Ethics, Missions, Goals, and Governance

Why are you here? What do you want? What's your purpose? Individually there can be a lot of different motivations and purposes of individuals. You could easily have philosophical, materialistic, or theological answers to each of the above questions. Each response might lead to even more questions. For example, if you have materialistic motives you might want to ask how much money is enough?

Ethics. Whatever your answer to the above, it's a function of your ethics - How do you want to live your life? Ethics is a system or set of moral principles, where principle refers to first or highest in rank, while moral centers on the distinction between right and wrong. As a general rule, most people have established their morals (discovered via reflection or by adopting some revealed perspective, e.g. religion) by the time they reach young adulthood. Since your ethics are already in place, the focus here is more along the lines of thinking about the stresses that will be placed on your ethics and encouraging you to clearly define them and think about what you may have to sacrifice in order to remain true to them.

While ethics is easy to define, a much tougher question is what is ethical?

Not surprisingly there are many different schools of thought regarding what's ethical. The extremes are moral universalists versus moral relativists. The universalists say that there are some common moral rules that should apply to everyone. The most famous of these are the fundamental rules of common morality:

> promise keeping - do what you say you will do;
> non-malevolence - don't seek to harm others, note this doesn't equal benevolence;
> mutual aid - help others in visible distress;
> respect for persons - humans are ends in and of themselves, don't treat as a means; and,
> respect for property - don't harm another's property.

Some of the best evidence for moral universalism is that almost every major religion includes these principles in some form or another. However, the relativists say that all ethics are subjective and therefore vary for each individual and society. This makes it impossible to make ethical judgments. This school of thought was in ascendancy right before World War Two (1939-1945) in Europe and right before the terrorist attacks of 2001 in the United States.

Your Ethics & Business. While the philosophers have helped us as individuals decide what is ethical, it is an especially difficult question for those in business because capitalism has a minor drawback. The capitalist economic system treats us as a means to an end. Therefore, many people believe that business is inherently unethical and that "business ethics" is an oxymoron. Interestingly, others say there shouldn't be a special set of ethics for business - there are simply ethics. While it may be tempting to simply reject these challenges out of hand they merit consideration.

There is a reason that most modern philosophers are Marxist. Like it or not, capitalism treats us as a means to an end. Unless an organization is losing money, an inherently unstable position, we have to assume that the organization is making more money off of its workers than it is paying them in wages and benefits. Under capitalism businesses essentially "use" people and we "use" each other. This is a clear violation of "respect for persons" and why Marxism and communism have such a strong ethical appeal to many.

Ready to become a Marxist? Please don't, because capitalism is an awesome economic system that has freedom at its heart. Recall that the purpose of economic systems is to efficiently

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allocate scarce resources. That is only a part of "how do you want to live your life." So a response to the ethical limitations of capitalism is that yes, it does treat people as a means to an end, but it almost always does so with their explicit permission and with them reciprocating the "use." For example, I freely go to Wal-Mart not because WMT cares about me or loves me but because that is where the cheap stuff is.

So, capitalism takes our self-interest and uses it to benefit society - the way to get more stuff is to provide something that others want - signaled via *their* willingness to pay - with our competing demands coordinated by prices. Selfish people destroy a communist system because the system cannot correct for them - they become rich while everyone else becomes poor. Capitalism turns selfish people into productive members of society - they become rich by helping others be better off. We may disagree that they should be rich, e.g. the Kardashian's, but they became so by helping others as demonstrated by their willingness to pay. While there are often huge wealth disparities in capitalist systems, this is frequently because of intergenerational wealth transfers or in situations where capitalism really isn't operating (e.g. lawsuits, executive compensation). As an *economic* system capitalism has no peer.

Therefore, a response to the critics of capitalism is that yes, capitalism has ethical problems, something that was recognized by its initial proponent, Adam Smith, way back in 1776 when he thought it up.[1] However, there is no reason that capitalism should be the sum total of a person's existence, after all it's an economic system, and economic systems make for crummy ethical systems.

