimp services. MailChimp allows customers to send an email for free to 1,999 people at once but charges for emails sent to over 2,000 people and for premium features. MailChimp charges a monthly recurring fee starting at $10 for sending more than 12,000 emails a month.

The idea quickly proved to be a huge success. MailChimp went from a few hundred thousand users to 1 million users in a year. The next year they added another million users.

The MailChimp founders learned a lot of lessons during their 17 years in business. One of their most important lessons is knowing when to change. When you see an opportunity, don't be afraid to pivot and change course, especially if it means focusing on a market you're passionate about. Listening to market feedback and following their passion earned MailChimp's founders \recognition as "2017 Business of the Year" by *Inc.* magazine.

Critical Thinking Questions

1. What led MailChimp's founders to change its focus on the customers they were selling to?
2. What was MailChimp's "big idea" that changed the business, and why was it so successful?

Sources: Maria Aspan, "Want Proof That Patience Pays Off? Ask the Founders of This 17-Year-Old $525 Million Email Empire," *Inc.*, https://www.inc.com, Winter 2017/January 2018 issue; "MailChimp: From Startup to Inc. Magazine's Top Company," *CNBC,* https://www.cnbc.com, December 12, 2017; Farhad Manjoo, "MailChimp and the Un-Silicon Valley Way to Make It as a Start-Up," *The New York Times,* https://www.nytimes.com, October 5, 2016.

A sound business plan is key to keeping the small-business owner in touch with all areas of his or her business. Hiring, training, and managing employees is another important responsibility because the owner's role may change over time. As the company grows, others will make many of the day-to-day decisions while the owner focuses on managing employees and planning for the firm's long-term success. The owner must constantly evaluate company performance and policies in light of changing market and economic conditions and develop new policies as required. They must also nurture a continual flow of ideas to keep the business growing. The types of employees needed may change too as the firm grows. For instance, a larger firm may need more managerial talent and technical expertise.

Using Outside Consultants

One way to ease the burden of managing a business is to hire outside consultants. Nearly all small businesses need a good certified public accountant (CPA) who can help with financial record keeping, decision-making, and tax planning. An accountant who works closely with the owner to help the business grow is a valuable asset. An attorney who knows about small-business law can provide legal advice and draw up essential contracts and documents. Consultants in areas such as marketing, employee benefits, and insurance can be used on an as-needed basis. Outside directors with business experience are another way for small companies to get advice. Resources such as these free the small-business owner to concentrate on medium- and long-range planning and day-to-day operations.

Some aspects of business can be outsourced or contracted out to specialists. Among the more common departments that use outsourcing are information technology, marketing, customer service, order fulfillment, payroll, and human resources. Hiring an outside company—in many cases another small business—can save money because the purchasing firm buys just the services it needs and makes no investment in expensive technology. Management should review outsourced functions as the business grows because at some point it may be more cost-effective to bring them in-house.

Hiring and Retaining Employees

It is important to identify all the costs involved in hiring an employee to make sure your business can afford it. Recruiting, help-wanted ads, extra space, and taxes will easily add about 10–15 percent to their salary, and employee benefits will add even more. Hiring an employee may also mean more work for you in terms of training and management. It's a catch-22: To grow you need to hire more people, but making the shift from solo worker to boss can be stressful.

Attracting good employees is more difficult for a small firm, which may not be able to match the higher salaries, better benefits, and advancement potential offered by larger firms. Small companies need to be creative to attract the right employees and convince applicants to join their firm. Once they hire an employee, small-business owners must make employee satisfaction a top priority in order to retain good people. A company culture that nurtures a comfortable environment for workers, flexible hours, employee benefit programs, opportunities to help make decisions, and a share in profits and ownership are some ways to do this.

Duane Ruh figured out how to build a $1.2 million business in a town with just 650 residents. It's all about treating employees right. The log birdhouse and bird feeder manufacturer, Little Log Co., located in Sargent, Nebraska, boasts employee-friendly policies you read about but rarely see put into practice. Ruh offers his employees a flexible schedule that gives them plenty of time for their personal lives. During a slow period last summer, Ruh cut back on hours rather than lay anyone off. There just aren't that many jobs in that part of Nebraska that his employees could go to, so when he received a buyout offer that would have closed his facility but kept him in place with an enviable salary, he turned it down. Ruh also encourages his employees to pursue side or summer jobs if they need to make extra money, assuring them that their Little Log jobs are safe.[18]

Going Global with Exporting

More and more small businesses are discovering the benefits of looking beyond the United States for market opportunities. The global marketplace represents a huge opportunity for U.S. businesses, both large and small. Small businesses' decision to export is driven by many factors, one of which is the desire for increased sales and higher profits. U.S. goods are less expensive for overseas buyers when the value of the U.S. dollar declines against foreign currencies, and this creates opportunities for U.S. companies to sell globally. In addition, economic conditions such as a domestic recession, foreign competition within the United States, or new markets opening up in foreign countries may also encourage U.S. companies to export.

Like any major business decision, exporting requires careful planning. Small businesses may hire international-trade consultants or distributors to get started selling overseas. These specialists have the time, knowledge, and resources that most small businesses lack. Export trading companies (ETCs) buy goods at a discount from small businesses and resell them abroad. Export management companies (EMCs) act on a company's behalf. For fees of 5–15 percent of gross sales and multiyear contracts, they handle all aspects of exporting, including finding customers, billing, shipping, and helping the company comply with foreign regulations.

Many online resources are also available to identify potential markets for your goods and services, as well as to decipher the complexities involved in preparing to sell in a foreign country. The Small Business Association's Office of International Trade has links to many valuable sites. The Department of Commerce offers services for small businesses that want to sell abroad. Contact its Trade Information Center, 1-800-USA-TRADE, or its Export Center (**http://www.export.gov**).

CONCEPT CHECK

1. How does the small-business owner's role change over time?
2. How does managing a small business contribute to its growth?
3. What are the benefits to small firms of doing business internationally, and what steps can small businesses take to explore their options?

7.6 The Large Impact of Small Business

6. What are the advantages and disadvantages facing owners of small businesses?

An uncertain economy has not stopped people from starting new companies. The National Federation of Independent Businesses reports that 85 percent of Americans view small businesses as a positive influence on American life. This is not surprising when you consider the many reasons why small businesses continue to thrive in the United States:

- *Independence and a better lifestyle:* Large corporations no longer represent job security or offer the fast-track career opportunities they once did. Mid-career employees leave the corporate world—either

voluntarily or as a result of downsizing—in search of the new opportunities that self-employment provides. Many new college and business school graduates shun the corporate world altogether to start their own companies or look for work in smaller firms.

- *Personal satisfaction from work:* Many small-business owners cite this as one of the primary reasons for starting their companies. They love what they do.
- *Best route to success:* Business ownership provides greater advancement opportunities for women and minorities, as we will discuss later in this chapter. It also offers small-business owners the potential for profit.
- *Rapidly changing technology:* Technology advances and decreased costs provide individuals and small companies with the power to compete in industries that were formerly closed to them.
- *Major corporate restructuring and downsizing:* These force many employees to look for other jobs or careers. They may also provide the opportunity to buy a business unit that a company no longer wants.
- *Outsourcing:* As a result of downsizing, corporations may contract with outside firms for services they used to provide in-house. Outsourcing creates opportunities for smaller companies that offer these specialized goods and services.
- *Small businesses are resilient:* They are able to respond fairly quickly to changing economic conditions by refocusing their operations.

There are several cities and regions that are regarded as the best locations for start-up businesses and entrepreneurs. Among them are Tulsa, Oklahoma; Tampa, Florida; Atlanta, Georgia; Raleigh, North Carolina; Oklahoma City, Oklahoma; Seattle, Washington; Minneapolis, Minnesota; and Austin, Texas.[19]

Why Stay Small?

Owners of small businesses recognize that being small offers special advantages. Greater flexibility and an uncomplicated company structure allow small businesses to react more quickly to changing market forces. Innovative product ideas can be developed and brought to market more quickly, using fewer financial resources and personnel than would be needed in a larger company. And operating more efficiently keeps costs down as well. Small companies can also serve specialized markets that may not be cost-effective for large companies. Another feature is the opportunity to provide a higher level of personal service. Such attention brings many customers back to small businesses such as gourmet restaurants, health clubs, spas, fashion boutiques, and travel agencies.

Steve Niewulis played in baseball's minor leagues before an injury to his rotator cuff cut short his career. Niewulis decided to combine his love of the game with a clever idea that has elevated him to the big leagues. The fact that players had trouble keeping their hands dry while batting inspired his big idea: a sweat-busting rosin bag attached to a wristband so that a player can dry the bat handle between pitches. In less than two years, Niewulis's Fort Lauderdale, Florida, company, Tap It! Inc., sold thousands of Just Tap It! wristbands. The product, which retails for $12.95, is used by baseball players, basketball players, tennis players, golfers, and even rock climbers. His secret to success? Find a small distribution network that allows small companies, with just one product line, to succeed.[20]

On the other hand, being small is not always an asset. The founders may have limited managerial skills or encounter difficulties obtaining adequate financing, potential obstacles to growing a company. Complying with federal regulations is also more expensive for small firms. Those with fewer than 20 employees spend about twice as much per employee on compliance than do larger firms. In addition, starting and managing a small business requires a major commitment by the owner. Long hours, the need for owners to do much of the work themselves, and the stress of being personally responsible for the success of the business can take a toll.

But managing your company's growing pains doesn't need to be a one-person job. Four years after he started DrinkWorks (now Whirley DrinkWorks), a company that makes custom drinking cups, Richard Humphrey was logging 100-hour weeks. "I was concerned that if I wasn't there every minute, the company would fall apart." Humphrey got sick, lost weight, and had his engagement fall apart. When forced by a family emergency to

leave the company in the hands of his five employees, Humphrey was amazed at how well they managed in his absence. "They stepped up to the plate and it worked out," he says. "After that the whole company balanced out."[21]

CONCEPT CHECK

1. Why are small businesses becoming so popular?
2. Discuss the major advantages and disadvantages of small businesses.

7.7 The Small Business Administration

7. How does the Small Business Administration help small businesses?

Many small-business owners turn to the **Small Business Administration (SBA)** for assistance. The SBA's mission is to speak on behalf of small business, and through its national network of local offices it helps people start and manage small businesses, advises them in the areas of finance and management, and helps them win federal contracts. Its toll-free number—1-800-U-ASK-SBA (1-800-827-5722)—provides general information, and its website at http://www.sba.gov offers details on all its programs.[22]

Financial Assistance Programs

The SBA offers financial assistance to qualified small businesses that cannot obtain financing on reasonable terms through normal lending channels. This assistance takes the form of guarantees on loans made by private lenders. (The SBA no longer provides direct loans.) These loans can be used for most business purposes, including purchasing real estate, equipment, and materials. The SBA has been responsible for a significant amount of small-business financing in the United States. In the fiscal year ending on September 30, 2017, the SBA backed more than $25 billion in loans to almost 68,000 small businesses, including about $9 billion to minority-owned firms and $7.5 billion in loans to businesses owned by women. It also provided more than $1.7 billion in home and business disaster loans.[23]

Other SBA programs include the New Markets Venture Capital Program, which promotes economic development and job opportunities in low-income geographic areas, while other programs offer export financing and assistance to firms that suffer economic harm after natural or other disasters.

More than 300 SBA-licensed **Small Business Investment Companies (SBICs)** provide about $6 billion each year in long-term financing for small businesses. The SBA's website suggests seeking angel investors and using SBA-guaranteed loans as a way to fund the start-up. These privately owned and managed investment companies hope to earn a substantial return on their investments as the small businesses grow.

SCORE-ing with Management Assistance Programs

The SBA also provides a wide range of management advice. Its Business Development Library has publications on most business topics. Its "Starting Out" series offers brochures on how to start a wide variety of businesses—from ice-cream stores to fish farms.

Business development officers at the Office of Business Development and local Small Business Development Centers counsel many thousands of small-business owners each year, offering advice, training, and educational programs. The SBA also offers free management consulting through two volunteer groups: the Service Corps of Retired Executives (SCORE), and the Active Corps of Executives (ACE). Executives in these programs use their own business backgrounds to help small-business owners. SCORE has expanded its outreach into new markets by offering email counseling through its website (http://www.score.org). The SBA also offers free online resources and courses for small-business owners and aspiring entrepreneurs in its

Learning Center, located on the SBA website under the "Learning Center" tab.

Assistance for Women and Minorities

The SBA is committed to helping women and minorities increase their business participation. It offers a minority small-business program, microloans, and the publication of Spanish-language informational materials. It has increased its responsiveness to small businesses by giving regional offices more decision authority and creating high-tech tools for grants, loan transactions, and eligibility reviews.

The SBA offers special programs and support services for socially and economically disadvantaged persons, including women, Native Americans, and Hispanic people through its Minority Business Development Agency. It also makes a special effort to help veterans go into business for themselves.

CONCEPT CHECK

1. What is the Small Business Administration (SBA)?
2. Describe the financial and management assistance programs offered by the SBA.

7.8 Trends in Entrepreneurship and Small-Business Ownership

8. What trends are shaping entrepreneurship and small-business ownership?

Entrepreneurship has changed since the heady days of the late 1990s, when starting a dot-com while still in college seemed a quick route to riches and stock options. Much entrepreneurial opportunity comes from major changes in demographics, society, and technology, and at present there is a confluence of all three. A major demographic group is moving into a significantly different stage in life, and minorities are increasing their business ownership in remarkable numbers. We have created a society in which we expect to have our problems taken care of, and the technological revolution stands ready with already-developed solutions. Evolving social and demographic trends, combined with the challenge of operating in a fast-paced technology-dominated business climate, are changing the face of entrepreneurship and small-business ownership.

Into the Future: Start-ups Drive the Economy

Did new business ventures drive the economic recovery from the 2001–2002 and 2007–2009 to recessions, and are they continuing to make significant contributions to the U.S. economy? The economists who review Department of Labor employment surveys and SBA statistics think so. "Small business drives the American economy," says Dr. Chad Moutray, former chief economist for the SBA's Office of Advocacy. "Main Street provides the jobs and spurs our economic growth. American entrepreneurs are creative and productive." Numbers alone do not tell the whole story, however. Are these newly self-employed workers profiting from their ventures, or are they just biding their time during a period of unemployment?

U.S. small businesses employed 57.9 million people in 2016, representing nearly 48 percent of the workforce. The number of net new jobs added to the economy was 1.4 million.[24]

The highest rate of growth is coming from women-owned firms, which continues to rise at rates higher than the national average—and with even stronger growth rates since the recession. There were an estimated 11.6 million women-owned businesses employing nearly 9 million people in 2016, generating more than $1.7 trillion in revenue.[25]

Between 2007 and 2017, women-owned firms increased by 114 percent, compared to a 44 percent increase among all businesses. This means that growth rates for women-owned businesses are 2.5 times faster than the national average. Employment growth was also stronger than national rates. Women-owned businesses

increased 27 percent over the past 20 years, while overall business employment has increased by 13 percent since 2007.[26]

These trends show that more workers are striking out on their own and earning money doing it. It has become very clear that encouraging small-business activity leads to continued strong overall economic growth.

Changing Demographics Create Entrepreneurial Diversity

The mantra, "60 is the new 40," describes today's Baby Boomers who indulge in much less knitting and golf in their retirement years. The AARP predicts that silver-haired entrepreneurs will continue to rise in the coming years. According to a recent study by the Kauffman Foundation, Baby Boomers are twice as likely as Millennials to start a new business. In fact, close to 25 percent of all new entrepreneurs fall between the ages of 55 and 64.[27] This has created a ripple effect in the way we work. Boomers have accelerated the growing acceptance of working from home, adding to the millions of U.S. workers already showing up to work in their slippers. In addition, the ongoing corporate brain drain could mean that small businesses will be able to tap into the expertise of seasoned free agents at less-than-corporate prices—and that seniors themselves will become independent consultants to businesses of all sizes.[28]

The growing numbers of Baby Boomer entrepreneurs has prompted some forward-thinking companies to recognize business opportunities in technology. At one time there was a concern that the aging of the population would create a drag on the economy. Conventional wisdom says that the early parenthood years are the big spending years. As we age, we spend less and, because Boomers are such a big demographic group, this was going to create a long-term economic decline. Not true, it now appears. The Boomer generation has built sizable wealth, and they are not afraid to spend it to make their lives more comfortable.

Minorities are also adding to the entrepreneurial mix. As we saw in **Exhibit 7.4**, minority groups and women are increasing business ownership at a much faster rate than the national average, reflecting their confidence in the U.S. economy. These overwhelming increases in minority business ownership paralleled the demand for U.S. Small Business Administration loan products. Loans to minority business owners in fiscal year 2017 set a record—more than $9.5 billion, or 31 percent, of SBA's total loan portfolio.[29]

The latest Kauffman Foundation Index of Startup Activity found that immigrants and Latinos have swelled the growing numbers of self-employed Americans in recent years, increasing the diversity of the country's entrepreneurial class. Overall, minority-owned businesses increased 38 percent. The SBA notes that the number of Hispanic-owned businesses has increased more than 46 percent between 2007 and 2012.[30]



Exhibit 7.6 The popularity of home businesses such as Rodan+Fields, eBay, and other e-commerce sites has given rise to a new kind of entrepreneur: the "mompreneur." Typically ex-corporate professionals, these web-driven women launch home businesses specializing in the sale of antiques, jewelry, thrift-store fashions, and other items. Aided by digital photography, wireless technology, and friendly postal workers, these savvy moms are one of the fastest-growing segments of entrepreneurs building successful businesses on the web. *Why are many professional women leaving the workplace to start entrepreneurial ventures online?* (Credit: Amanda nobles/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))

How Far Will You Go to Get Rich?

With enough intelligence and determination, people can get rich almost anywhere in the United States. Whether you own chains of dry cleaners in Queens, car dealerships in Chicago, or oil wells in West Texas, fortunes have been made in every state in the Union. There are some places, however, where the chances of creating wealth are much greater than others. That is the reason why people who hope to strike it rich move to places such as Manhattan or Palo Alto. It's not because the cost of living is low or the quality of life as a struggling entrepreneur is fun. Whether starting a software or soft-drink company, entrepreneurs tend to follow the money

But not all companies follow the herd. Guild Education, founded in 2015 by Rachel Carlson and Brittany Stich at Stanford University, left San Francisco due to the high cost of living that could slow down the company's growth. "We have a lot of women who are executives and department heads here, starting with myself and my cofounder," CEO Rachel Carlson said. "So when we left, we deliberately chose a place where you can have a family."[31] Guild Education's mission is to help large employers offer college education and tuition reimbursement as a benefit to the 64 million working-age adults who lack a college degree.

Since moving to Denver, Guild Education has raised another $21 million in venture capital, bringing the total funding to $31.5 million with a company valuation of $125 million.[32] The company headquarters in Denver is next door to a Montessori school and employs 58 employees. "We were joking that we're the polar opposite of Apple," said Carlson. "Remember when the new 'mothership' came out? Every single parent noticed that it had a huge gym but not a day care."

According to PwC's quarterly venture capital study, "MoneyTree Report," the top regions in the United States for venture-backed deals in the third quarter of 2017 were San Francisco ($4.1 billion), New York Metro ($4.2 billion), Silicon Valley (Bay Area $2.2 billion), and New England ($1.8 billion). [33]

In 2017, equity financing in U.S. start-ups rose for the third straight quarter, reaching $19 billion, according to the PwC/CB Insights "MoneyTree Report Q3 2017." "Financing was boosted by a large number of mega-rounds," says Tom Ciccolella, Partner, U.S. Ventures Leader at PwC.[34] Twenty-six mega-rounds of $100 million

in companies such as WeWork, 23andMe, Fanatics, and NAUTO contributed to the strong activity levels in the first three quarters of 2017. The top five U.S. industry sectors with the most deals and funding were Internet, Healthcare, Mobile and Telecommunications, Software (Non-Internet/Mobile), and Consumer Products.

CONCEPT CHECK



1. What significant trends are occurring in the small-business arena?
2. How is entrepreneurial diversity impacting small business and the economy?
3. How do ethics impact decision-making with small-business owners?

Key Terms

angel investors Individual investors or groups of experienced investors who provide financing for start-up businesses by investing their own funds.

business plan A formal written statement that describes in detail the idea for a new business and how it will be carried out; includes a general description of the company, the qualifications of the owner(s), a description of the product or service, an analysis of the market, and a financial plan.

debt A form of business financing consisting of borrowed funds that must be repaid with interest over a stated time period.

entrepreneurs People with vision, drive, and creativity who are willing to take the risk of starting and managing a business to make a profit, or greatly changing the scope and direction of an existing firm.

equity A form of business financing consisting of funds raised through the sale of stock (i.e., ownership) in a business.

intrapreneurs Entrepreneurs who apply their creativity, vision, and risk-taking within a large corporation, rather than starting a company of their own.

small business A business with under 500 employees that is independently managed, is owned by an individual or a small group of investors, is based locally, and is not a dominant company in its industry.

Small Business Administration (SBA) A government agency that speaks on behalf of small business; specifically it helps people start and manage small businesses, advises them in the areas of finance and management, and helps them win federal contracts.

Small Business Investment Company (SBIC) Privately owned and managed investment companies that are licensed by the Small Business Administration and provide long-term financing for small businesses.

venture capital Financing obtained from venture capitalists, investment firms that specialize in financing small, high-growth companies and receive an ownership interest and a voice in management in return for their money.

Summary of Learning Outcomes

7.1 Entrepreneurship

1. Why do people become entrepreneurs, and what are the different types of entrepreneurs?

Entrepreneurs are innovators who take the risk of starting and managing a business to make a profit. Most want to develop a company that will grow into a major corporation. People become entrepreneurs for four main reasons: the opportunity for profit, independence, personal satisfaction, and lifestyle. Classic entrepreneurs may be micropreneurs, who plan to keep their businesses small, or growth-oriented entrepreneurs. Multipreneurs start multiple companies, while intrapreneurs work within large corporations.

7.2 Characteristics of Successful Entrepreneurs

2. What characteristics do successful entrepreneurs share?

Successful entrepreneurs are ambitious, independent, self-confident, creative, energetic, passionate, and committed. They have a high need for achievement and a willingness to take moderate risks. Good managerial, interpersonal, and communication skills, as well as technical knowledge are important for entrepreneurial success.

7.3 Small Business

3. How do small businesses contribute to the U.S. economy?

Small businesses play an important role in the economy. They account for over 99 percent of all employer firms and produce about half of U.S. economic output. Most new private-sector jobs created in the United States over the past decade were in small firms. The Small Business Administration defines a small business as independently owned and operated, with a local base of operations, and not dominant in its field. It also

defines small business by size, according to its industry. Small businesses are found in every field, but they dominate the service, construction, wholesale, and retail categories.

7.4 Start Your Own Business

4. What are the first steps to take if you are starting your own business?

After finding an idea that satisfies a market need, the small-business owner should choose a form of business organization. Preparing a formal business plan helps the business owner analyze the feasibility of his or her idea. The written plan describes in detail the idea for the business and how it will be implemented and operated. The plan also helps the owner obtain both debt and equity financing for the new business.

7.5 Managing a Small Business

5. Why does managing a small business present special challenges for the owner?

At first, small-business owners are involved in all aspects of the firm's operations. Hiring and retaining key employees and the wise use of outside consultants can free up an owner's time to focus on planning, strategizing, and monitoring market conditions, in addition to overseeing day-to-day operations. Expanding into global markets can be a profitable growth strategy for a small business.

7.6 The Large Impact of Small Business

6. What are the advantages and disadvantages facing owners of small businesses?

Because of their streamlined staffing and structure, small businesses can be efficiently operated. They have the flexibility to respond to changing market conditions. Small firms can serve specialized markets more profitably than large firms, and they provide a higher level of personal service. Disadvantages include limited managerial skill, difficulty in raising capital needed for start-up or expansion, the burden of complying with increasing levels of government regulation, and the major personal commitment that is required by the owner.

7.7 The Small Business Administration

7. How does the Small Business Administration help small businesses?

The Small Business Administration is the main federal agency serving small businesses. It provides guarantees of private-lender loans for small businesses. The SBA also offers a wide range of management assistance services, including courses, publications, and consulting. It has special programs for women, minorities, and veterans.

7.8 Trends in Entrepreneurship and Small-Business Ownership

8. What trends are shaping entrepreneurship and small-business ownership?

Changes in demographics, society, and technology are shaping the future of entrepreneurship and small business in America. More than ever, opportunities exist for entrepreneurs of all ages and backgrounds. The numbers of women and minority business owners continues to rise, and older entrepreneurs are changing the small-business landscape. Catering to the needs of an older population and a surge in web-based companies fuel continues technology growth. Entrepreneurs typically follow the money and set up shop in places where there is venture capital money easily available.

Chapter Review Questions

1. What are the differences between classic, multipreneurs, and intrapreneurs?
2. What differentiates an entrepreneur from a small-business owner?
3. What are some major factors that motivate entrepreneurs to start businesses?
4. How can potential business owners find new business ideas?
5. Why is it important to develop a business plan? What should such a plan include?

6. What financing options do small-business owners have? What risks do they face?
7. How do the small-business owner's and entrepreneur's roles change over time?
8. What are the benefits to small firms of doing business internationally, and what steps can small businesses take to explore their options?
9. Describe the financial and management assistance programs offered by the SBA.
10. What significant trends are occurring in the small-business arena?
11. How is entrepreneurial diversity impacting small business and the economy?
12. How do ethics impact decision-making with small-business owners?

Management Skills Application Exercises

1. After working in software development with a major food company for 12 years, you are becoming impatient with corporate "red tape" (regulations and routines). You have an idea for a new snack product for nutrition-conscious consumers and are thinking of starting your own company. What entrepreneurial characteristics do you need to succeed? What other factors should you consider before quitting your job? Working with a partner, choose one to be the entrepreneurial employee and one to play the role of his current boss. Develop notes for a script. The employee will focus on why this is a good idea—reasons he will succeed—and the employer will play devil's advocate to convince him that staying on at the large company is a better idea. Then switch roles and repeat the discussion.

2. What does it really take to become an entrepreneur? Find out by interviewing a local entrepreneur or researching an entrepreneur you've read about in this chapter or in the business press. Get answers to the following questions, as well as any others you'd like to ask:

    - How did you research the feasibility of your idea?
    - How did you develop your vision for the company?
    - How long did it take you to prepare your business plan?
    - Where did you obtain financing for the company?
    - Where did you learn the business skills you needed to run and grow the company?
    - What are the most important entrepreneurial characteristics that helped you succeed?
    - What were the biggest challenges you had to overcome?
    - What are the most important lessons you learned by starting this company?
    - What advice do you have for would-be entrepreneurs?

3. Your class decides to participate in a local business plan competition. Divide the class into small groups, and choose one of the following ideas:

    - A new computer game based on the stock market
    - A company with an innovative design for a skateboard
    - Travel services for college and high school students

    Prepare a detailed outline for the business plan, including the objectives for the business and the types of information you would need to develop product, marketing, and financing strategies. Each group will then present its outline for the class to critique.

Managerial Decision Exercises

1. A small catering business in your city is for sale for $250,000. The company specializes in business luncheons and small social events. The owner has been running the business for four years from her home but is expecting her first child and wants to sell. You will need outside investors to help you purchase the business. Develop questions to ask the owner about the business and its prospects, as well as a list of documents you want to see. What other types of information would you need before making a decision to buy this company? Summarize your findings in a memo to a potential investor that explains the appeal of the business for you and how you plan to investigate the feasibility of the purchase.

2. As the owner of a small factory that makes plastic sheeting, you are constantly seeking ways to increase profits. As the new year begins, one of your goals is to find additional funds to offer annual productivity and/or merit bonuses to your loyal, hardworking employees. Then a letter from a large national manufacturer of shower curtains seems to provide an answer. As part of a new "supplier diversity" program it is putting in place, the manufacturer is offering substantial purchase contracts to minority-owned suppliers. Even though the letter clearly states that the business must be minority owned to qualify for the program, you convince yourself to apply for it based on the fact that all your employees are Latino. You justify your decision by deciding they will benefit from the increased revenue a larger contract will bring, some of which you plan to pass on to them in the form of bonuses later in the year. Using a web search tool, locate articles about this topic, and then write responses to the following question. Be sure to support your arguments and cite your sources.

    a. Is it wrong for this business owner to apply for this program even though it will end up benefiting his employees as well as his business?



Critical Thinking Case

Fostering Entrepreneurship in "Innovation Deserts"

You may have heard of food deserts or Internet deserts -- those places where groceries or online access are difficult to come by. But certain communities fall into similar "innovation deserts," where the population is cut off from educational, technical, and other resources connected to small business and entrepreneurial success. Often coinciding with economically distressed locations, innovation deserts force residents to look elsewhere for opportunities and support, causing both a talent and economic drain that exacerbates the problem.

Felecia Hatcher has committed herself to ridding communities of these deserts. A self-described C-student in high school, she found creative ways to achieve and finance her education and early career. As a freshman at Lynn University, she launched a company focused on mentoring high school students. Upon graduating, she went on to lead social media campaigns for major brands such as Nintendo, Sony, Microsoft, and Little Debbie. Soon after, she landed a major position with the Minnesota Lynx of the WNBA. She left it to start an ice cream company.

That company, Feverish Ice Cream, went from a small food truck and cart operation to a venture capital-backed promotional partner to some of the biggest brands in the world. Her success -- and the financial resources it provided -- enabled Felecia to pivot once again.

In 2012, Hatcher started Code Fever, an organization focused on teaching Miami residents how to integrate technical knowledge into their skillset. Soon after, Hatcher and her partners brought Black Girls Code to Miami, and hosted numerous camps and events for local youth. In 2015, they started Black Tech Week to further the cause of creating inclusive innovation communities. The conference hosted several thousand attendees and some of the nation's top entrepreneurs, venture capitalists, educators, and tech professionals.

The following year, Hatcher's organizations further expanded their entrepreneurship programs. They began a VC-in-residence program to connect Black innovators with potential mentors and investors. They also partnered with PowerMoves to launch bootcamps and pitch competitions. Black Tech Week soon expanded from Miami to eight other cities.

Like many communities in South Florida, the Overton section of Miami was an innovation desert. Social mobility was relatively low, and potential entrepreneurs had few support networks or access to resources. Even though Miami was the nation's densest city for co-working spaces (seen as particularly helpful for start-ups), Overton didn't have one. Hatcher sought to directly fill the gap by opening a co-working space named a Space Called Tribe. The two-story hub offers individuals or small companies low-cost access to WiFi, office space, conference rooms, collaboration opportunities, and a wide array of workshops and guest speaker events. Even though members are from different companies serving different industries and customers, their

shared experience can create networking and support relationships.

Felecia Hatcher and her group recently rebranded to The Center for Black Innovation; beyond the services and events described above, they work as a think tank and advocacy organization to further promote investment and innovation in the Black community, and better help all marginalized communities. During the COVID-19 pandemic, they launched a number of educational programs to help those affected launch "side hustles" to supplement their income. The Center also continues to serve as an incubator and capital investment networker to help people develop and scale their start-ups. And after helping thousands of business people, the Center frequently collaborates with past participants to mentor new ones and continue the cycle of innovation.

Critical Thinking Questions

1. What qualities or characteristics might lead to the emergence of an innovation desert? Is it always a geographical definition, or could it be defined in other ways?
2. In her efforts to help marginalized people gain technical and business experience, how was Felecia Hatcher's progression similar to business growth and grand expansion?
3. How might a Space Called Tribe and the larger efforts of the Center for Black Innovation lead to opportunity for local entrepreneurs?

Sources: Center for Black Innovation website, https://www.centerforblackinnovation.org/#what-we-do ; Felecia Hatcher-Pearson, "Ridding Communities of Innovation Deserts," Impakter, September 5, 2019, https://impakter.com/ridding-communities-of-innovation-deserts-how-corporations-and-governments-can-support-black-communities-innovation-potential/ ; Blair Levin and Larry Downes, "Cities, Not Rural Areas, Are The Real Internet Deserts," Washington Post, September 13, 2019, https://www.washingtonpost.com/technology/2019/09/13/cities-not-rural-areas-are-real-internet-deserts/ ; Rob Wile, "In a long-neglected Miami neighborhood, a new co-working space stirs to life," Miami Herald, May 30, 2018, https://www.miamiherald.com/news/business/technology/article212112389.html;



8

Strategic Analysis: Understanding a Firm's Competitive Environment

Exhibit 8.1 (Credit: Antii T. Nussinen/ flickr/ Attribution 2.0 Generic (CC BY 2.0))

Introduction

Learning Outcomes

After reading this chapter, you should be able to answer these questions:

1. What is strategic analysis and why do firms need to analyze their competitive environment?
2. What is a SWOT analysis and what can it reveal about a firm?
3. What makes up a firm's external macro environment, and what tools do strategists use to understand it?
4. What makes up a firm's external micro environment, and what tools do strategists use to understand it?
5. How and why do managers conduct an internal analysis of their firms?
6. What does it mean to compete with other firms in a business environment, what does it mean when a firm has a competitive advantage over its rivals, and what generic strategies can a firm implement to gain advantage over its rivals?
7. What elements go into determining a firm's strategic position?

EXPLORING MANAGERIAL CAREERS

Lauri Goodman Lampson, Planning Design Research Corporation

Lauri Goodman Lampson is president and CEO of Planning Design Research Corporation,[1] a firm that analyzes work environments to understand how employees work and what kind of spaces and facilities they need to do their best, most productive work. Lampson was hired by Accenture, a consulting firm, to evaluate and improve its location in Houston. Accenture's Houston office was a three-story, 66,000-square-foot building that served 800 employees.[2] Accenture employees are consultants themselves, and they typically spend up to two-thirds of their working time away from the office serving clients.

Lampson worked with Accenture director of workplaces Dan Johnson and Steelcase, an office furniture

manufacturer, to study how Accenture was using its Houston space. Lampson's "focus is on gaining a deep understanding of the business and its strategy for success and then developing strategic workplace solutions that enable those goals."[3] To achieve this outcome, Lampson and Steelcase analyzed employee demographics and expectations and studied how employees actually interacted with each other and performed tasks in the workplace. Accenture wanted to have a workspace that fostered its corporate goals of: worker innovation, collaboration, and flexibility.[4]



Exhibit 8.2 American General Center The American General Center is a complex of several office buildings in Houston, Texas, and home offices for Accenture. (Credit: Ken Luncd/ flickr/ Attribution-ShareAlike 2.0 Generic (CC BY-SA 2.0))

Understanding a firm's strengths is an important step in strategic analysis, and Lampson's focus on supporting those strengths in the workplace environment led to Workplace 2.0, Accenture's reimagined facility. Not only does the new workspace provide better physical and technological support for collaboration among Accenture employees, but Lampson and Steelcase were able to identify opportunities for Accenture to significantly reduce the size of its offices. Accenture saves money by using less space (it was able to downsize to a single floor of 25,000 square feet to serve the same number of workers) and supports worker interaction and engagement by providing a more effective workspace. You can watch a video of this transformation here: **https://www.youtube.com/watch?v=y4oIlY3HJfo**

8.1 Gaining Advantages by Understanding the Competitive Environment

1. What is strategic analysis, and why do firms need to analyze their competitive environment?

Strategic analysis is the process that firms use to study and understand the many different layers and aspects of their competitive environment. Why do firms spend time and money trying to understand what is going on around them? Firms do not operate in a vacuum. They are impacted by forces and factors from inside their organizations and outside in the world at large. Understanding these forces and factors is crucial to achieving

success as a business. For example, the growth in the Spanish-speaking population in the United States has led many firms to change the signage in their stores and labels on their products to include Spanish, in order to make their stores easier to shop in and their products easier to identify for this growing market. The external environment is continually changing, and the most successful firms are able to prepare for and adapt to environmental changes because they have done their homework and understand how external forces impact their operations.

To react to change more easily and develop products consumers want, managers and consultants engage in **environmental scanning**—the systematic and intentional analysis of both a firm's internal state and its external, competitive environment. From a local coffee shop to an international corporation, firms of all sizes benefit from strategic analysis. Let's examine some important strategic factors in more detail.

The Competitive Environment

A firm's **competitive environment** includes components inside the firm and outside the firm. **External factors** are things in the global environment that may impact a firm's operations or success, examples are a rise in interest rates, or a natural disaster. External factors cannot be controlled, but they must be managed effectively and to understand them so that the firm can be as successful. For example, the unemployment rate will affect a firm's ability to hire qualified employees at a reasonable rate of pay. If unemployment is high, meaning that a lot of people are looking for jobs, then a firm will probably have a lot of applicants for any positions it needs to fill. It will be able to choose more highly qualified applicants to hire and may be able to hire them at a lower pay rate because the employee would rather work for a lower pay rate than not have a job at all. On the other hand, when unemployment is low, meaning that not many people are looking for jobs, firms may have to offer higher pay or settle for lower qualifications to find someone to fill a position.

Internal factors are characteristics of the firm itself. To plan to compete against other firms, a firm needs to understand what physical, financial, and human resources it has, what it is good at, and how it is organized. For example, Walmart has a sophisticated IT system that tracks inventory and automatically orders products before they run out, by calculating how long it will take for the new product to arrive and comparing that to the rate at which the product is selling off the shelves. The system orders new product so that it will arrive just as the product on the shelves is running out, so that Walmart stores do not need to have storage space for inventory. All Walmart inventory is on the store shelves, ready to be sold to customers. How does this system benefit Walmart? It does not have to spend money on storing or keeping track of inventory, all products in the store can generate revenue because they are available for customers to buy, and when the system is working optimally, the store never runs out of items customers want.

CONCEPT CHECK

1. Why do managers use strategic analysis?
2. How are internal factors different from external factors in a firm's competitive environment?

8.2 Using SWOT for Strategic Analysis

2. What is a SWOT analysis, and what can it reveal about a firm?

You may already have heard of one very common tool firms use to analyze their strategic and competitive situations: **SWOT**, which is an acronym for **s**trengths, **w**eaknesses, **o**pportunities, and **t**hreats. Firms use SWOT analysis to get a general understanding of what they are good or bad at and what factors outside their doors might present chances for success or difficulty. Let's take a look at SWOT analysis piece by piece (Exhibit 8.3).

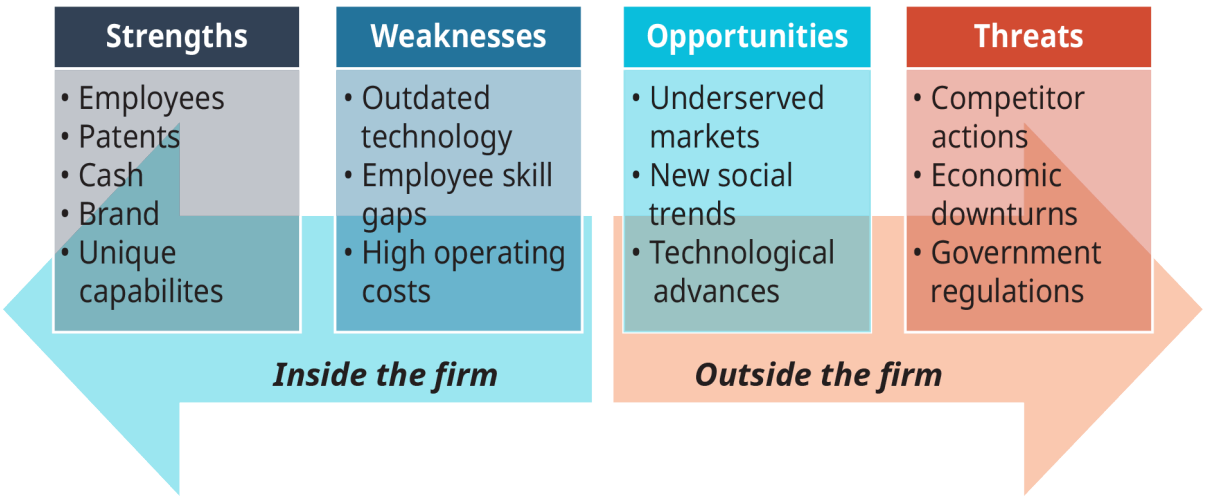

Exhibit 8.3 The Components of SWOT (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

Strengths

A firm's **strengths** are, to put it simply, what it is good at. Nike is good at marketing sports products, McDonald's is good at making food quickly and inexpensively, and Ferrari is good at making beautiful fast cars. When a firm analyzes its strengths, it compiles a list of its capabilities and assets. Does the firm have a lot of cash available? That is a strength. Does the firm have highly skilled employees? Another strength. Knowing exactly what it is good at allows a firm to make plans that exploit those strengths. Nike can plan to expand its business by making products for a sport it doesn't currently serve. Its sports marketing expertise will help it successfully launch that new product line.