However, here is where it pays to think about what you want very seriously, because even if it has not already, at some point capitalism is going to give you the opportunity to trade part of your soul for "stuff." There is a very real chance that one day you will be compelled to violate what you thought were your ethical beliefs or lose your job or business. It wont be very dramatic. It will probably be something like deceiving a customer to make a sale, or as thousands of Americans did in 2006-07, sign loan papers that listed their income incorrectly.[2] Please, prepare now! To the extent financial security is important to you, or will become important to you if you have a family to provide for, carefully consider how much you want. Be honest with yourself, there is no shame in liking stuff, but there is shame in lying to yourself. After all, evil never considers itself evil, different, amoral, simply an engine for change, or even good, but never evil.

The firm's purpose - its mission statement. Just like humans may have a generic purpose like "being happy" firms have "maximize share holder value." This is almost a mantra in finance classes. While this is a great leap forward from increasing market share (the prior goal of every firm) it is still a deceptively simple question. What is this? How do we do it? Does it really make sense for every firm to have the same purpose?

There is some debate about the relationship between a few related terms: mission statement, strategic intent, and goals. Semantic differences at this high a level are not that critical, *the critical issue is if the workers in the firm are thinking about what they are collectively trying to accomplish*. If they are, then they may discover new ways to accomplish it (e.g. innovate) or work with more focus and direction (e.g. enhanced motivation). You can see that in order to accomplish this some formal declaration of what the company is trying to achieve might be in order, let's call this the mission statement. A mission statement articulates the purpose and scope of the organization. A good mission statement helps workers in an organization focus their actions:

[1] This is also why institutions such as rule of law are important for capitalism to work successfully.
[2] A great story of this, albeit from an unusual source is at:
http://www.pbs.org/cringely/pulpit/2008/pulpit_20080704_005191.html

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Why does firm performance differ? → Focus and direction of the actions taken by its members.

However, in order to be useful to an organization, to facilitate its employees' focus and organizational alignment (see Implementation), a mission statement must be two things. First it must be understandable. Do customers, workers, and owners (i.e. all the stakeholders - see below) understand what it means? Second, the mission statement should differentiate the organization from other organizations. This will help guide the setting of goals that will help the organization achieve its unique purpose. This is why spending some time on a mission statement can be worthwhile, though too frequently it is a joke.[3]

Goals. Coming from the mission statement are goals - a desired future state. Any goal **must** be specific (or precise) and measurable. Other potentially desirable aspects of goals include addressing important issues, being challenging yet realistic, and specifying a time period.[4] However, each of these latter three ideas is up for considerable debate. For example, do you think "world peace" would be a good goal for an organization? Why or why not?

The Firm's Ethics (Business Ethics). A good question to think about for the implications of business and ethics is the issue of placing a value on our life. How much money would you take for a one in a million chance of dying? Keep in mind, you implicitly do this every day, as life is full of microscopic risks that we incur in exchange for convenience. If this could be done on a massive scale, then business ethics could be reduced to little more than a cost benefit calculation. However, it cannot, and business decisions do have serious consequences, safety standards[5] are obvious, but even things like lay offs can have important mental health and well being consequences. Therefore, since they affect people, business decisions do have a moral component.

The most devastating perspective of business ethics came in a New York Times article by Milton Friedman.[6] The noble prize winning economist savages the idea of business ethics by pointing out the only purpose for the firm is to maximize shareholder value within the laws of the nation states it operates in. This is a powerful critique and efforts to respond to it have had only limited empirical success.

However, there is one critical weakness, in the United States at least, of this argument. Laws of nations are NOT stable, they can change. Therefore, a company whose conduct can be seen as unethical, yet abides strictly to the existing laws, can be unpleasantly surprised when the laws do change. This is especially common in the United States because of tort laws. A tort is an implicit duty that we all have but that are not codified into law. In the U.S. entire industries have been decimated because of tort lawsuits, e.g. asbestos and civil aviation, or forced to pay considerable sums, e.g. tobacco companies.