Weaknesses

A firm's **weaknesses** are what it is not good at—things that it does not have the capabilities to perform well. Weaknesses are not necessarily faults—remember that not all firms can be great at all things. When a firm understands its weaknesses, it will avoid trying to do things it does not have the skills or assets to succeed in, or it will find ways to improve its weaknesses before undertaking something new. A firm's weaknesses are simply gaps in capabilities, and those gaps do not always have to be filled within the firm.

SWOT analysis alerts firms to the gaps in their capabilities so they can work around them, find help in those areas, or develop capabilities to fill the gaps. For example, Paychex is a firm that handles payroll for over 600,000 firms.[5] Paychex processes hours, pay rates, tax and benefits deductions, and direct deposit for firms that would rather not have to perform those tasks themselves. A large firm would need to have a team of employees dedicated to fulfilling that task and equip that team with software systems to do the job efficiently and accurately. For Paychex, these capabilities are a company strength—that's what it does. Other companies that do not have the resources to develop this capability or may not be interested in doing so can hire Paychex to do the job for them.

Opportunities

While strengths and weaknesses are internal to an organization, but opportunities and threats are always external. An **opportunity** is a potential situation that a firm is equipped to take advantage of. Think of opportunities in terms of things that happen in the market. Opportunities offer positive potential, however sometimes a firm is not equipped to take advantage of an opportunity which is why considering the entire SWOT is important before deciding what to do. For example, as cities are becoming more populated, parking is becoming scarcer. Younger consumers who live in cities are starting to question whether it makes sense to own a car at all, when public transportation is available and parking is not. Sometimes, however, a person might need a car to travel outside the city or transport a special purchase. Daimler, the manufacturer of Mercedes-Benz and Smart cars, started a car-sharing service in Europe, North America, and China called

Car2Go to offer cars to this new market of part-time drivers. By establishing Car2Go, Daimler has found a way to sell the use of its products to people who would not buy them outright.

Threats

When a manager assesses the external competitive environment, they label anything that would make it harder for their firm to be successful as a **threat**. A wide variety of situations and scenarios can threaten a firm's chances of success, from a downturn in the economy to a competitor launching a better version of a product the firm also offers. A good threat assessment looks thoroughly at the external environment and identifies threats to the firm's business so it can be prepared to meet them. Opportunities and threats can also be a matter of perspective or interpretation: the Car2Go service that Daimler developed to serve young urban customers who don't own cars could also be cast as a defensive response to the trend away from car ownership in this customer group. Daimler could have identified decreasing sales among young urban professionals as a threat and developed Car2Go as an alternative way to gain revenue from these otherwise lost customers.

The Limitations of SWOT Analysis

Although a SWOT analysis can identify important factors and situations that affect a firm, it only works as well as the person doing the analysis. SWOT can generate a good evaluation of the firm's internal and external environments, but it is more likely to overlook key issues because it is difficult to identify or imagine everything that could, for example, be a threat to the firm. That's why the remainder of this chapter will present tools for developing a strategic analysis that is more thorough and systematic in examining both the internal and external environments that firms operate in.

CONCEPT CHECK

1. Explain the elements of a SWOT analysis.
2. What information does a SWOT analysis provide managers? What information might it miss?

8.3 A Firm's External Macro Environment: PESTEL

3. What makes up a firm's external macro environment, and what tools do strategists use to understand it?

The world at large forms the **external environment** for businesses. A firm must confront, adapt to, take advantage of, and defend itself against what is happening in the world around it to succeed. To make gathering and interpreting information about the external environment easier, strategic analysts have defined several general categories of activities and groups that managers should examine and understand. Exhibit 8.4 illustrates layers and categories found in a firm's environment.

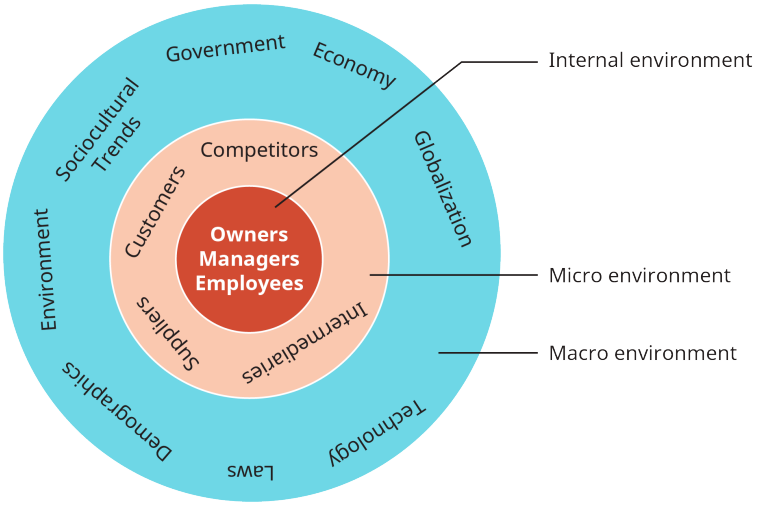

Exhibit 8.4 Components of a Firm's Environment (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

A firm's **macro environment** contains elements that can impact the firm but are generally beyond its direct control. These elements are characteristics of the world at large and are factors that all businesses must contend with, regardless of the industry they are in or type of business they are. In the Exhibit 8.4, the macro environment is indicated in blue. Note that the terms contained in the blue ring are all "big-picture" items that exist independently of business activities. That is not to say that they do not affect firms or that firm activities cannot affect macro environmental elements; both can and do happen, but firms are largely unable to directly change things in the macro environment.

Strategists study the macro environment to learn about facts and trends that may present opportunities or threats to their firms. However, they do not usually just think in terms of SWOT. Strategists have developed more discerning tools to examine the external environment.

PESTEL

PESTEL is a tool that reminds managers to look at several distinct categories in the macro environment. Like SWOT, PESTEL is an acronym. In this case, the letters represent the categories to examine: **p**olitical factors, **e**conomic factors, **s**ociocultural factors, **t**echnological factors, **e**nvironmental factors, and **l**egal factors. When using PESTEL to analyze a specific firm's situation, overlap between different categories of PESTEL factors can sometimes happen just as it can with SWOT.

Remember our earlier example: When urban millennials decide that car ownership is no longer attractive, car manufacturers' sales are threatened. However, those same manufacturers might be able to adapt their sales methods to offer millennials car-sharing services, taking advantage of the opportunity to earn revenue from millennials who want access to cars for vacations or big shopping trips. PESTEL can also reveal multiple impacts from a single element in the external environment. For example, decreasing interest in car ownership among urban millennials would be a sociocultural trend. However, the technological connectedness of those same urban millennials is exactly what makes it possible for ride-sharing services such as Uber and Lyft to thrive: their services are app based and provide convenience both by connecting drivers and passengers quickly and by making transactions cashless.

Exhibit 8.5 illustrates the components of PESTEL, which will be discussed individually below.

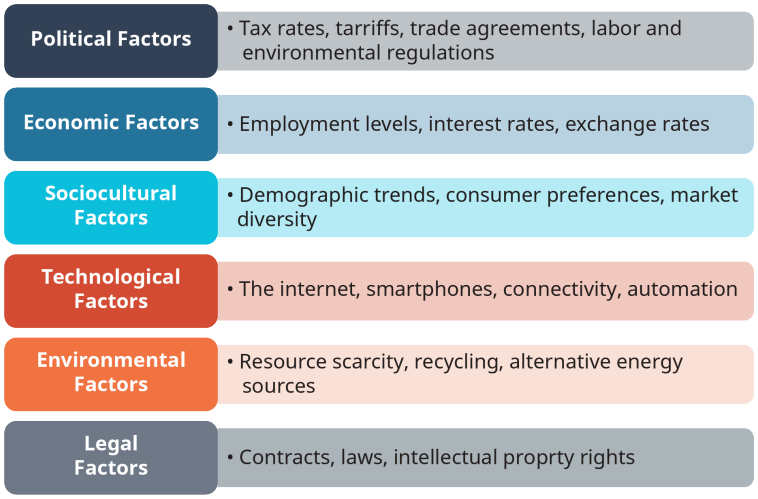

Exhibit 8.5 The PESTEL Model for External Environmental Analysis (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

Political Factors

Political factors in the macro environment include taxation, tariffs, trade agreements, labor regulations, and environmental regulations. Note that in PESTEL, factors are not characterized as opportunities or threats. They are simply things that a firm can take advantage of or treat as problems, depending on its own interpretation or abilities. American Electric Power, a large company that generates and distributes electricity, may be negatively impacted by environmental regulations that restrict its ability to use coal to generate electricity because of pollution caused by burning coal. However, another energy firm has taken advantage of the government's interest in reducing coal emissions by developing a way to capture the emissions while producing power. The Petra Nova plant, near Houston, was developed by NRG and JX Nippon, who received Energy Department grants to help fund the project.[6] Although firms do not directly make government policy decisions, many industries and firms invest in lobbying efforts to try to influence government policy development to create opportunities or reduce threats.

Economic Factors

All firms are impacted by the state of the national and global economies. The increased interdependence of individual country economies has made evaluating the **economic factors** in a firm's macro environment more complex. Firms analyze economic indicators to make decisions about entering or exiting geographic markets, investing in expansion, and hiring or laying off employees. As discussed earlier in this chapter, employment rates impact the quantity, quality, and cost of employees available to firms. Interest rates impact sales of big-ticket items that consumers normally finance, such as appliances, cars, and homes. Interest rates also impact the cost of capital for firms that want to invest in expansion. Exchange rates present risks and opportunities to all firms that operate across national borders, and the price of oil impacts many industries, from airlines and transportation companies to solar panel producers and plastic recycling companies. Once again, any scenario can be a threat to one firm and an opportunity to another, so economic forces should not be assumed to be intrinsically good or bad.

Sociocultural Factors

Quite possibly the largest category of macro environmental factors an analyst might examine are **sociocultural factors**. This broad category encompasses everything from changing national demographics to fashion trends and many things in between. **Demographics**, a subset of this category, includes facts about income, education levels, age groups, and the ethnic and racial composition of a population. All of these facts present market challenges and possibilities. Firms can target products to specific market segments by studying the needs and preferences of demographic groups, such as working women (they might need day-care services but not watch daytime television), college students (who would be interested in affordable

textbooks but couldn't afford to buy new cars), or the elderly (who would be willing to pay for lawn-mowing services but might not be interested in adventure tourism).

Changes in people's values and interests are also included in this category. Environmental awareness has spurred demand for solar panels and electric and hybrid cars. A general interest in health and fitness has created industries in gyms, home gym equipment, and organic food. The popularity of social media has created an enormous demand for instant access to information and services, not to mention smartphones. Values and interests are constantly changing and vary from country to country, creating new market opportunities as well as communication challenges for companies trying to enter unfamiliar new markets.

Technological Factors

The rise of the Internet may be the most disruptive technological change of the last century. The globe has become more interconnected and interdependent because of the fast, low-cost communications the Internet provides. Customer service agents in India can serve customers in Kansas because technology has advanced to the point that the customer's account information can be instantly accessed by the service provider in India. Entrepreneurs around the world can reach customers anywhere through companies such as eBay, Alibaba, and Etsy, and they can get paid, regardless of their customers' currency, through PayPal. The Internet has enabled Jeff Bezos, who started an online bookselling company called Amazon in 1994, to transform how consumers shop for goods.

How else have **technological factors** impacted business? The Internet is not the only technological advance that has transformed how businesses operate. Automation has increased efficiency for manufacturers. MRP (materials requirement planning) systems have changed how companies and their suppliers work together, and global-positioning technology has helped construction engineers manage large projects more accurately. Consumers and firms have nearly unlimited access to information, and this access has empowered consumers to make more-informed buying decisions and challenged firms to develop ways to analyze the large amounts of data their businesses generate.

Environmental Factors

The physical environment, which provides natural resources for manufacturing and energy production, has always been a key part of human business activity. As resources become scarcer and more expensive, **environmental factors** impact businesses more every day. Firms are developing technology to operate more cleanly and using fewer resources. Political pressure on businesses to reduce their impact on the natural environment has increased globally and dramatically in the 21st century. In 2017, London, Barcelona, and Paris announced their plans to ban cars with internal combustion engines over the next few decades, in order to combat air-quality issues.[7]

This external environment category often overlaps with others in PESTEL because concern for the environment is also a sociocultural trend, as more consumers look for recycled products and buy electric and hybrid cars. On the political front, firms are facing increased regulation around the world on their carbon emissions and natural resource use. Although SWOT would characterize these factors as either opportunities or threats, PESTEL simply identifies them as aspects of the external environment that firms must consider when planning for their futures.

Legal Factors

Legal factors in the external environment often coincide with political factors because laws are enacted by government entities. This does not mean that the categories identify the same issues, however. Although labor laws and environmental regulations have deep political connections, other legal factors can impact business success. For example, in the streaming video industry, licensing fees are a significant cost for firms. Netflix pays billions of dollars every year to movie and television studios for the right to broadcast their content. In addition to the legal requirement to pay the studios, Netflix must consider that consumers may find illegal

ways to view the movies they want to see, making them less willing to pay to subscribe to Netflix. Intellectual property rights and patents are major issues in the legal realm.

Note that some external factors are difficult to categorize in PESTEL. For instance tariffs can be viewed as either a political or economic factor while the influence of the internet could be viewed as either a technological or social factor. While some issues can overlap two or more PESTEL areas, it does not diminish the value of PESTEL as an analytical tool,

CONCEPT CHECK

1. Describe a firm's macro environment.
2. What does PESTEL stand for? How do managers use PESTEL to understand their firm's macro environment?

ETHICS IN PRACTICE



Sustainability and Responsible Management: *Can LEGO Give up Plastic?*

"In 2012, the LEGO Group first shared its ambition to find and implement sustainable alternatives to the current raw materials used to manufacture LEGO products by 2030. The ambition is part of the LEGO Group's work to reduce its environmental footprint and leave a positive impact on the planet our children will inherit."[8]

Danish toy company LEGO announced in 2015 that it would invest almost $160 million dollars into its efforts to meet the goal it announced in 2012. You know LEGO—they are the colored plastic bricks that snap together to make toys ranging from Harry Potter castles to Star Wars fighter craft. The family-owned company was founded in 1932 by Ole Kirk Christiansen and has since grown to be the world's number one toy brand.[9]

Given that LEGO and plastic seem to go hand in hand, why would the company want to give up on the material that makes their toys so successful? LEGO's manufacturing process relies on plastic to make highly precise plastic bricks that always fit together securely and easily. Replacing the plastic with another material that is durable, can be brightly colored, and can be molded as precisely is a difficult task. LEGO's leadership has decided that a strategic position based on fossil fuels is not sustainable and is making plans now to transition to a more environmentally friendly material to manufacture its products.

Switching from oil-based plastic might make economic sense as well. Manufacturers who rely on petroleum-based products must weather volatile oil prices. LEGO's raw materials costs could skyrocket overnight if the price of oil climbs again as it did in 2011. That price spike was due to conflict in Libya and other parts of the Arab world,[10] something entirely beyond the control of any business.

Technological innovations in bio-based plastics may be the answer for LEGO,[11] which is working with university researchers around the globe to find a solution to its carbon-footprint problem.

Sources: Trangbæk, Roar Rude (2016). "LEGO Group to invest 1 Billion DKK Boosting Search for Sustainable Materials." https://www.lego.com/en-us/aboutus/news-room/2015/june/sustainable-materials-centre. Accessed July 29, 2017; Brand Finance (2017). "Toys 25 2016." http://brandfinance.com/images/upload/brand_finance_toys_25_2017_report_locked.pdf Accessed July 29, 2017; Holodny, Elena (2016). TIMELINE: The tumultuous 155-year history of oil prices. *Business Insider*. http://www.businessinsider.com/

timeline-155-year-history-of-oil-prices-2016-12 Accessed July 29, 2017; and Peters, Adele (2015). "Why LEGO is Spending Millions to Ditch Oil-Based Plastic." *Fast Company*. https://www.fastcompany.com/3048017/why-lego-is-spending-millions-to-ditch-oil-based-plastic Accessed July 29, 2017.

Critical Thinking Questions

1. How would you approach this issue if you were the manager in charge of sourcing raw materials for LEGO? How would PESTEL analysis inform your actions?
2. What PESTEL challenges is LEGO trying to address by changing the raw materials used in its products?
3. Explain what favorable PESTEL factors support LEGO's efforts.

8.4 A Firm's Micro Environment: Porter's Five Forces

4. What makes up a firm's external micro environment, and what tools do strategists use to understand it?

A firm's **micro environment** is illustrated in the green circle in **Exhibit 8.4**. These entities are all directly connected to the firm in some way, and firms must understand the micro environment in order to successfully compete in an industry. All firms are part of an **industry**—a group of firms all making similar products or offering similar services, for example automobile manufacturers or airlines. Firms in an industry may or may not compete directly against one another, as we'll discuss shortly, but they all face similar situations in terms of customer interests, supplier relations, and industry growth or decline.

Harvard strategy professor Michael Porter developed an analysis tool to evaluate a firm's micro environment. **Porter's Five Forces** is a tool used to examine different micro-environmental groups in order to understand the impact each group has on a firm in an industry (**Exhibit 8.6**). Each of the forces represents an aspect of competition that affects a firm's potential to be successful in its industry. It is important to note that this tool is different than Porter's generic strategy typology that we will discuss later.

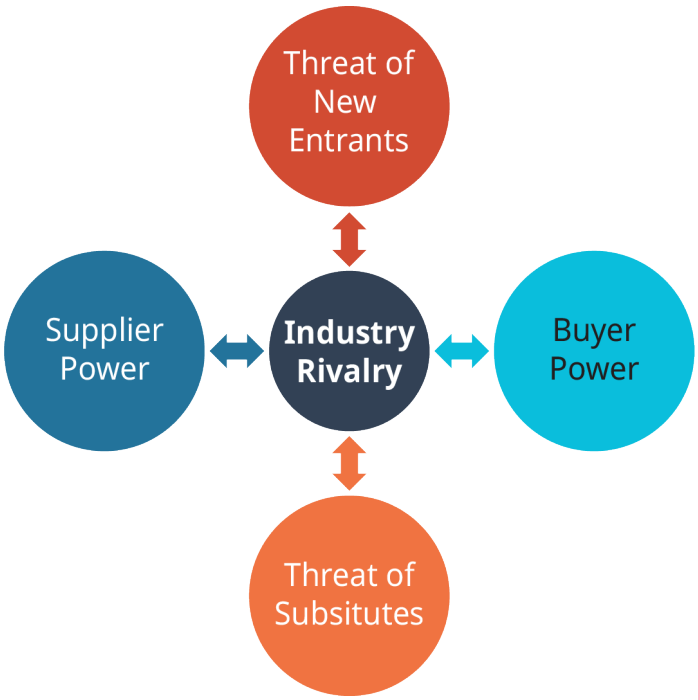

Exhibit 8.6 Porter's Five Forces Model of Industry Competition (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

Industry Rivalry

Industry rivalry, the first of Porter's forces, is in the center of the diagram. Note that the arrows in the diagram show two-way relationships between rivalry and all of the other forces. This is because each force can affect how hard firms in an industry must compete against each other to gain customers, establish favorable supplier relationships, and defend themselves against new firms entering the industry.

When using Porter's model, an analyst will determine if each force has a strong or weak impact on industry firms. In the case of rivalry, the question of strength focuses on how hard firms must fight against industry rivals (competitors) to gain customers and market share. Strong rivalry in an industry reduces the profit potential for all firms because consumers have many firms from which to purchase products or services and can make at least part of their purchasing decisions based on prices. An industry with weak rivalry will have few firms, meaning that there are enough customers for everyone, or will have firms that have each staked out a unique position in the industry, meaning that customers will be more loyal to the firm that best meets their particular needs.

The Threat of New Entrants

In an industry, there are incumbent (existing) firms that compete against each other as rivals. If an industry has a growing market or is very profitable, however, it may attract **new entrants**. These either are firms that start up in the industry as new companies or are firms from another industry that expand their capabilities or target markets to compete in an industry that is new to them.

Different industries may be easier or harder to enter depending on **barriers to entry**, factors that prevent new firms from successfully competing in the industry. Common barriers to entry include cost, brand loyalty, and industry growth. For example, the firms in the airline industry rarely face threats from new entrants because it is very expensive to obtain the equipment, airport landing rights, and expertise to start up a new airline.

Brand loyalty can also keep new firms from entering an industry, because customers who are familiar with a strong brand name may be unwilling to try a new, unknown brand. Industry growth can increase or decrease the chances a new entrant will succeed. In an industry with low growth, new customers are scarce, and a firm can only gain market share by attracting customers of other firms. Think of all the ads you see and hear from competing cell phone providers. Cell phone companies are facing lower industry growth and must offer consumers incentives to switch from another provider. On the other hand, high-growth industries have an increasing number of customers, and new firms can successfully appeal to new customers by offering them something existing firms do not offer. It is important to note that barriers to entry are not always external, firms often lobby politicians for regulations that can be a barrier to entry. These types of barriers will be covered in greater depth in more upper level courses.

Threat of Substitutes

In the context of Porter's model, a **substitute** is any other product or service that can satisfy the same need for a customer as an industry's offerings. Be careful not to confuse substitutes with rivals. Rivals offer similar products or services and directly compete with one another. Substitutes are completely different products or services that consumers would be willing to use instead of the product they currently use. For example, the fast food industry offers quickly prepared, convenient, low-cost meals. Customers can go to McDonald's, Wendy's, Burger King, or Taco Bell—all of these firms compete against each other for business. However, their customers are really just hungry people. What else could you do if you were hungry? You could go to the grocery store and buy food to prepare at home. McDonald's does not directly compete against Kroger for customers, because they are in different industries, but McDonald's does face a threat from grocery stores because they both sell food. How does McDonald's defend itself from the threat of Kroger as a substitute? By making sure their food is already prepared and convenient to purchase—your burger or salad is ready to eat and available without even getting out of your car.



Exhibit 8.7 McDonalds A drive-through menu at this McDonald's is designed to help customers choose their meal quickly and have it ready for pickup at the drive-through window. (Credit: Caribb/ flickr/ Public Domain)

Supplier Power

Virtually all firms have suppliers who sell parts, materials, labor, or products. **Supplier power** refers to the balance of power in the relationship between firms and their suppliers in an industry. Suppliers can have the upper hand in a relationship if they offer specialized products or control rare resources. For example, when Sony develops a new PlayStation model, it often works with a single supplier to develop the most advanced processor chip it can for their game console. That means its supplier will be able to command a fairly high price for the processors, an indication that the supplier has power. On the other hand, a firm that needs commodity resources such as oil, wheat, or aluminum in its operations will have many suppliers to choose from and can easily switch suppliers if price or quality is better from a new partner. Commodity suppliers usually have low power.

Buyer Power

The last of Porter's forces is **buyer power**, which refers to the balance of power in the relationship between a firm and its customers. If a firm provides a unique good or service, it will have the power to charge its customers premium prices, because those customers have no choice but to buy from the firm if they need that product. In contrast, when customers have many potential sources for a product, firms will need to attract customers by offering better prices or better value for the money if they want to sell their products. One protection firms have against buyer power is **switching costs**, the penalty consumers face when they choose to use a particular product made by a different company. Switching costs can be financial (the extra price paid to choose a different product) or practical (the time or hassle required to switch to a different product). For example, think about your smartphone. If you have an iPhone now, what would be the penalty for you to switch to a non-Apple smartphone? Would it just be the cost of the new phone? Smartphones are not inexpensive, but even when cell phone service providers offer free phones to new customers, many people still don't switch. The loss of compatibility with other Apple products, the need to transfer apps and phone settings to another system, and the loss of favorite iPhone features, such as iMessage, are enough to keep many people loyal to their iPhones.

CONCEPT CHECK

1. Describe each of Porter's Five Forces. What information does each provide a manager trying to

understand her firm's micro environment?

8.5 The Internal Environment

5. How and why do managers conduct an internal analysis of their firms?

A firm's internal environment is illustrated in Exhibit 8.4 by the innermost orange circle. The **internal environment** consists of members of the firm itself, investors in the firm, and the assets a firm has. Employees and managers are good examples; they are firm members who have skills and knowledge that are valuable assets to their firms. Evaluating a firm's internal environment is not just a matter of counting heads, however. Successful firms have a wide range of resources and capabilities that they can use to maintain their success and grow into new ventures. A thorough analysis of a firm's internal situation provides a manager with an understanding of the resources available to pursue new initiatives, innovate, and plan for future success.

Resources and Capabilities

A firm's resources and capacities are the unique skills and assets it possesses. **Resources** are things a firm has to work with, such as equipment, facilities, raw materials, employees, and cash. **Capabilities** are things a firm can do, such as deliver good customer service or develop innovative products to create value. Both are the building blocks of a firm's plans and activities, and both are required if a firm is going to compete successfully against its rivals. Firms use their resources and leverage their capabilities to create products and services that have some advantage over competitors' products. For example, a firm might offer its customers a product with higher quality, better features, or lower prices. Not all resources and capabilities are equally helpful in creating success, though. Internal analysis identifies exactly which assets bring the most value to the firm.

The Value Chain

Before examining the role of resources and capabilities in firm success, let's take a look at the importance of how a firm uses those factors in its operations. A firm's **value chain** is the progression of activities it undertakes to create a product or service that consumers will pay for. A firm should be adding value at each of the chain of steps it follows to create its product. The goal is for the firm to add enough value so that its customers will believe that the product is worth buying for a price that is higher than the costs the firm incurs in making it. As an example, Exhibit 8.8 illustrates a hypothetical value chain for some of Walmart's activities.

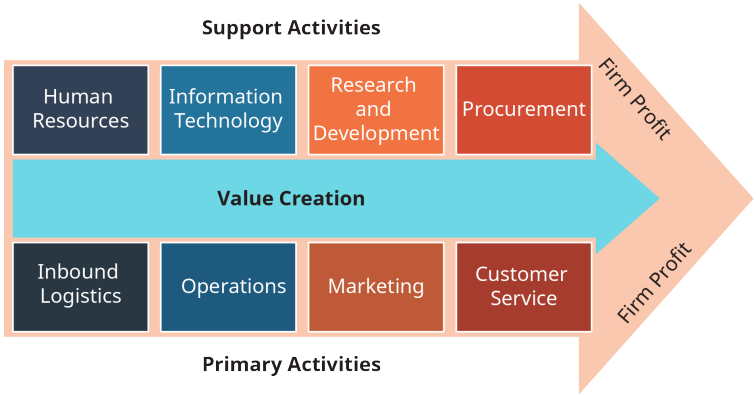

Exhibit 8.8 A Value Chain Example (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

In this example, note that value increases from left to right as Walmart performs more activities. If it adds enough value through its efforts, it will profit when it finally sells its services to customers. By working with product suppliers (procurement), getting those products to store locations efficiently (inbound logistics), and automatically keeping track of sales and inventory (information technology), Walmart is able to offer its customers a wide variety of products in one store at low prices, a service customers value. **Primary activities**,

the ones across the bottom half of the diagram, are the actions a firm takes to directly provide a product or service to customers. **Support activities**, the ones across the top of the diagram, are actions required to sustain the firm that are not directly part of product or service creation.

Using Resources and Capabilities to Build an Advantage over Rivals

A firm's resources and capabilities are not just a list of equipment and things it can do. Instead, resources and capabilities are the distinctive assets and activities that separate firms from each other. Firms that can amass critical resources and develop superior capabilities will succeed in competition over rivals in their industry. Strategists evaluate firm resources and capabilities to determine if they are sufficiently special to help the firm succeed in a competitive industry.

Using VRIO

The analytical tool used to assess resources and capabilities is called **VRIO**. As usual, this is an acronym developed to remind managers of the questions to ask when evaluating their firms' resources and capabilities. The four questions of VRIO, which focus on **v**alue, **r**arity, **i**mitation, and **o**rganization, are illustrated in **Exhibit 8.9**.

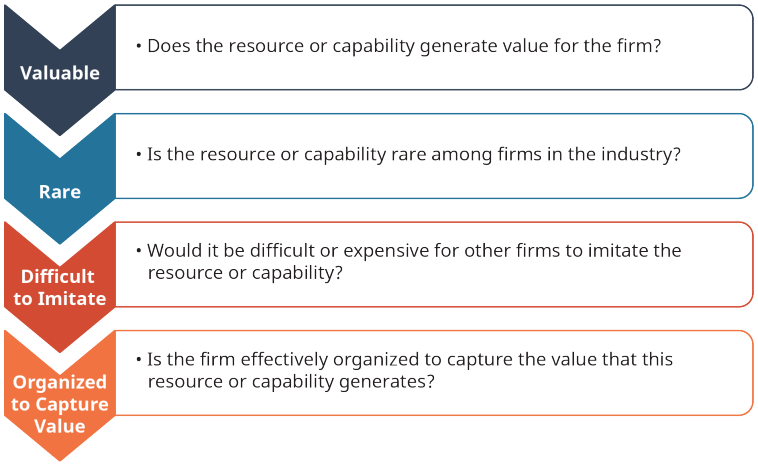

Exhibit 8.9 VRIO, a Tool for Evaluating Firm Resources and Capabilities (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

If each question can be answered with a "yes," then the resource or capability being evaluated can be the source of a competitive advantage for the firm. An example will help you better understand the VRIO process.

Imagine that you are a top manager for Starbucks and you want to understand why you are able to be successful against rivals in the coffee industry. You make a list of some of Starbucks' resources and capabilities and use VRIO to determine which ones are key to your success. These are shown in **Table 8.1**.

Starbucks' Resources and Capabilities	
Resources	**Capabilities**
Brand name	Making quality coffee drinks
Thousands of locations worldwide	Delivering excellent customer service
Cash	Training excellent staff

Table 8.1 (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

Starbucks' Resources and Capabilities	
Resources	**Capabilities**
Loyal customers	Paying above-average wages
Well-trained employees	Retaining quality employees

Table 8.1 (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

You look at your list and decide to pick a few of the entries to evaluate with VRIO (Table 8.2):

Evaluating Starbucks' VRIO					
Resource/ Capability	**Is it valuable?**	**Is it rare?**	**Is it difficult to imitate?**	**Is Starbucks organized to capture its value?**	**Can it be a basis for competitive advantage?**
Brand name	Yes	Yes	Yes	Yes	Yes
Delivering excellent customer service	Yes	Yes	Yes	Yes	Yes
Thousands of locations worldwide	Yes	No	No	Yes	No

Table 8.2 (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

According to the evaluation above, Starbucks' brand helps it compete and succeed against rivals, as does its excellent customer service. However, simply having a lot of locations globally isn't enough to beat rivals—McDonald's and Subway also have thousands of worldwide locations, and both serve coffee. Starbucks succeeds against them because of their brand and customer service.

CONCEPT CHECK

1. What are firm resources and capabilities?
2. Describe a value chain and what the activities in the chain represent.
3. What is VRIO? What questions do the letters stand for, and how does using VRIO help a manager make decisions?

MANAGING CHANGE

Technology and Innovation: Uber, Lyft, and the Self-Driving Car: The Transportation of the Future Is Coming Soon

Although the ride-sharing industry is still relatively new, it has seen explosive growth, and its two main rivals, Uber and Lyft, are looking for ways to increase their capacity to serve riders. Both firms, and rivals like them, operate in basically the same way. A person needing a ride uses a smartphone app to alert a nearby person with a car of their location. The driver, usually an independent contractor for the service (meaning they are just a person with a car that has signed up to provide rides in exchange for a portion of the fare the customer pays), picks up the customer and drives them to their destination. Paying for the ride is also handled through the app, and the driver receives about 75–80% of the fare, with Uber or Lyft keeping the balance.[12]



Exhibit 8.10 Rideshare pickup area The ride-share pickup area at Pierre Elliott Trudeau Airport in Montreal. Due to the popularity of ride sharing with companies such as Uber and Lyft, municipalities and airports have had to accommodate the changing demands of customers. (Credit: Quinn Dombroski/ flickr/ Attribution-ShareAlike2.0 Generic (CC BY-NC 2.0))

The popularity of ride-sharing services has soared, and both companies are constantly recruiting more drivers. However, both companies have also explored alternatives to independent drivers: self-driving cars. Uber and Lyft have taken different paths to develop this capability. Uber has worked to internally develop its own software technology and self-driving car technology, while Lyft has focused on software interfaces that can accommodate other companies' self-driving cars.[13] Lyft's partnerships with firms such as Google and GM that are already developing self-driving cars has put it ahead of Uber in the race to get driverless vehicles into its ride-sharing network, and it was able to test self-driving cars in Boston by partnering with NuTonomy in 2017.[14] Lyft offered a demonstration to journalists at the Consumer Electronics Show in Las Vegas in 2018, offering rides in self-driving cars developed by Aptiv.[15] Uber had been testing similar technology in Pittsburgh but suspended its self-driving car program after a fatal pedestrian accident in

Arizona.[16]

Sources: Ridester (2017). "How Much do Uber Drivers Actually Make? The Inside Scoop." *Ridester.com.* https://www.ridester.com/how-much-do-uber-drivers-make/ Accessed July 29, 2017; Bensinger, Greg (2017). "Lyft Shifts Gears With New Driverless-Car Division; San Francisco company to hire hundreds of engineers and open new Silicon Valley office." *The Wall Street Journal*. July 21, 2017; Edelstein, Stephen (2017). "Lyft Finally Launches Its Boston Self-Driving Car Pilot Program." *The Drive*. Dec. 17, 2017. http://www.thedrive.com/tech/16779/lyft-finally-launches-its-boston-self-driving-car-pilot-program; O'Kane, Sean (2018). "I took a gamble by riding in a self-driving Lyft in Las Vegas." *The Verge*. January 8, 2018. https://www.theverge.com/2018/1/8/16860590/self-driving-lyft-las-vegas-ces-2018; and Korosec, Kristen (2018). "Uber self-driving cars back on public roads, but in manual mode/" *Tech Crunch*. July 24, 2018. https://techcrunch.com/2018/07/24/uber-self-driving-cars-back-on-public-roads-but-in-manual-mode/.

Critical Thinking Questions

1. What resource or capability challenges have Uber and Lyft faced because their fast company growth?
2. What PESTEL factors do you think are contributing to the popularity of ride-sharing services?
3. What industry challenges (think of Porter's Five Forces) does the use of self-driving cars address?

8.6 Competition, Strategy, and Competitive Advantage

6. What does it mean to compete with other firms in a business environment, what does it mean when a firm has a competitive advantage over its rivals, and what generic strategies can a firm implement to gain advantage over its rivals?

Now that you understand more about the environment that businesses operate in, let's take a deeper look at exactly how they operate. Businesses exist to make profits by offering goods and services in the marketplace at prices that are higher than the costs they incurred creating those goods and services. Businesses rarely exist alone in an industry; **competition** is a usually a key part of any marketplace. This means that businesses must find ways to attract customers to their products and away from competitors' products. **Strategy** is the process of planning and implementing actions that will lead to success in competition.

The analytical tools we discuss here are part of the strategic planning process. Managers cannot successfully plan to compete in an industry if they don't understand its competitive landscape. It is also unlikely that a firm planning to launch a new product they are not equipped to make will be successful.

Competition

Porter's Five Forces model is centered around rivalry, a synonym for competition. In any industry, multiple firms compete against each other for customers by offering better or cheaper products than their rivals. Firms use PESTEL to understand what consumers are interested in and use VRIO to evaluate their own resources and capabilities so that they can figure out how to offer products and services that match those consumer interests and that are better in quality and price than the products offered by their competitors.

A firm is described as having a **competitive advantage** when it successfully attracts more customers, earns more profit, or returns more value to its shareholders than rival firms do. A firm achieves a competitive advantage by adding value to its products and services or reducing its own costs more effectively than its rivals in the industry.

Generic Business-Level Competitive Strategies

When discussing business strategy, a business is a firm or a unit of a firm that centers its activities around one primary type of product or service line. Business-level strategy is the general way that a business organizes its activities to compete against rivals in its product's industry. Michael Porter (the same Harvard professor who

developed the Five Forces Model) defined three **generic business-level strategies** that outline the basic methods of organizing to compete in a product market. He called the strategies "generic" because these ways of organizing can be used by any firm in any industry.

Cost Leadership

When pursuing a **cost-leadership strategy**, a firm offers customers its product or service at a lower price than its rivals can. To achieve a competitive advantage over rivals in the industry, the successful cost leader tightly controls costs throughout its value chain activities. Supplier relationships are managed to guarantee the lowest prices for parts, manufacturing is conducted in the least expensive labor markets, and operations may be automated for maximum efficiency. A cost leader must spend as little as possible producing a product or providing a service so that it will still be profitable when selling that product or service at the lowest price. Walmart is the master of cost leadership, offering a wide variety of products at lower prices than competitors because it does not spend money on fancy stores, it extracts low prices from its suppliers, and its pays its employees relatively low wages.

Differentiation

Not all products or services in the marketplace are offered at low prices, of course. A **differentiation strategy** is exactly the opposite of a cost-leadership strategy. While firms do not look to spend as much as possible to produce their output, firms that differentiate try to add value to their products and services so they can attract customers who are willing to pay a higher price. At each step in the value chain, the differentiator increases the quality, features, and overall attractiveness of its products or services. Research and development efforts focus on innovation, customer service is excellent, and marketing bolsters the value of the firm brand. These efforts guarantee that the successful differentiator can still profit even though its production costs are higher than a cost leader's. Starbucks is a good example of a differentiator: it makes coffee, but its customers are willing to pay premium prices for a cup of Starbucks coffee because they value the restaurant atmosphere, customer service, product quality, and brand.

Porter's typology assumes that firms can succeed through either cost leadership or differentiation. Trying to combine these two, Porter suggests, can lead to a firm being stuck in the middle.

Focus

Porter's third generic competitive strategy, **focus**, is a little different from the other two. A firm that focuses still must choose one of the other strategies to organize its activities. It will still strive to lower costs or add value. The difference here is that a firm choosing to implement a focused strategy will concentrate its marketing and selling efforts on a smaller market than a broad cost leader or differentiator. A firm following a focus-differentiation strategy, for example, will add value to its product or service that a few customers will value highly, either because the product is specifically suited to a particular use or because it is a luxury product that few can afford. For example, Flux is a company that offers custom-made bindings for your snowboard. Flux is a focus differentiator because it makes a specialized product that is valued by a small market of customers who are willing to pay premium prices for high-quality, customized snowboarding equipment.