Therefore, since laws and regulations are made by people based on their collective individual ethical systems (at least in democracies), individuals responsible for making business decisions ignore them at their own peril. Adopting an economic system, e.g. capitalism, as a model for one's ethical system, setting aside the potential damage to one's soul, can easily lead to disastrous results for one's organization.

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[3] See for example the "Mission Statement Generator" at www.dilbert.com/comics/dilbert/games/career/bin/ms.cgi
[4] Drucker, *The Practice of Management*, 1954.
[5] Safety standards are generated using the value of a "statistical life" usually calculated by the EPA.
[6] Friedman, M. The Social Responsibility of a Business is to Increase its Profits, *New York Times Magazine*, 30 September, 1970, pp. 122-5.

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A business's "ethics" are often manifested in how it orders its stakeholders. Who comes first, workers, stockholders, customers, top executives?

Stakeholders. A large number of corporate goals focus on shareholders. Why might this be?[7] (NOTE: It is okay to mix shareholders with stockholders, as they are the same. However, remember that shareholders or stockholders are only examples of stakeholders, which is a much broader concept. Please be watchful!)

Rather than an exclusive focus on shareholders, it may be helpful to have broader view. This was how the idea of stakeholders came into broad usage. But before discussing this we need to make a quick detour to power.

We are going to talk about power from time to time. While there are lots of definitions of power the broadest one centers around the idea of uncertainty. In any organization or relationship the person that addresses the most or most important uncertainty will have the most power. This is often phrased as power is the ability to absorb others' uncertainty. You can think about this in your own life by thinking about how the amount of power your parents have over you has changed. So a key issue becomes: Who has power in firms?

A place to start the answer to this question is who influences the firm? A stakeholder is anyone who influences or is influenced by an organization. This could be a very long list. Stakeholders can be divided into internal and external and are best ordered according to the influence they have on an organization, i.e. power. Stakeholders are important because the firm must make sure that their contributions are balanced by their inducements. Generally stakeholders will provide different things to the organization and want things that conflict from the organization. Managers must make the difficult (political) decisions of who gets what in the organization. This decision should be modeled on who provides what contributions to the organization. The term for this is stakeholder analysis - systematically listing the organizations stakeholders, their contributions, inducements, and any conflicts they might have. When you have questions over who makes the most important contributions, the key metric to use is either power, i.e. who takes away uncertainty for an organization, or ethics. How a company winds up ordering its stakeholders is a good gauge of its ethics.

Corporate Governance. Corporate governance refers to who is ultimately responsible for the actions taken by the firm. While most attention is on the CEO, it is usually helpful to look at a slightly broader group - the top management team (hereafter, TMT) that is charged with allocating firm resources to all the various stakeholders. As stakeholders, there is a strong tendency to allocate considerable firm resources to themselves. This often consists of on the job consumption (using firm resources for private benefit), excessive pay, and empire building (expanding for expansion's sake). Another problem is that TMT members have a tendency to be more risk adverse than shareholders would want. This is counter intuitive but occurs because while it is easy for a stockholder to diversify their risk by owning stock in many different companies, a TMT member cannot diversify their job. Therefore, they will pass up risky projects that a shareholder would want them to take. Overcoming this interesting problem explains aspects of corporate governance including why stock *options* are preferable to stock grants for executive compensation and why golden parachutes - giving a fired executive a large payout - might make sense.

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[7] Shareholders are the legal owners is the most common explanation, but why are the owners more important than customers or workers? After all, we expect workers to make many firm specific investments (see _____). Another explanation is that shareholders came to prominence when capital was scarce in the late 70s early 1980s. Before that, employees usually dominated. Also, shareholders are the most liquid of stakeholders.

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The theoretical foundation for the problems of corporate governance is the classic principle-agent problem. This problem occurs whenever the managers of a company are not its owners. This problem is common in management and basically consists of an owner, the principle, trusting a more knowledgeable agent, the manager, with the conduct of their affairs. Since the agent has better information, there is said to be information asymmetry between the two. The problem of course is that the agent may exploit their superior information and choose to act opportunistically against the principle.