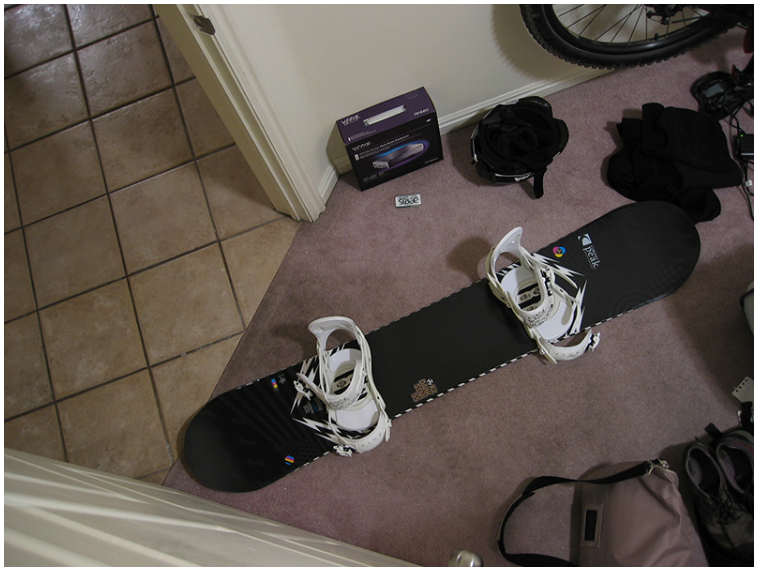

Exhibit 8.11 Snowboard bindings The Flux premium bindings on this snowboard are an example of a product on a focus-driven company. Snowboard bindings are the only products Flux markets. (Credit: Ted and dani Percival/ flickr/ Attribution 2.0 Generic (CC BY 2.0))

Strategic Groups

When managers analyze their competitive environment and examine rivalry within their industry, they are not confronted by an infinite variety of competitors. Although there are millions of businesses of all sizes around the globe, a single business usually competes mainly against other businesses offering similar products or services and following the same generic competitive strategy. Groups of businesses that follow similar strategies in the same industry are called **strategic groups**, and it is important that a manager know the other firms in their strategic group. Rivalry is fiercest within a strategic group, and the actions of one firm in a group will elicit responses from other group members, who don't want to lose market share in the industry. Take a look at **Exhibit 8.12**: although all of the firms shown are in the retail industry, they don't all compete directly against one another.

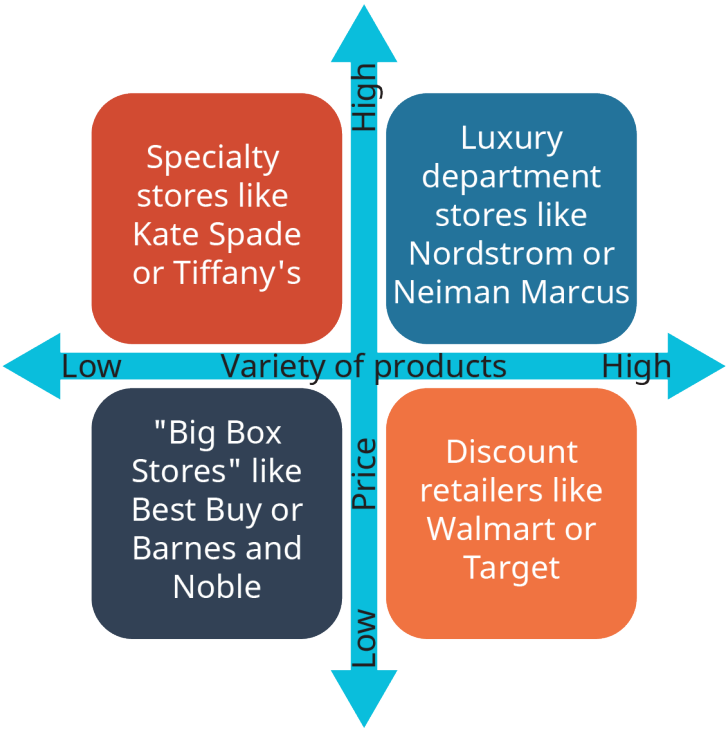

Exhibit 8.12 Strategic Groups in the Retail Industry (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

Although some cross competition can occur (for example, you could buy a Kate Spade wallet at Nordstrom), firms in different strategic groups tend to compete more with each other than against firms outside their group. Although Walmart and Neiman Marcus both offer a wide variety of products, the two firms do not cater to the same customers, and their managers do not lose sleep at night wondering what each might do next. On the other hand, a Walmart manager would be concerned with the products or prices offered at Target; if laundry detergent is on sale at Target, the Walmart manager might lose sales from customers who buy it at Target instead, and so the Walmart manager might respond to Target's sale price by discounting the same detergent at Walmart.

CONCEPT CHECK

1. What is competition, and what is the role of strategy in competition?
2. When does a firm have a competitive advantage over its rivals?
3. Explain the differences between the three business-level generic competitive strategies.

8.7 Strategic Positioning

7. What elements go into determining a firm's strategic position?

A manager who has done all of the analysis described so far in this chapter has some decisions to make based on all of the information the analysis has revealed. A firm's decisions on how to serve customers and compete against rivals is called **strategic positioning**. In order to develop its position, a firm combines its understanding of the competitive environment, including the firm's own resources and capabilities, its industry situation, and facts about the macro environment. A strategic position includes a choice of generic competitive strategy, which a firm selects based on its own capabilities and in response to the positions already staked out by its industry rivals. The firm also determines which customers to serve and what those customers are willing

to pay for. A strategic position also includes decisions about what geographic markets to participate in.

Most importantly, a firm's strategic position should try to be unique in some way that competitors cannot imitate quickly or easily. Competitive advantage is achieved when a firm attracts more customers or makes more profit than rivals. This cannot happen unless the firm organizes its activities to provide customers with better value than rivals.

CONCEPT CHECK



1. How does strategic analysis help a firm develop its own strategic position?

Key Terms

barriers to entry Industry factors (such as high start-up costs) that can prevent new firms from successfully launching new operations in that industry.

buyer power In the relationship between a firm and its customers, buyers with high power can negotiate product price or features, while buyers with low power cannot.

capabilities A firm's skill at coordinating and leveraging resources to create value.

competition Business actions a firm undertakes to attract customers to its products and away from competitors' products.

competitive advantage When a firm successfully attracts more customers, earns more profit, or returns more value to its shareholders than rival firms do.

competitive environment Factors and situations both inside the firm and outside the firm that have the potential to impact its operations and success.

cost-leadership strategy A generic business-level strategy in which a firm tightly controls costs throughout its value chain activities in order to offer customers low-priced goods and services at a profit.

demographics Part of PESTEL that includes facts about the income, education, age, and ethnic and racial composition of a population.

differentiation strategy A generic business-level strategy in which firms add value to their products and services in order to attract customers who are willing to pay a higher price.

economic factors PESTEL category that includes facts (such as unemployment rates, interest rates, and commodity prices) about the state of the local, national, or global economy.

environmental factors PESTEL category that examines a firm's external situation with respect to the natural environment, including pollution, natural resource availability and preservation, and alternative energy.

environmental scanning The systematic and intentional analysis of a firm's internal state and its external environment.

external environment The aspects of the world at large and of a firm's industry that can impact its operations.

external factors Things in the world or industry environments that may impact a firm's operations or success, such as the economy, government actions, or supplier power. Strategic decisions can be made in response to these things but normally cannot directly influence or change them.

focus strategy A generic business-level competitive strategy that firms use in combination with either a cost-leadership or differentiation strategy in order to target a smaller demographic or geographic market with specialized products or services.

generic business-level strategies Basic methods of organizing firm value chain activities to compete in a product market that can be used by any sized firm in any industry.

industry A group of firms all offering products or services in a single category, for example restaurants or athletic equipment.

industry rivalry One of Porter's Five Forces; refers to the intensity of competition between firms in an industry.

internal environment Innermost layer of a firm's competitive environment, including members of the firm itself (such as employees and managers), investors in the firm, and the resources and capabilities of a firm.

internal factors Characteristics of a firm itself, such as resources and capabilities, that the firm can use to successfully compete against its rivals.

legal factors In PESTEL, the laws impacting business, such as those governing contracts and intellectual property rights and illegal activities, such as online piracy.

macro environment The outermost layer of elements in a firm's external environment that can impact a business but are generally beyond the firm's direct control, such as the economy and political activity.

micro environment The middle layer of elements in a firm's external environment, primarily concerned with a firm's industry situation.

new entrants One of Porter's Five Forces, the threat of new entrants assesses the potential that a new firm

will start operations in an industry.

opportunity A situation that a firm has the resources and capabilities to take advantage of.

PESTEL A strategic analysis tool that examines several distinct categories in the macro environment: **p**olitical, **e**conomic, **s**ociocultural, **t**echnological, **e**nvironmental, and **l**egal.

political factors PESTEL factor that identifies political activities in the macro environment that may be relevant to a firm's operations.

Porter's Five Forces Evaluates the interconnected relationships between various actors in an industry, including competing firms, their suppliers, and their customers, by examining five forces: industry rivalry, threat of new entrants, threat of substitutes, supplier power, and buyer power.

primary activities Firm activities on the value chain that are directly responsible for creating, selling, or servicing a product or service, such as manufacturing and marketing.

resources Things a firm has, such as cash and skilled employees, that it can use to create products or services.

sociocultural factors PESTEL category that identifies trends, facts, and changes in society's composition, tastes, and behaviors, including demographics.

strategic analysis Process that firms use to study and understand their competitive environment.

strategic group Businesses offering similar products or services and following the same generic competitive strategy.

strategic positioning Firm's decisions on how to organize its actions and operate to effectively serve customers and compete against rivals.

strategy Process of planning and implementing actions that will lead to success in competition.

strengths Resources and capabilities of a firm; what it is good at.

substitutes One of Porter's Five Forces; products or services outside a firm's industry that can satisfy the same customer needs as industry products or services can.

supplier power One of Porter's Five Forces; describes the balance of power in the relationship between firms in an industry and their suppliers.

support activities Value chain activities that a firm performs to sustain itself; do not directly create a product or service but are necessary to support the firm's existence, such as accounting and human resources.

switching costs Penalty, financial or otherwise, that a consumer bears when giving up the use of a product currently being used to select a competing product or service.

SWOT Strategic analysis tool used to examine a firm's situation by looking at its **s**trengths, **w**eaknesses, **o**pportunities, and **t**hreats.

technological factors PESTEL category that includes factors such as the Internet, social media, automation, and other innovations that impact how businesses compete or how they manufacture, market, or sell their goods or services.

threat Anything in the competitive environment that would make it harder for a firm to be successful.

value chain Sequence of activities that firms perform to turn inputs (parts or supplies) into outputs (goods or services).

VRIO analytical tool that evaluates a firm's resources and capabilities to determine whether or not it can support an advantage for the firm in the competitive environment: **v**alue, **r**arity, **i**mitation, and **o**rganization.

weaknesses Things that a firm does not have good capabilities to perform or gaps in firm resources.

Summary of Learning Outcomes

8.1 Gaining Advantages by Understanding the Competitive Environment

1. What is strategic analysis, and why do firms need to analyze their competitive environment?

Strategic analysis is a systematic evaluation of a firm's situation, both internally and with respect to what is happening in the outside world. This analysis examines what the firm itself is good or bad at, how rivals in its

industry are competing against it for customers, and what factors in the world environment, such as economic indicators or demographic changes, might impact the firm's ability to be successful.

Firms need to conduct this analysis in order to be aware of and prepared for changes in their competitive environment and to maximize their chance of successfully competing against rivals and sustaining their profitability and market share in their industry.

8.2 Using SWOT for Strategic Analysis

2. What is a SWOT analysis, and what can it reveal about a firm?

SWOT is a traditional analytical tool that identifies a firm's **s**trengths, **w**eaknesses, **o**pportunities, and **t**hreats (SWOT is an acronym of these four factors). It is useful for conducting a quick look at the internal capabilities (strengths and weaknesses) and external events and situations (opportunities and threats) a firm is facing.

SWOT is not a comprehensive analytical tool, because the four categories for analysis are too broad and will not necessarily identify all of the factors important to a firm's success that a more thorough analysis would.

8.3 A Firm's External Macro Environment: PESTEL

3. What makes up a firm's external macro environment, and what tools do strategists use to understand it?

The external environment of a firm is composed of two primary layers: the macro environment and the micro environment. The macro environment includes facts and situations that a firm must be aware of but cannot always influence. The macro environment is analyzed using the PESTEL analytical tool that considers a firm's political and legal aspects, economic indicators, sociocultural trends, demographic facts, technological changes, and environmental aspects.

8.4 A Firm's Micro Environment: Porter's Five Forces

4. What makes up a firm's external micro environment, and what tools do strategists use to understand it?

The second layer of a firm's external environment is its micro environment, which includes the components of a firm's industry, such as competitors, suppliers, and customers. Porter's Five Forces of industry competition (industry rivalry, threat of new entrants, threat of substitutes, supplier power, and buyer power) capture the dynamic relationships between these components.

8.5 The Internal Environment

5. How and why do managers conduct an internal analysis of their firms?

Managers cannot lead their firms to success without understanding what the firm is able to do. An analysis of the firm's resources and capabilities, as well as its gaps, is essential in determining the best path forward for the firm. A good strategy for competitive advantage capitalizes on a firm's key resources and capabilities, as identified and evaluated using the VRIO (**v**alue, **r**arity, **i**mitation, and **o**rganization) analytical tool.

Resources and capabilities that satisfy VRIO criteria are the key things that a firm is best at, and these should be leveraged so the firm can compete against rivals.

8.6 Competition, Strategy, and Competitive Advantage

6. What does it mean to compete with other firms in a business environment, and what does it mean when a firm has a competitive advantage over its rivals and what generic strategies can a firm implement to gain advantage over its rivals?

Competition is the battle for customers. Firms compete against rivals offering similar products and services and try to attract customers by making sure their product or service is a little better or less expensive than those of their competitors. The firm that is most successful in this battle, measured in terms of profitability or in terms of market share, has a competitive advantage.

Generic competitive strategies are the basic templates for organizing firm activities in order to achieve competitive advantage in an industry. A firm will perform value chain activities, such as marketing and research and development, in order to support the overall competitive strategy it has chosen.

Following a generic cost-leadership strategy requires that a firm try to save money throughout the value chain so that it can offer customers low-priced goods and services. In contrast, differentiators add value to their products and services while performing value chain activities so that they can charge premium prices to consumers.

A third generic competitive strategy, focus, is chosen in combination with one of the other two strategies by firms who decide to target smaller geographic or demographic customer groups.

8.7 Strategic Positioning

7. What elements go into determining a firm's strategic position?

A firm develops a strategic position in response to the factors present in its competitive environment. Strategic analysis is essential in identifying and understanding the factors that a strategic position must address. The choice of strategic position factors in a firm's key resources and capabilities when choosing a generic competitive strategy, product or service to be offered, target market, and geographic reach to compete successfully against rivals in an industry. To be successful in allowing a firm to achieve a competitive advantage in its industry, a firm's strategic position should be different from its competitors' positions in the same industry and should be hard for competitors to copy so that the firm's competitive advantage lasts.

Chapter Review Questions

1. Why do managers use strategic analysis?
2. What information does a SWOT analysis provide managers? What information might it miss?
3. Describe a firm's macro environment and how managers use PESTEL to understand it.
4. What is a firm's micro environment, and why is it important?
5. What is an industry, and how do Porter's Five Forces help a manager trying to understand a firm's industry environment?
6. What are firm resources and capabilities, and what information does VRIO provide about them?
7. When does a firm have a competitive advantage over its rivals?
8. What are generic competitive strategies, and how are they implemented in a firm's value chain activities?
9. What do strategic group members have in common with each other? What impact do firms outside a strategic group have on those in that group?
10. How does strategic analysis help a firm develop its own strategic position? Why should that position be unique?

Management Skills Application Exercises

1. (Analytical Skills) Assume that you have been hired by a local small-business consulting firm. You have been asked by your boss to review a proposal from a client who is considering opening a new Pilates and yoga studio in a trendy part of town. Because you know SWOT analysis, you have been asked to group the following attributes about the proposed business into a SWOT analysis:

    a. The proposed location is on the same street corner as the main subway line station and three blocks from a ferry terminal that commuters use go to work.
    b. The proposed location has a vestibule and a new HVAC system.
    c. The street that the location is situated on has many small shops, restaurants, and bars and is a popular gathering place.
    d. There are many historic structures that are in need of updates, but some owners are reluctant to invest in these aging structures.

e. The area has become gentrified over the past decade, and there is more disposable income than in the past.
f. In addition to the young professionals, a large number of 55 and over retirees who are now empty nesters have been moving into the neighborhood.
g. With the young professionals and empty nesters, this area has one of the lowest birth rates in the nation.
h. The two-year lease is affordable for the business plan, but there is no guarantee of renewal after the term.
i. There is a rumor of a spin studio opening two blocks away.
j. The building has been updated with ramps and restrooms to accommodate disabled patrons.
k. The local paper has interviewed the client and will be running a "Pilates Craze" feature in the upcoming weekend newspaper.

2. (Interpersonal Skills) Your instructor may assign you to a small group, and you will receive either a "Team A" or "Team B" assignment. Team A groups will need to meet for 15 minutes in a face-to-face setting, while Team B members will meet electronically either by setting up a meeting via Skype or using text messaging on their cell phones. Team A members will need to set up a time and location for their meeting while Team B members will need to share their contact information with a team leader.

   Your instructor will assign a company to discuss and report on. Team A will discuss a firm's internal environment while team B will discuss the firm's external environment. In class, each team will report its conclusions about its assignment and report on the benefits and challenges that meeting in person or electronically posed.

3. (Communication) Set up an interview with a manager at a local business who is involved in the strategic planning process at her company. Ask her what type of planning she is involved in (strategic, operational). Discover if she involves the employees who report to her in the planning process and how planning is tied to goal setting. Write a report on your findings. The interview should take no more than 15 minutes.



Managerial Decision Exercises

1. Select three different businesses from different industries, such as a hospitality business (hotel, restaurant, fitness center), a manufacturing company, and a not-for-profit business. Perform a SWOT analysis for each business.

2. Perform a quick PESTEL analysis of the companies listed below. What is the largest risk for each of the companies? Assume that you had $100,000 to invest in one of more of these companies. Explain how you would allocate your investment and why you chose this particular allocation.

   a. Uber
   b. Tesla
   c. General Motors

3. Technology has the ability to disrupt industries. You are involved in an industry that is undergoing change and disruption by taking this class. The traditional textbook industry is being disrupted by the availability of digital textbooks, and free textbooks such as this one are further impacting traditional textbook publishers. Place the following statements into Porter's Five Forces model.

   a. Students have access to the material at a greatly reduced cost.
   b. Authorship is funded through philanthropic donations rather than royalties paid from textbook sales revenue.
   c. More students have access to the Internet than ever before.
   d. Companies, governments, and students invest large sums of money in their education.
   e. Traditional public educational institutions are adapting their delivery models for online learning.

f. Private companies such as Apollo (University of Phoenix) are offering lower-cost education options.
g. Bookstores now offer traditional textbooks as well as used and rental options.
h. Government legislation is urging faculty to consider lower-cost options.



Critical Thinking Case

Tesla Aims for the Mass Market

Elon Musk cofounded Tesla in 2003 with the vision of making electric cars that could rival, and even replace, traditional gas-engine cars in the consumer marketplace. At the start of the 21st century, the external environment was beginning to show favorable signs for the development of electric cars: people were becoming more concerned about the environment and their carbon footprints, and gas prices were beginning a steep climb that had already spurred the sales of hybrid gas-electric cars such as the Toyota Prius.

The automobile industry was not responding to these environmental trends, instead relying on the fact that trucks such as the Ford F-150 and Chevrolet Silverado were still the two top-selling vehicles in America in 2003. Musk saw a different future for vehicles, and Tesla introduced the all-electric Roadster in 2008. Four years later, the more practical Model S was introduced, and Tesla sales began to climb.

As a new entrant in the automobile industry, though, Tesla faced several challenges. Manufacturing and distribution in this industry are extremely expensive, and Tesla had to develop the capability of efficiently manufacturing large quantities of cars. Tesla also had to establish dealerships for its cars, although it also decided to sell cars online, taking advantage of tech-savvy consumers' comfort with online shopping. Perhaps Tesla's greatest challenge was convincing consumers to trust the new technology of all-electric cars. *Range anxiety* became an actual term, describing people's fear that their car batteries would run out before they reached their destinations. To combat this, Tesla developed an extensive network of charging stations so consumers could be confident that they could charge their cars conveniently.

Elon Musk has been a master of raising money to fund Tesla's efforts to successfully enter the mainstream automobile manufacturing industry; so far, Tesla's entry has cost billions of dollars. Tesla has also taken advantage of tax incentives to develop its charging stations and to sell its cars, because Tesla customers receive tax credits for the purchase of their cars. Tesla cars are not inexpensive, however, and that has limited their marketability. Most Americans cannot afford the Model S or more recent Model X's high prices (up to and exceeding $100,000).

In 2017, Tesla launched the Model 3, designed to transform the car industry by being its first mass-market, affordable model. The company started taking "reservations" for the model in 2016, promising that it would arrive with a $35,000 price tag. By mid-2017, the reservations list had reached half a million customers, creating a new problem for Tesla. How could it possibly manufacture that many cars when production levels for all of 2016 were less than 84,000 cars?



Exhibit 8.13 Tesla 3 The Tesla Model 3. (Credit: Brian Doyle/ flickr/ Attribution 2.0 Generic (CC BY 2.0))

Critical Thinking Questions

1. What PESTEL factors supported Tesla's success? Which factors posed challenges?
2. How has Tesla's strategic position changed since it was founded in 2003?
3. What kind of responses would you expect from Tesla's rivals in the automobile manufacturing industry to the Model 3's popularity?

Sources: Tesla company website: https://www.tesla.com/ and investor relations site: http://ir.tesla.com/; Edmunds, "Top 10 Best Selling Cars in 2003." https://www.edmunds.com/car-reviews/top-10/top-10-best-selling-vehicles-in-2003.html (updated May 12, 2009); Bill Vlasic, "In Pivotal Moment, Tesla Unveils its First Mass Market Sedan." New York Times, July 29, 2017, https://www.nytimes.com/2017/07/29/business/tesla-model-3-elon-musk.html?ref=business.



9

The Strategic Management Process: Achieving and Sustaining Competitive Advantage

Exhibit 9.1 (Credit: Steve Pisano/ flickr/ Attribution 2.0 Generic (CC BY 2.0))

Introduction

Learning Outcomes

After reading this chapter, you should be able to answer these questions:

1. What is the strategic management process?
2. What is the difference between a firm's vision and its mission?
3. Why is strategic analysis important to strategy formulation?
4. What are strategic objectives, levels of strategy, and a grand strategy? How are they related?
5. How and why do managers plan? Why are goals important in the planning process?
6. How and why do managers evaluate the effectiveness of strategic plans?

EXPLORING MANAGERIAL CAREERS

Chieh Huang, Boxed

As a successful entrepreneur, Chieh Huang knows how spot a business opportunity. His current business venture, Boxed, ships warehouse-club type products directly to customers' homes. The company has grown from $8 million in revenue to more than $100 million in just three years. How has Huang achieved this success? He started "basically trying to solve a problem that I myself have. I grew up in the burbs, and every other weekend would go to the Price Club, and then I went to the city and didn't have a car anymore. Am I just supposed to get ripped off?"[1] Huang thought that other millennials might be in the same situation and developed a company to offer bulk items like paper towels and energy bars at warehouse-club prices to millennials who want app-based shopping convenience.



Exhibit 9.2 Chieh Huang Chieh Huang, founder and CEO of Boxed. (Credit: Boxed.com / Attribution 2.0 Generic (CC BY 2.0))

Huang explained his entrepreneurial approach this way: "With repeat entrepreneurs, you not only solve a problem, you look for changes taking place in the world that become tailwinds to help the business exponentially grow."[2] Environmental analysis might reveal an opportunity, but strategic planning is what makes it grow. Huang has managed growth by obtaining the resources necessary to serve more customers. As CEO of Boxed, Huang has raised money to build distribution centers, hired employees, developed private-label products to offer customers low prices, and expanded supplier relationships.

What is the strategy at Boxed? Huang discussed the company's position in an interview on CNBC. He acknowledged that today's selling environment is focused on "value, convenience, and brand,"[3] and said that when companies sell at similar low prices and offer similar delivery services, the only real differentiator left is brand. Huang has worked hard to develop the Boxed brand, promoting it on CNN, MSNBC, and the Today Show. The Boxed brand is also enhanced by reports of the benefits Huang offers employees. The CEO pays college tuition for employees' children and even pays for employee weddings. For millennials, a company's values have become part of its value, and if the price and convenience offered by Boxed match other sellers, Boxed's values may be their best asset in attracting customers. This YouTube video is a CNBC story about Boxed with an interview with Huang.

https://www.youtube.com/watch?v=3ANAe1vLAIw

9.1 Strategic Management

1. What is the strategic management process?

In the previous chapter we focused on analyzing and understanding a firm's competitive environment. In this chapter, we see how the information strategic analysis provides gets put to work. The **strategic management process** is the set of activities that firm managers undertake in order to try to put their firms in the best possible position to compete successfully in the marketplace. Strategic management is made up of several distinct activities, shown in **Exhibit 9.3**. This chapter will detail the role each activity plays in developing and sustaining a successful competitive position.

While **Exhibit 9.3** presents strategic management as an orderly process. However, most top managers deal with all of the steps simultaneously; they engage in environmental scanning to update their analytical view of the firm, they are executing strategies formulated in the past, they are formulating strategies to execute in the future, and so on. While it is useful to discuss the strategic management process in a stepwise fashion, it's important to point out that the cycle occurs such that everything is being done at once.

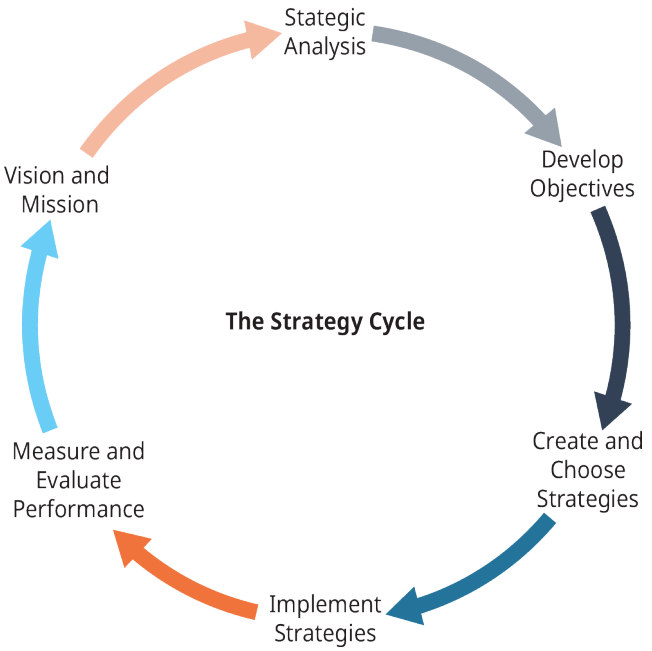

Exhibit 9.3 The Strategy Cycle (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

CONCEPT CHECK

1. What activities make up the strategic management process?

9.2 Firm Vision and Mission

2. What is the difference between a firm's vision and its mission?

The first step in the process of developing a successful strategic position should be part of the founding of the firm itself. When entrepreneurs decide to start a business, they usually have a reason for starting it, a reason that answers the question "What is the point of this business?" Even if an entrepreneur initially thinks of starting a business in order to be their own boss, they must also have an idea about what their business will do. Overall, entrepreneurs start businesses for a variety of reasons. A **vision statement** is an expression of what a business's founders want that business to accomplish. The vision statement is usually very broad, and it does not even have to mention a product or service. The vision statement does not describe the strategy a firm will use to follow its vision—it is simply a sentence or two that states why the business exists.

While a firm's vision statement is a general statement about its values, a firm's **mission statement** is more specific. The mission statement takes the *why* of a vision statement and gives a broad description of *how* the firm will try to make its vision a reality. A mission statement is still not exactly a strategy, but it focuses on describing the products a firm plans to offer or the target markets it plans to serve.

Exhibit 9.4 gives examples of vision and mission statements for the Walt Disney Company and for Ikea. Notice that in both cases, the vision statement is very broad and is not something a business could use as a strategy because there's simply not enough information to exhibit out what kind of business they might be. The mission statements, on the other hand, describe the products and services each company plans to offer and the customers each company plans to serve in order to fulfill their vision.

Vision → Mission		
	Broad: *Why do we exist?*	**Focused: *How will we accomplish our vision?***
Disney	**"To make people happy."**	"The mission of The Walt Disney Company is to be one of the world's leading producers and providers of entertainment and information. Using our portfolio of brands to differentiate our content, services and consumer products, we seek to develop the most creative, innovative and profitable entertainment experiences and related products in the world."
Ikea	**"To create a better everyday life for the many people."**	"We shall offer a wide range of well-designed, functional home furnishing products at prices so low that as many people as possible will be able to afford them."

Exhibit 9.4 Vision and Mission Statements (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

An interesting thing to note about vision and mission statements is that many companies confuse them, calling a very broad statement their mission. For example, Microsoft says that its mission is "to help people around the world realize their full potential."[4] By the description above, this would be a good vision statement. However, Microsoft's official vision statement is to "empower people through great software anytime, anyplace, and on any device."[5] Although the second statement is also quite broad, it does say *how* Microsoft wants to achieve the first statement, which makes it a better mission statement than vision statement.

Why are vision and mission statements important to a firm's strategy for developing a competitive advantage? To put it simply, you can't make a plan or strategy unless you know what you want to accomplish. Vision and mission statements together are the first building blocks in defining why a firm exists and in developing a plan to accomplish what the firm wants to accomplish.

CONCEPT CHECK

1. What does a mission statement explain about a firm that a vision statement does not?
2. What are the similarities and differences between vision and mission?

9.3 The Role of Strategic Analysis in Formulating a Strategy

3. Why is strategic analysis important to strategy formulation?

In the previous chapter, you read about the various levels of analysis that a manager carries out in order to understand their firm's competitive environment. A **strategic analysis** of a firm's external environment (the world, competitors) and internal environment (firm capabilities and resources) gives its managers a clear picture of what they have to work with and also what needs to be addressed when developing a plan for the firm's success. Analysis comes early in the strategic process because the information a manager gets from the analysis informs the decision-making that follows. The information is so critical that entrepreneurs writing business plans (before the business even exists) do this analysis to understand if their business idea is feasible, and to understand how to position their business relative to existing competitors or potential customers in order to maximize their odds of success. Exhibit 9.5 outlines just a few of the questions that strategic analysis tools can help answer.



Exhibit 9.5 Some Questions That Strategic Analysis Should Answer

As an example of how the strategic tools help inform decisions, look back at the Walt Disney mission and vision in Exhibit 9.4. Imagine if you were Mr. Walt Disney today, and you wanted to start a company with a vision of making people happy in the 21st century. What products or services would you plan to offer? A PESTEL analysis would tell you that technology is an important part of entertainment and that sociocultural trends include people's preference for on-demand entertainment, to be convenient and compatible with their busy schedules. Disney's mission statement is broad enough about products and services to include a wide variety of offerings (they are thinking about the future too!), but if you were starting this company today, where would you start? Would you make movies for movie theaters, or develop a way to offer video entertainment online? Would you make console video games or phone apps? Who would your competition be, and what do they offer? How could you offer something better or cheaper?

Managers learn about the conditions that their business will have to operate in by doing strategic analysis, and understanding those conditions is required in order to develop the plans and actions that will lead to success.

CONCEPT CHECK

1. What strategic analysis tools from the previous chapter would a manager use when planning a strategy for an existing business? What tools would be most helpful for a start-up business?

9.4 Strategic Objectives and Levels of Strategy

4. What are strategic objectives, levels of strategy, and a grand strategy? How are they related?

Once a strategic analysis has been completed, the next step in the strategy process is to establish strategic objectives. At this point, the manager has decided why the company exists and how it will try to fulfill its mission. Strategic analysis has provided information about customer preferences, competitors, and the firm's resources and capabilities. Now it is time to start planning for success.

Strategic objectives

Strategic objectives are the big-picture goals for the company: they describe what the company will do to try to fulfill its mission. Strategic objectives are usually some sort of performance goal—for example, to launch a new product, increase profitability, or grow market share for the company's product.

Exhibit 9.6 shows what might be some strategic objectives for Disney. To make people happy (Disney's vision), Disney focuses on entertainment (its mission). Top executives then decide each year what entertainment products the company will offer. Because Disney is a large corporation (more on that shortly), it has a variety of resources available to create entertainment products to offer. For example, they may decide to release three movies this year, as well as build a new theme park and create five new shows for their television network. In reality, the strategic objectives at Disney are much more complex than this, because some of these choices involve long-term efforts (they cannot build a theme park in one year).

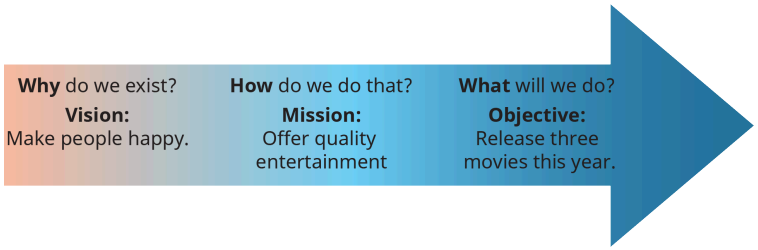

Exhibit 9.6 A Possible Strategic Path from Vision to Objective for Disney (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

Levels of Strategies

Once a firm has set its objectives, it then must turn to the question of how it will achieve them. A **business-level strategy** is the framework a firm uses to organize its activities, and it is developed by the firm's top managers. Examples of business-level strategies include cost leadership and differentiation. These strategies are pursued by businesses with a single product or a range of products.

For example, imagine that you own a coffee shop. You aren't Starbucks—you are a local shop in your neighborhood, and you run it yourself. You have employees, but you are the manager, owner, and all-around decision maker. While developing your vision and mission statements, you have already made some basic decisions about how your shop will operate. For example, you have chosen to either offer quick, inexpensive coffee (cost leadership) or a full-service coffee experience (differentiation). That decision impacts whether or not you choose premium or discount suppliers, how your shop is decorated, and how many employees you have to offer attention (service) to your customers. A business-level strategy guides a company in how they approach the activities in the value chain. Operations, for example, would focus on efficiency for a cost leader and focus on adding value for a differentiator.

When you develop strategic objectives for your shop, you will decide whether or not you want to try to attract more customers (grow), maintain your business at its current level, or shrink your business (perhaps you feel you don't have enough time to spend with your family). If you decide that your objective is to grow, for example, you should set a specific target, say, to grow revenue by 10%. Once you set that specific objective, you can exhibit out exactly what business-level actions you will need to take to reach that target.

Even if a business is much larger than a local coffee shop, the strategic objectives pursued by these larger companies are not significantly different in concept. Large companies like Nike or Apple, which have many different business units, develop strategies at several levels. Each individual business unit (say Nike Basketball) will have a manager who decides the objectives for that unit, just as in the coffee shop example. However, the company as a whole will have a chief executive officer (the top manager for the company) who develops strategy for the entire corporation. **Corporate strategy** is the broadest level of strategy, and is concerned with decisions about growing, maintaining, or shrinking very large companies. At this level, business-level strategy activities, such as an advertising campaign to attract new customers for a single product line, are not going to

be enough to significantly impact the company as a whole.

The corporate CEO essentially manages a group of businesses (unless the firm operates as one business unit) and develops strategies to create success for the overall group. Think of the group of businesses as an investment portfolio: investors try to have a diverse set of investments to spread risk and maximize the performance of the overall portfolio. On any given day, an investment that isn't doing so well should be offset by one that is doing well. Corporate strategy tries to achieve the same thing, and CEOs have to weigh the pros and cons of each business unit and how it is contributing to the success of the overall corporation. For example, a company that has business units that do well in the winter (ski resorts) will try to also have business units that will perform in the summer (swimming pools) to reduce the risk of having periods of low revenue. One tool that corporate strategists use to understand how each of their businesses contributes to the corporation as a whole is the **BCG Matrix**, illustrated in Exhibit 9.7.

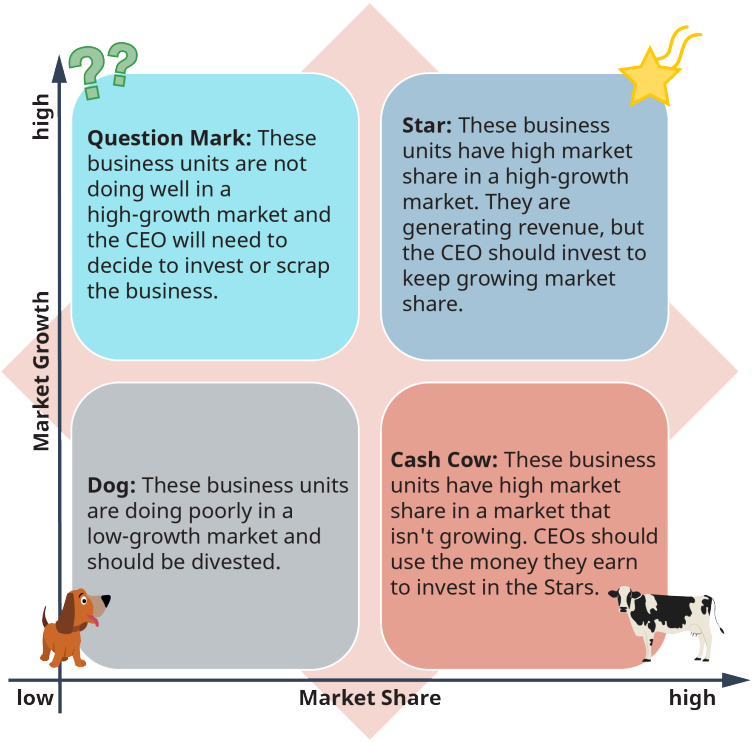

Exhibit 9.7 The BCG Matrix (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

The BCG Matrix gives managers a quick picture of which business units are doing well and which are not. The tool has recommendations for businesses in each quadrant—for example, a business in the dog quadrant should be sold or closed. Cash cows provide income to the corporation, and stars provide growth. A CEO is always trying to balance the group of business units throughout the quadrants to maximize overall corporate performance. Note that the BCG Matrix is not applicable for firm's that operate in one business unit.

In order to achieve the scale of growth necessary to meet corporate strategic objectives, a CEO must find ways to develop entirely new business units or reach brand-new markets. For example, for Walmart to grow their 2017 revenue by 5%, they would need to add $25 billion in new revenue. That's more revenue than opening some new stores could generate. CEOs have several ways of growing their corporations, as shown in Table 9.1.

How Grand Strategies Are Translated into Objectives and Actions			
	Grand Strategy	**Strategic Objective**	**Potential Action**
Business-Level Strategy	Growth	Increase business revenue by 25%	• Introduce a new product. • Expand to a new location.
Corporate-Level Strategy	Growth	Increase corporate revenue by 10%	• Acquire a competitor. • Expand to a new country. • Develop a business in a new industry.
International Strategy	Growth	Attract 10% overall market share in a new country	• Export products to that country. • Acquire a local company in that country to gain their customers.