Fortunately, there are several safeguards that, in theory, prevent self-serving behavior as well as other unwise allocation decisions by the TMT at the expense of the shareholders. The most important limit is the board of directors (BoD) who are ultimately responsible to the shareholders for the management of the firm and protecting shareholder interests. Board members are nominated by the chairman of the board and are ratified by all shareholders. They in turn hire and fire the CEO and possibly other members of the TMT. They also review and approve major actions of the firm such as acquisitions and major projects. Another important control mechanism is using stock option grants as a major form of executive compensation. Stock options give the managers the right but not the obligation to buy stock in the company at some future time point but at today's stock price. The idea being that this opportunity to purchase a future ownership stake will link TMT incentives to stockholder incentives. The TMT is encouraged to pursue good projects because if they go well and the firm makes money they will benefit from the rise in the stock price. If things don't work out, the TMT members don't make as much money as they otherwise would have, since the stock options don't have much (or any value), but they don't lose anything and do still have their job.

Unfortunately, these safeguards are often overcome. CEO duality is the most common way that the oversight of the board can be constrained. The chairperson of the board nominates its members that in turn are ratified by the stockholders. A dual CEO is a CEO that serves both as CEO and as Chairperson of the Board. About 60% of large U.S. corporations have dual CEOs. Can you see the potential problem? A dual CEO has the opportunity to appoint the people that are charged with monitoring the CEO's conduct and approving their pay packages. So there is a large temptation to appoint one's "friends and family" to the board. Since shareholders who don't vote in proxy contests have their shares counted as voting with the board, approval of whomever the chairperson selects is almost always automatic. This is how oversight from the board of directors is easily manipulated by opportunistic CEOs. Disney's Michael Eisner is perhaps the most famous example of this. At one time or another, his personal lawyer, architect, personal friend, and the headmistress of the private school where he sent his kids were members of Disney's board. The good news is that recent corporate scandals have resulted in more board members being chosen by a nominating committee rather than just the chairperson.

There is a legitimate reason for CEO duality. Often, a CEO will be hired to turn around a troubled company. Under these circumstances the CEO can make a legitimate case that he or she needs to be focused on the company and not being second guessed by the board of directors. However, it is questionable if 60% of large U.S. companies fit this situation.

Stock options have also developed some serious problems. First, stock options are expensive, but financial reporting standards allow considerable discretion and do not track fair value models such as Black-Scholes. Therefore shareholders are paying executives very large amounts of compensation but are not always fully aware of it. Another problem is that there are many reasons besides the value adding activities of TMT that a stock price may go up or down. Finally, many companies "back dated" their stock option grants to give the TMT an artificially low price to buy their future shares. Thus stock options have generally led to expansion of TMT incomes, not necessarily better corporate governance.

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One additional control that is frequently discussed is the "market for corporate control." The idea is that if the TMT of a publicly traded firm is doing poorly then another group will come along and buy the firm and do a better job of managing it. There was a lot of this in the 1980s when these individuals were called "corporate raiders." Take over defenses such as poison pills and staggered board elections have served to virtually end hostile takeovers today. What is more common is large private investment pools such as hedge funds working with existing management to buy out a company, a so-called "leveraged buy out."[8] While different than a hostile takeover, the net effect is that shareholders are bought out and the new owners attempt to realize more value from the firm's assets.

The new Sarbanes-Oxley (SARBOX) law has changed corporate governance a bit by requiring more internal controls. However, despite the positive changes of this law, corporate governance promises to be a major issue going forward for large firms.

There's nothing wrong with making shit tons of money, but you don't have to fuck people over to do it. –Kid Rock 7 June 2013 in the WSJ on Ticketmaster and his $20 concert tour

[8] It's called a leveraged buy out because it is usually financed with debt, "leverage" in financial parlance.

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