Table 9.1 (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

In Walmart's case, for example, growing has meant expanding their online capabilities to better compete with Amazon. They have acquired new companies to support this goal, including Shoebuy, Jet, ModCloth, and Flipkart to reach customers and increase their online product selection, as well as Parcel, to build delivery services.[6]

International strategy is similar to corporate strategy because it is concerned with the large-scale actions involved in entering a brand-new geographic market. For companies operating internationally, strategic questions focus on how to successfully enter and compete in a foreign market. International strategy can combine with business-level or corporate-level strategies because a growth strategy at either scale can involve entering new markets in order to reach new customers.

The Grand Strategy

At all three levels, companies choose a **grand strategy** in response to the first question they should ask themselves: does the firm want to grow, strive for stability, or take a defensive position in the marketplace? Often, the choice of a grand strategy is based on conditions in the business environment because firms generally want to grow unless something (like a recession) makes that difficult. Note that a grand strategy and a corporate strategy can overlap significantly.

- A **growth strategy** involves developing plans to increase the size of the firm in terms of revenue, market share, or geographic reach (often a combination of these, as they can overlap significantly). Walmart is implementing a growth strategy with the acquisitions discussed in the corporate strategy section.
- A **stability strategy** is a strategy for a company to maintain its current income, market share, or geographic reach. A firm usually works to maintain a stable position when the alternative is to lose ground in one of those categories, for example because of competition or economic factors. In today's business environment, publicly held firms rarely aim solely to maintain the status quo, because shareholders and the stock market reward firm growth.
- Firms pursue **defensive strategies** in the face of challenges. A company that is struggling may decide to shrink its operations to reduce costs in order to survive, for example. A company facing strong new competition may have to radically rethink its product offerings or pricing in order not to lose too much market share to the newcomer. A technological innovation may make a company's products obsolete (or at least less attractive), forcing it to work to catch up to the new technology. Ford made a defensive decision

when it recently decided to stop selling sedans in the United States because of slow sales compared to trucks and SUVs.

Operationalizing a Grand Strategy

A firm operationalizes its choice of a grand strategy differently at each level of strategy (business, corporate, international). At the business level, a growth strategy means that the manager will have to develop ways to grow the business by developing new products or expanding the customer base for existing products, either at home or abroad. Expanding a corporation can take a wider variety of forms. The CEO can develop new businesses, expand to new countries, acquire or merge with competitors, or perform previously outsourced activities. International expansion can be accomplished by exporting goods to another country or by acquiring a similar firm in another country to establish the company's presence in that country. In all three of these cases, the grand strategy would be growth, and the strategic objectives could be expressed in terms of revenue growth, profit growth, market share growth, or even share price growth. Table 9.1 outlines how a grand strategy can be used to develop specific company actions.

CONCEPT CHECK

1. What is the difference between strategic objectives and a strategy?
2. Describe the three levels of strategy and what a manager developing strategy at each level is concerned with.
3. What is a grand strategy, and how does it relate to strategic objectives and the three levels of strategy?
4. What are the three grand strategies, and why would firms pursue each of them?

9.5 Planning Firm Actions to Implement Strategies

5. How and why do managers plan? Why are goals important in the planning process?

When managers create strategies, they are making plans for how their firm will compete in the marketplace and what actions the firm will have to undertake to compete. A **plan** is a decision to carry out a particular action in order to achieve a specific goal. A plan includes decisions about when and how actions should be accomplished and what resources will be required to complete the actions. Because planning is one of the basic functions of management, a good manager should have good goal-setting skills, technical knowledge about the tasks necessary to reach goals, time-management skills, and the organizational skills required to arrange company resources to be available to complete the planned tasks. Planning is a combination of deciding what needs to be done, figuring out how to do it, assigning roles to people and providing them the resources to complete their tasks, and overseeing the work to make sure it gets done correctly and in a timely manner.

MANAGING CHANGE



Technology and Innovation: Amazon Puts Brick-and-Mortar Retailers on the Defensive

Amazon.com has become the place everyone buys from. It wasn't always that way, though. In 1995, Jeff Bezos founded Amazon in the garage of his house as an online book-selling company. Even then, however, he had a bigger mission: he wanted Amazon to be "an everything store." In a little over two decades, Bezos has achieved his vision by growing Amazon in almost every possible way. Amazon reaches across international borders, with 14 country-specific websites, and has expanded product offerings to include

almost anything a shopper might be looking for. They have developed their own products, like the Kindle reader and Echo/Alexa digital home assistant, and now, with the acquisition of Whole Foods grocery stores, Amazon operates physical "brick-and-mortar" stores. Amazon uses the expertise it has developed along the way to serve other online retailers by hosting their stores and also by offering other tech services.

Amazon's online business model has transformed how people shop, which has impacted the retail industry. Malls and brick-and-mortar stores have struggled to match Amazon's prices, selection, and convenience. **Exhibit 9.8** shows the stock market's reaction to retail's struggles: Amazon's share price has soared even as shares of stores such as Macy's and Best Buy have lost value.



Exhibit 9.8 Share Price Comparison: Amazon, Best Buy, and Macy's (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

How have traditional brick-and-mortar retailers adjusted their strategies and objectives in response to changing customer shopping habits? Clothing retailers like Macy's have had to adopt defensive strategies by lowering prices, reducing the number of locations, and expanding their own online sales capabilities. Big-box stores like Best Buy, in an effort to sustain their business, have fought back against "showrooming," the process that occurs when a customer visits a brick-and-mortar store to check out a product in person

and then goes home to order it online. To combat this practice, big-box stores offer installation services and price match the online retailers.

The transformation of the retail industry has hurt some stores, like Macy's, whose share price has declined as they shrink their operations in order to try to survive. Best Buy, on the other hand, is trying to adapt by choosing defensive actions that will maintain their operations. Best Buy has had some success in figuring out how to attract buyers in the era of online retail, and market investors have approved their actions, as shown in their share price increases. Will these retailers survive over the long term? It's hard to say. Macy's and JCPenney have announced that they are closing stores, and Sears recently filed for bankruptcy. Analysts have predicted the death of Best Buy for years and still think that over the long term, physical retail stores are going to have to become service providers to differentiate themselves from product retailers like Amazon. For example, in 2002, Best Buy acquired Geek Squad, a computer-repair company, in order to provide in-home computer repair services.

Sources: Hartmans, Avery (2017). "15 fascinating facts you probably didn't know about Amazon." *Business Insider*. http://www.businessinsider.com/jeff-bezos-amazon-history-facts-2017-4/#amazon-wasnt-the-companys-original-name-1. Accessed September 4, 2017; Amazon.com (2017). https://www.amazon.com/p/feature/rzekmvyjojcp6uc ; Radial (2016). "Best Buy Omnichannel Strategy: A Model for Other Brick-and-Mortar Retailers?" Radial.com. https://www.radial.com/insights/best-buy-omnichannel-strategy-model-other-brick-and-mortar-retailers. Accessed September 4, 2017; Garfield, Leanna (2017). "17 photos show the meteoric rise and fall of Macy's, JCPenney, and Sears." *Business Insider*. http://www.businessinsider.com/department-store-sears-macys-jcpenney-closures-history-2017-8. Accessed September 4, 2017; Isidore, Chris (2018). "Sears, the Store that Changed America, Declares Bankruptcy." *CNN Business*. https://www.cnn.com/2018/10/15/business/sears-bankruptcy/index.html . October 15, 2018; Kline, Daniel B. (2016). "Here's Why Even a Well-Run Best Buy Can't Compete." The Motley Fool. https://www.fool.com/investing/general/2016/01/23/heres-why-even-a-well-run-best-buy-cant-compete.aspx. Accessed September 4, 2017; Innosight, Clayton Christensen and (2007). "Mega-Merger Fever." *Forbes*. https://www.forbes.com/2007/08/31/christensen-megamergers-att-pf-guru_in_cc_0904christensen_inl.html#4f3a915a7f69. Accessed October 14, 2018.

Critical Thinking Questions

1. What PESTEL forces (see **Chapter 8**) have contributed to the transformation of the retail industry?
2. Amazon has entered into the brick-and-mortar store business with the acquisition of Whole Foods. Do you think this is a good move or a bad move for Amazon? Why?
3. What strategic actions do you think a store like Macy's can undertake to survive in the current retail industry?



Exhibit 9.9 Amazon's aggressive strategy has forced retailers like Macy's to shutter some of their underperforming stores, like this one in downtown Miami. (Credit: Phillip Pessar/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))

Goal Setting

To examine the planning process, we need to start by understanding what the planning is for. A **goal** is something that you are trying to accomplish, and any firm will have many items on its list of things to accomplish. Consider the situation of a Walmart store in a college town. When it's time for students to arrive back to school in the fall, the store needs to be ready with all the products students need when they move in. The Walmart store manager will plan months in advance and use information learned from the previous year's sales to decide what products to order and how many, and when to have extra staff in the store to efficiently check out increased numbers of shoppers. Note that since Walmart is a global firm, goals will likely be prescribed from a higher level and the store manager's responsibility would be to functional strategy response.

The manager's plans will take into account the lead time for ordering products to make sure that mini-refrigerators and twin XL sheets arrive and can be stocked in the store in time for the back-to-school rush. Preparing for the back-to-school season may involve reducing prices on other items to get them out of the way to make room for all those small refrigerators, and hiring and training additional employees so that there will be enough associates to help students and their parents. The manager's ultimate goal is to have a successful back-to-school sales season, but achieving that goal will involve completing tasks such as making product-selection decisions, meeting ordering deadlines, and setting intermediate goals for hiring and training additional employees.

Setting Good Goals: The SMART Framework

Good goals have a few common characteristics, and **Exhibit 9.10** presents a framework for creating good goals.

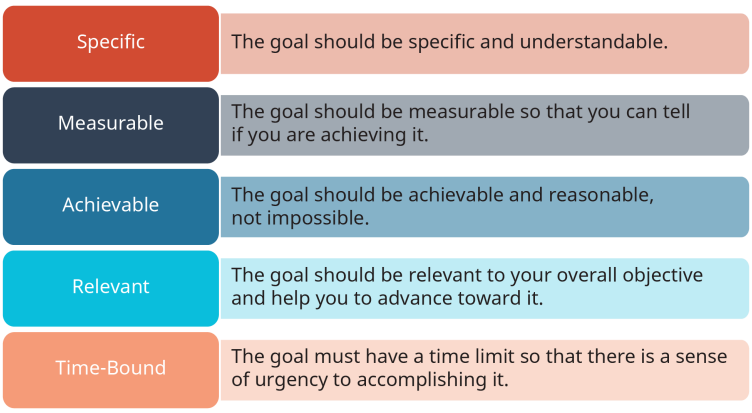

Exhibit 9.10 SMART Goals (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

The **SMART framework** can be applied to business or personal goals. A good goal should be **s**pecific, **m**easurable, **a**chievable, **r**elevant, and **t**ime-bound.

Say you want to do well in this class. You need to turn that into a specific goal, because "doing well" is a little vague. Make the goal more *specific* by stating that your goal is to get an A in this course. Is this goal *measurable*? Well, yes: grades are good examples of performance measures. Is your goal *achievable*? That's something you have to think about yourself: Do you usually get good grades? Are you able to put in the time to study the course material? Is the goal *relevant* to the achievement of a larger objective such as graduating with a good overall grade point average? If so, then getting an A in this class would contribute to that larger goal. Will you have *time* to accomplish your goal? Class-grade goals are inherently time-bound because the class ends on a certain date. So it's possible that getting an A in this class is an overall SMART goal. To achieve it, however, you have to set some shorter term goals—for example, you should set a SMART goal for getting an A on the next exam.

The Planning Process

Exhibit 9.11 illustrates the planning cycle. It looks a lot like the strategy cycle shown in Exhibit 9.3 because they have a lot in common. In fact, the planning process is an integral part of the strategy cycle, since developing objectives, creating strategies, and implementing firm-wide activities all require extensive planning.

The first step in planning is to set a goal to be accomplished. Making sure that the goal checks off all of the SMART criteria will help make the planning process easier and more likely to be successful, so be sure to spend some time developing a good goal.

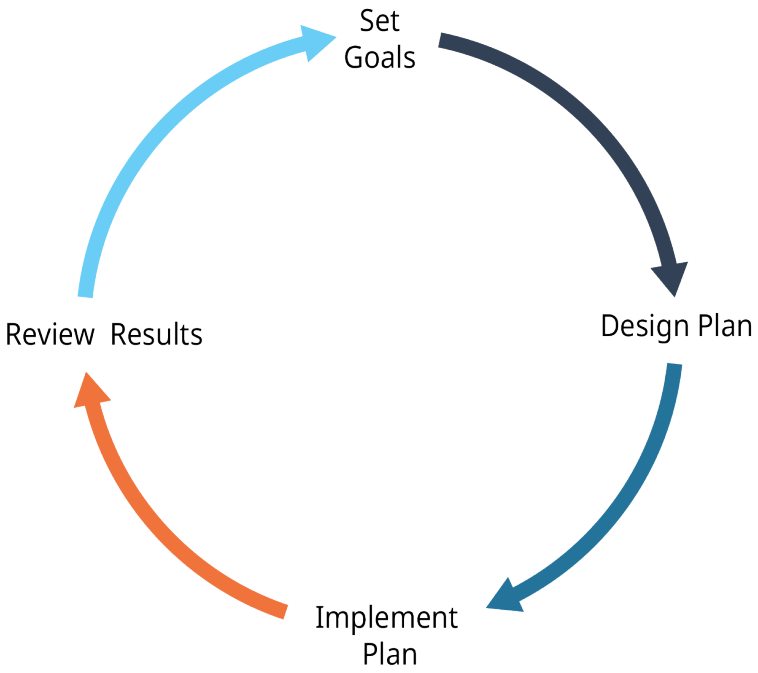

Exhibit 9.11 The Planning Cycle (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

Once you've figured out your goal, the next step is to design the plan. "Designing the plan" involves several distinct activities, so let's break it down into what needs to happen. Think of planning as a problem-solving exercise. A plan is a set of actions developed to accomplish a goal, and *planning* is essentially figuring out what those actions should be. The goal is the end point, and the plan answers the question "How do we get there?"

When designing a plan, a manager may think of many ways to achieve a goal. They or she can have a group of employees brainstorm to come up with ideas. Not all of the potential ideas are likely to be feasible, however. Part of the manager's task in designing a plan is to coordinate various ideas with a firm's resources and capabilities and its time constraints (see **Exhibit 9.12**). When does the goal need to be accomplished? What other resources does the firm need to complete the project?

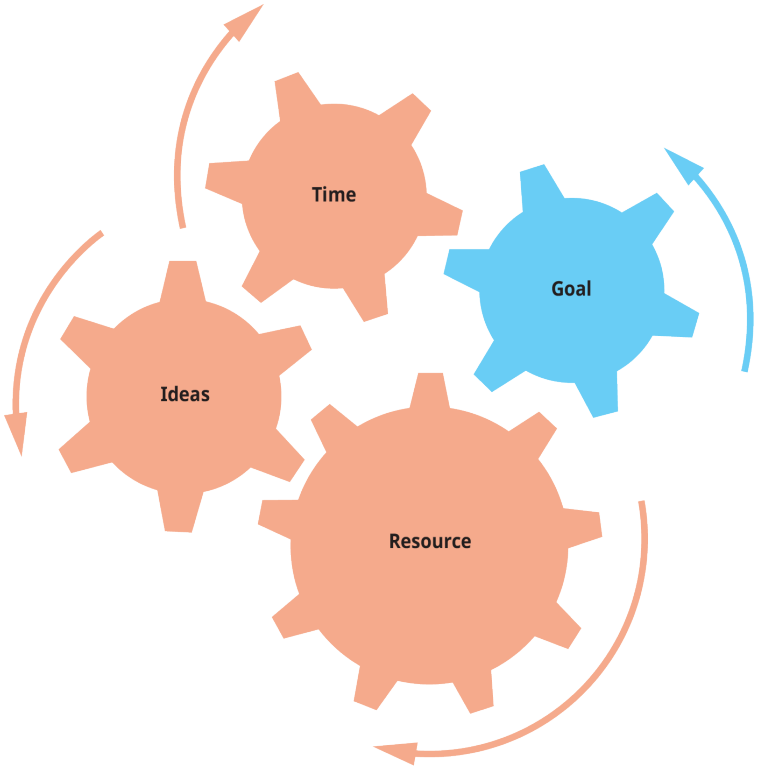

Exhibit 9.12 Planning Requires Coordination (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

Designing the plan becomes a puzzle of figuring out what is the best way to reach a goal with the resources the firm has or can reasonably get in the time available. There is no prescription for this, and the best way to learn how to plan is to practice. Fortunately, you probably have a pretty good amount of practice already, because you've been planning in one form or another for a long time. You have planned study time, team practices, club events, and even meals. Strategic planning uses the same skills in a new context. Planning a product launch may sound complicated, but so is planning a wedding. The scale and scope of the things a manager must coordinate in order to reach company goals may be larger than what you are used to, but the specific skills are likely not new at all.

For example, let's take a look at the challenge Tesla is currently facing.

Tesla has developed a mass-market car and has a line of about half a million customers waiting to buy one. Until now, Tesla has been more of a boutique car maker, manufacturing small numbers of cars that they are able to sell at high prices. The Model 3, however, has been specifically conceived as an affordable car that almost anyone can buy. The brand and reputation Tesla has built with its premium cars has generated a lot of enthusiasm and demand for this new model. So Elon Musk, CEO of Tesla, is planning to make cars in larger numbers and more quickly than ever before.

What's Tesla's goal? Manufacture cars at a rate of 500,000 per year in order to meet demand. Is this a SMART goal? Analysts around the world are arguing over this (is it achievable?), but it's the goal that Tesla is focusing on, so Musk has to design a plan to reach that goal. What resources does Tesla need in order to reach this level of production? They developed a car that is easy to manufacture, because they knew that they would want to build it in large numbers. Still, they need manufacturing facilities, parts, and production employees. To get these resources, they need money. Elon Musk is a spectacular fundraiser, but they need billions of dollars to develop manufacturing capabilities on this scale. So while Tesla builds the world's largest factory in Nevada, called the Gigafactory, Musk continues to raise funds.

Components (specifically the batteries) are also an issue for the Model 3, and Musk has built his giant factory in part to manufacture the hundreds of thousands of batteries needed to power the Model 3. Tesla's planning

involves many interrelated activities, and figuring out what the activities are, what resources Tesla needs to perform the activities, and how to obtain resources that they need but don't have yet are the challenges Elon Musk is tackling. Tesla is a fascinating company that is multifaceted. There have been serious questions raised about their ability to produce enough cars and an examination of more recent commentary is encouraged.

Implementing Plans for Different Levels of Firm Activity and Time Horizons

Developing plans happens simultaneously at multiple levels in any company. Plans, as in our earlier grade example, often require different steps in order to achieve a large-scale objective. If a firm decides on growth as a grand strategy, actions at every level of firm activity should contribute to firm growth, and managers at all of those levels should develop plans so that their part of the firm is working to implement the growth strategy. A grand strategy cascades throughout the company, becoming more and more specific, until front-line employees are working on specific tasks that support the grand strategy.

Time is an important consideration when top managers develop company goals and the plans to achieve them. In general, firms have two time spans that they plan for: short term and long term. A **short-term strategic plan** is one that can be accomplished in a year or sooner. A **long-term strategic plan** is developed when an objective cannot be accomplished in less than a year. Companies generally have both scales of plans in place at any given time: short-term plans might involve quarterly sales goals, for example, but a firm might have a longer-term goal of establishing operations in another country or building a new facility. Tesla's Gigafactory and Apple's new headquarters at Apple Park in Cupertino, California, are both multiyear, multibillion dollar projects, and so would be good examples of long-term plans. In Tesla's case, the Gigafactory was initially planned many years ago when the company knew that it wanted to mass-produce cars at the scale required for the Model 3.[7]

Scale Levels of Planning

Another dimension that impacts strategic planning is scale. We have already looked at some large-scale planning concepts, such as business-level and grand strategies. However, the day-to-day planning that managers do to take steps toward those bigger objectives is key to achieving success. Exhibit 9.13 shows the typical levels of planning going on in a company at any given time.

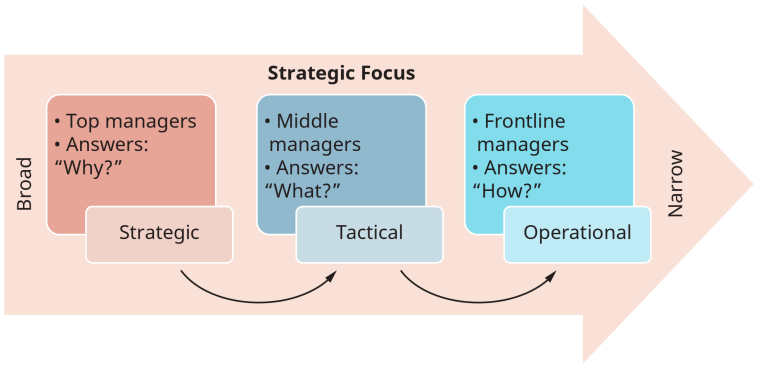

Exhibit 9.13 Levels of Strategic Planning (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

Notice that, if you compare Exhibit 9.13 to Exhibit 9.6, the "what" and "how" are switched. The switch is a scale switch. Vision and mission are both conceived at the broadest scale, and so even the "how" of the mission is a large-scale idea. In contrast, when managers are planning, the "how" of operational planning lays out precise actions and steps to follow to achieve a specific objective.

Let's look at the levels one by one. **Strategic planning** is what we've been discussing so far. It's the high-level planning performed by company executives in order to set the overall direction of the company. Grand strategies are part of strategic planning, as are business-level strategies such as cost leadership. Strategic planning connects the company's actions back to its vision and mission statements (the "why does this

company exist" question).

Tactical planning is mid-level planning that consists of broad ideas of what the company should do to pursue its mission. This is the sort of planning done by division managers. For example, Walmart division managers carry out the company's growth and cost-leadership strategies by finding ways for the company to grow and continue to be able to offer low prices. They may decide where to locate distribution centers to maximize store-stocking efficiency, which manufacturers of goods they can buy inventory from at low prices, and where to build new stores to attract more customers.

Operational planning lays out the front-line activities that each employee in the company will do to advance the tactical plans. A McDonald's restaurant manager develops operational plans, but you might recognize them more as employee schedules or promotional plans. Operational plans are the daily activities required for the company to function, including ordering inventory or supplies, scheduling workers and defining their work tasks, and developing sales goals and promotions to help achieve those goals. At McDonald's, as at other companies that pursue a cost-leadership strategy, scheduling enough employees to work in the restaurant at specific times to keep the store functioning smoothly without scheduling more than you need (and incurring excess labor costs) is a critical task for the manager, and doing that task successfully is how the manager contributes to the company's larger cost-leadership strategy.

Implementing Planned Strategies

Implementation of planned strategies refers to the execution of a strategy by assigning tasks for people to carry out to accomplish the company's strategic goals. Although a manager may talk about "implementing a differentiation strategy," the real implementation of a strategy happens at the bottom of not just the strategy hierarchy, but the organizational hierarchy, in the actions of operational employees who carry out planned tasks that add value to the company's product. Such tasks include research and development to add unique features, monitoring manufacturing to ensure company products meet high quality standards, and marketing the product to add brand value in the eyes of consumers.

CONCEPT CHECK

1. What are the three levels of planning, and what kinds of plans do managers develop at each level?
2. Why is strategic implementation most commonly carried out at the operational level?

9.6 Measuring and Evaluating Strategic Performance

6. How and why do managers evaluate the effectiveness of strategic plans?

The last step in the strategy cycle in **Exhibit 9.3** is measuring and evaluating performance. The "M" in SMART goals is also about measurement. A company's actions need to be measured so that managers can understand if the firm's strategic plans are working. Any action in a plan should be designed so that the people performing the action and the manager who is supervising employees can understand whether or not the action is accomplishing what it was designed to. You have been living in this sort of framework all of your life. For many life goals, standards exist to measure achievements. For example, students are given standardized tests to see if they are learning what they are expected to, and the results are used to assess the effectiveness of education at all levels.

In businesses, measurement is also a fact of life. Investors decide whether or not to invest in a particular company based on its performance, and publicly held companies are required to disclose their financial performance so investors can make informed decisions. So the overall performance of a business is often defined by its financial measures, but how do they make sure their financial performance will make investors

happy? Strategy. Firms make strategic plans in order to be successful. This chapter has explained the steps of making those plans, but a final step closes the circle of the strategy cycle. Checking to see if that success is happening is as important as making the plans in the first place.

Performance measurement comes in many forms, from financial reports to quality measures like defect rates. Any activity a firm can perform can have a performance measure developed to evaluate the success of that activity. Table 9.2 lists a few common firm objectives and how actions to achieve them might be evaluated. Evaluation involves setting a performance standard, measuring the results of firm activities, and comparing the results to the standard. One specific form of evaluation is called **benchmarking**, a process in which the performance standard is based on another firm's superior performance. In the hospitality industry, for example, Disney theme park operations are used as standards for other companies in the theme park industry. Universal theme parks, for example, likely compare their customer satisfaction to Disney's in order to evaluate whether or not they are also offering a superior park experience to their customers.

Three Different Actions to Support a Differentiation Strategy and Ways to Measure Results			
Strategic Plan	**Tactical Plan**	**Operational Plan**	**Performance Measure**
Product differentiation	Innovation	Hire three engineers to develop new products.	Number of new products launched
Product differentiation	Increase customer satisfaction	Improve customer service with hiring and training program for customer service associates.	Customer complaints per 10,000 products sold
Product differentiation	Quality improvement	Reduce defective products by improving manufacturing process accuracy.	Defect rate per 10,000 units produced

Table 9.2 (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

Performance evaluation closes the strategy cycle because of what managers do with the feedback they get in the evaluation process. When a manager compares performance to a standard, they are deciding whether or not the performance is acceptable or needs to be improved. The strategy cycle is a process managers use to achieve an advantage in the marketplace, and the measurement and evaluation stage tells managers whether the advantage is being achieved. If firm performance meets or exceeds objectives, then the manager reports the success to middle and upper-level managers. The company CEO may develop more ambitious objectives based on that success, and the strategy cycle starts over. If performance fails to meet objectives, the operational manager must develop new actions to try to meet the objectives or report to higher-level managers that the objectives cannot be met. In this case, a new round of operational planning begins, or upper managers examine their strategic plan to see if they need to make adjustments.

The strategy process is always circular. Performance feedback becomes part of the strategic analysis of the firm's capabilities and resources, and firm leadership uses the information to help develop better strategies for firm success.

CONCEPT CHECK

1. Why is performance evaluation critical in strategic planning?

2. How does the strategic planning process inform itself?

Key Terms

BCG matrix a tool used to evaluate the various business units in a corporation.
benchmarking a performance evaluation technique where the standard for a firm's performance is based on another firm's superior performance.
business-level strategy ways that single-product firms organize their activities to succeed against rivals; at this level, include cost leadership and differentiation.
corporate strategy the broadest level of strategy, concerned with decisions about growing, maintaining, or shrinking very large companies.
defensive strategy a grand strategy pursued by companies facing challenges.
goal something that a firm is trying to accomplish; can also be called an objective.
growth strategy a grand strategy to increase the size of the firm in terms of revenue, market share, geographic reach, or a combination of these elements.
implementation the execution of a strategy by planning and assigning actions to employees to carry out in order to accomplish the company's strategic objectives.
international strategy the level of strategy concerned with the large-scale actions involved in entering a brand-new geographic market.
long-term strategic plan company actions to achieve an objective that will take a year or longer to accomplish.
mission statement a general description of how the firm will try to accomplish the firm's vision.
operational planning first-line strategic planning consisting of specific daily and short-term actions that employees will perform to make the company function.
performance measurement the evaluation of firm activities to determine the success of that activity in helping the firm reach its strategic objectives.
plan a decision to carry out a particular action in order to achieve a specific goal, including decisions about when and how the action should be accomplished and what resources will be required to carry out the action.
short-term strategic plan company actions to achieve an objective in a time frame of a year or less.
SMART framework an acronym for the characteristics of good goals: specific, measurable, achievable, relevant, and time-bound.
stability strategy a grand strategy for a company that wants maintain its current income, market share, or geographic reach.
strategic analysis the systematic examination of a firm's internal and external situation that informs managerial decision-making.
strategic management process the set of activities that firm managers undertake in order to try to put their firms in the best possible position to compete successfully in the marketplace.
strategic objectives the big-picture goals for the company: what the company will do to try to fulfill its mission.
strategic planning connects the company's actions back to its vision and mission statements.
tactical planning mid-level strategic planning consisting of broad ideas of what a company should do to pursue its mission.
vision statement a broad expression of what a business's founders want that business to accomplish.

Summary of Learning Outcomes

9.1 Strategic Management

1. What is the strategic management process?

The strategic management process is the set of activities that firm managers undertake to put their firms in the best possible position to compete successfully in the marketplace. Strategic management is made up of several distinct activities: developing the firm's vision and mission; strategic analysis; developing objectives;

creating, choosing, and implementing strategies; and measuring and evaluating performance.

9.2 Firm Vision and Mission

2. What is the difference between a firm's vision and its mission?

A firm's vision is a broad statement expressing the reason for the firm's existence and what it hopes to accomplish. The mission statement explains (still broadly) how the firm intends to fulfill its vision—for example, by stating what products or services the firm will offer or what customers it wants to serve.

9.3 The Role of Strategic Analysis in Formulating a Strategy

3. Why is strategic analysis important to strategy formulation?

Strategic analysis produces information that managers need in order to develop appropriate strategies for their firms. A good strategy should use a firm's resources and capabilities to stake out a position in the marketplace that sets it apart from competitors and enables it to successfully compete in the external environment.

9.4 Strategic Objectives and Levels of Strategy

4. What are strategic objectives, levels of strategy, and a grand strategy? How are they related?

Strategic objectives are the big-picture goals for the company: what the company will do to try to fulfill its mission. These goals are broad and are developed based on top management's choice of a generic competitive strategy and grand strategy for the firm. For example, cost-leadership and growth competitive and grand strategies will require managers to develop objectives for growing the firm in a low-cost way.

Business-level strategy is concerned with positioning a single company or business unit that focuses on a single product or product line. The primary business-level strategies are cost leadership and differentiation, as well as focus, which is combined with one of the other two strategies (focus-cost leadership, focus-differentiation).

Corporate-level strategy is concerned with the management and direction of multi-business corporations. These large firms make decisions about what businesses and industries to operate in so they can improve their overall performance and reduce the risk they would face if all of their operations were concentrated in a single business or industry. Corporate CEOs use the BCG Matrix to evaluate their portfolio of businesses and use corporate actions like acquisitions to make significant changes to their companies.

International strategy can be combined with either of the previous two strategies to incorporate international operations into a business or corporation. International strategy answers questions of what country or countries to operate in and how to be successful in foreign operations.

Grand strategies outline an approach to firm growth. The three grand strategies are growth, stability, and defensive, and a firm chooses one of these approaches in addition to their choice of business-level, corporate, and/or international strategies. The choice of grand strategy is often dictated by conditions in the business environment such as recessions or competitor activities.

9.5 Planning Firm Actions to Implement Strategies

5. How and why do managers plan? Why are goals important in the planning process?

Managers plan in order to decide what actions the firm will perform in order to achieve a specific goal. Planning includes decisions about when and how the goal should be accomplished and what resources will be required to perform the planned action. Planning is one of the basic functions of management, along with organizing, leading, and controlling.

Firms typically have several levels of planning happening simultaneously: one based on time and another based on detail. The time scale is expressed in terms of short-term (within the year) or long-term (over a

yearlong) planning. Planning details become more specific as the manager moves downward in the hierarchy of planning levels. Strategic planning is the responsibility of firm leadership (CEO), while unit or division managers take the CEO's broad plans and focus them to be more suitable for their own units (tactical planning). Operational planning is the frontline manager's domain—they develop specific action plans for operational employees so that their work advances the entire firm towards the large-scale strategic goal.

Good goals are specific, measurable, achievable, relevant, and time-bound. These terms can be remembered by using the acronym SMART. Goals are critical to planning because they focus firm activities on specific objectives or outcomes.

9.6 Measuring and Evaluating Strategic Performance

7. How and why do managers evaluate the effectiveness of strategic plans?

Performance evaluation is to determine if plans have been successful and identify any changes that might be necessary. This is done both at the end and the beginning of strategic planning because when managers measure firm activities and progress towards objectives, the information they learn by doing that measurement becomes part of the analysis they use to develop improved plans and objectives to keep the firm on track to fulfill their mission and improve their overall performance.

Chapter Review Questions

1. What does a mission statement explain about a firm that a vision statement does not?
2. Describe the three levels of strategy and what a manager developing strategy at each level is concerned with.
3. Give an example for why a firm would pursue each of the three grand strategies.
4. What actions can help a firm grow?
5. What managerial skills and actions are included in the planning process?
6. Why are good goals important to the planning process?
7. What are the strategic planning time frames? How do they work together?
8. Why is performance measurement often the start of new strategy development?

Management Skills Application Exercises

1. (Analytical Skills) You have recently completed a leadership development program, and your company has given you a retail store to manage. The employees at your store are diverse in terms of age, race, gender, and fluency in English. Your company has told you to set individual performance objectives for your employees to increase your store's profitability.

    A. What specific types of actions do you think you should include in a plan to increase profitability in a retail environment?
    B. Would you set the same performance objectives for different store roles, for example sales associates and cashiers?
    C. Should your employees be involved in creating their own performance objectives? Why or why not?
    D. Should your communication of performance goals be adapted for the diversity of the employees you supervise? How and why (or why not)?

2. (Ethical skills) You have probably experienced a situation in which you were not happy with the service you received as a customer of a business. Put yourself in the shoes of the manager of a business, and think about the following:

    A. How does a company's vision and mission impact your approach to trying to appease an unhappy customer?
    B. Imagine that the company follows a cost-leadership strategy and has a "no cash refunds" policy in order to reduce company costs. What kind of plan or rules would you develop for your employees to

follow to deliver consistent customer service if a customer wants a refund?

C. When might it be ethical to violate the rules you developed in (b) above in order to deliver the right response to a customer service problem?

3. (Personal skills) Use the strategy cycle (**Exhibit 9.3**) to outline a strategy for yourself. What is your personal vision and mission? Analyze your current situation, and develop three personal, professional, or educational goals or objectives that you would like to reach within the next five years. Brainstorm some strategies to achieve those goals. Even though you can't really implement them in the context of this exercise, think about performance measures you might use to track your progress towards your objectives.



Managerial Decision Exercises

1. Each of the following statements is a goal or objective, but it is not expressed very clearly. Rewrite each statement as a SMART goal, and be ready to explain what you had to change to make it SMART.

   a. Amazon wants to improve product delivery times.
   b. Starbucks baristas should make customized drinks more quickly.
   c. Sales associates should sell more cars this month.
   d. McDonald's needs more customers at dinnertime.
   e. FedEx wants to compete with UPS.
   f. Boxed wants to reach more customers.
   g. Lyft wants to increase revenue.

2. Entrepreneurs must be strategic thinkers in order to develop the plans and objectives necessary to start a business that will last. Imagine you are starting a new music-streaming service. You have decided to differentiate your service from the others already in the marketplace. Think of three ways to add value to your service and also the performance measures you'll need to use in order to know if your added value is really valued by customers.



Critical Thinking Case

Interface Inc.'s Strategy for Sustainability

Watch Interface CEO Ray Anderson present his vision for Interface, Inc.:

https://www.youtube.com/watch?v=NskixbVn0BE

Interface, Inc. is the world's largest manufacturer of carpet tile. Headquartered in Atlanta, Georgia, the global company manufactures the kind of carpet that millions of commercial buildings of all types have on their floors. Carpet manufacturing is a historically dirty business. Not only is commercial carpet a petroleum-based product, the manufacturing process is water-intensive, and carpet squares are installed using toxic glue. Because this carpet is aimed at the commercial market (think schools, libraries, malls, office buildings), it usually does not have a long life span. Malls and schools regularly remove and replace carpet after just a few years because of fading and wear from daily foot traffic. This puts millions of square feet of old carpet into landfills annually.

In 1994, Ray Anderson, the founder of Interface, was put on the spot when he was asked what his company was doing to be sustainable. He realized that the answer to the question was, unfortunately, "not much." Anderson realized that in order to improve the company's sustainability performance, Interface was going to have to radically reimagine every part of their business.

Unlike what many CEOs in his position might have done, Anderson decided to do just that. He gave Interface a new vision, which he called Mission Zero. The objective was to reduce Interface's environmental impact to zero by the year 2020. To accomplish this vision, the company looked at every aspect of its operations and

developed what it called the "Seven Fronts of Sustainability":

Front #1—Eliminate Waste: Eliminate all forms of waste in every area of the business.

Front #2—Benign Emissions: Eliminate toxic substances from products, vehicles, and facilities.

Front #3—Renewable Energy: Operate facilities with 100% renewable energy.

Front #4—Closing the Loop: Redesign processes and products to close the technical loop using recycled and biobased materials.

Front #5—Efficient Transportation: Transport people and products efficiently to eliminate waste and emissions.

Front #6—Sensitizing Stakeholders: Create a culture that uses sustainability principles to improve the lives and livelihoods of all of our stakeholders.

Front #7—Redesign Commerce: Create a new business model that demonstrates and supports the value of sustainability-based commerce.

To achieve the seven sustainability goals, Interface needed to redesign their operations from start to finish and even reconsider what constituted the start and finish for their products. Anderson empowered employees and invested in research to develop new ways to design, manufacture, and install carpet tiles. Interface also reimagined how its clients would use and dispose of carpet tiles.

Changing the strategy of a successful company is always risky, but Anderson felt he had to take the risk. Developing action plans for such a radical change meant that every step of the business had to be rethought, and Interface is on the way to achieving Ray Anderson's vision. "Since January 2014, Interface's plants in Holland and Northern Ireland have been using around 90% less carbon and 95% less water than in 1996, with no waste going to landfill. Its plant in Scherpenzeel, Netherlands, has hit two of its zero targets."

How has Interface made these changes? In addition to changing the way they thought about their product's life cycle, Interface has implemented performance measures to track its progress and it has incentivized employees to be part of the company's successful redesign. Connecting company actions to real cost savings was a key part of Ray Anderson's vision. "Over time, programs that linked bonuses for employees at all company levels to reductions in waste started to put meat on the bones of Ray's 'business case for sustainability.'" Interface's costs have dropped as they have learned to use fewer resources to manufacture their products, and the cost savings have improved profitability even as Interface continues to invest in Mission Zero.

Critical Thinking Questions

1. What reaction do you think employees had when Ray Anderson announced he wanted to change the company's mission?
2. How would you turn the Seven Fronts of Sustainability into SMART goals?
3. How is tying rewards to improved sustainability performance a form of strategic control?

Sources: Interface Inc. company website: http://www.interfaceglobal.com/Company.aspx and sustainability site: http://www.interfaceglobal.com/Sustainability.aspx ; Thorpe, Lorna (2014). "Interface is a carpet-tile revolutionary." The Guardian Sustainable Business. https://www.theguardian.com/sustainable-business/sustainability-case-studies-interface-carpet-tile-revolutionary; Davis, Mikhail (2014). "Radical Industrialists: 20 years later, Interface looks back on Ray Anderson's legacy." Greenbiz.com. https://www.greenbiz.com/blog/2014/09/03/20-years-later-interface-looks-back-ray-andersons-legacy.