2

The Context of Strategic Management

chapter objectives

After reading this chapter, you should have a good understanding of:

LO 1 The effects of globalization and business ethics on today's organizations and on the nature of competition.

LO 2 The sources of national advantage; that is, why an industry in a given country is more (or less) successful than the same industry in another country.

LO 3 The potential benefits and risks of international expansion.

LO 4 The vital role of corporate governance and stakeholder management as well as how "symbiosis" can be achieved among an organization's stakeholders.

LO 5 The importance of social responsibility including environmental sustainability.

Globalization and business ethics are two pervasive factors that play important roles in all organizations' strategic management activities. The global marketplace provides many opportunities for firms to increase their profits, but it also presents potential pitfalls that firms must avoid. Meanwhile, firms face considerable pressure to conduct their activities in ways that meet high moral standards. Globalization and business ethics have accelerated the rate of change that executives face, making it essential that executives understand key aspects of both in order to maximize their chances of leading their firms toward success. Together, these two factors create a context within which the strategic management process takes place.

After some introductory comments on the global economy, we address the question: What explains the level of success of a given industry in a given country? To provide a framework for analysis, we draw on Michael Porter's "diamond of national advantage," in which he identified four factors that help to explain performance differences across national borders.

In the second section of the chapter, we shift our focus to the level of the firm and discuss some of the major motivations and risks associated with international expansion. Recognizing these potential benefits and risks enables executives to better assess the growth and profit potential in a given country. We also address important issues associated with a topic of growing interest in the international arena—offshoring and outsourcing.

Next, we consider three key aspects of business ethics: corporate governance, stakeholder management, and social responsibility. Corporate governance addresses the issue of who "governs" the corporation and determines its direction. It consists of three primary participants: stockholders (a firm's owners), executives (led by the chief executive officer), and the board of directors (elected by stockholders to monitor executives). Stakeholder management recognizes that the interests of various stakeholders such as owners, customers, and employees can conflict and create decision-making dilemmas. However, we discuss how some firms have been able to achieve "symbiosis" among stakeholders wherein their interests are considered interdependent and can be served simultaneously. We also discuss the importance of social responsibility, including the need for firms to incorporate environmental sustainability in their strategic actions.

LEARNING FROM MISTAKES

Wal-Mart, the world's largest retailer, certainly didn't have a good year in 2006.[1] There were executive turnover problems—such as the resignation of Sam's Clubs marketing head Mark Goodman and the embarrassing firing of Julie Roehm, the young advertising whiz whom Wal-Mart had hired away from DaimlerChrysler. Also, there were ongoing legal problems—a Philadelphia jury ordered Wal-Mart to pay $78 million to a class of 185,000 workers who had claimed that they were denied breaks and forced to work off the clock.

There were also business setbacks: same-store sales were up only 1.6 percent (while those of Costco and Target were up 9 percent and 4.1 percent, respectively). Wal-Mart's stock was flat in an otherwise strong year for equities. In fact, from the period of January 2000 (when Lee Scott took over for David Glass as CEO) to early 2007, the stock had fallen 22 percent.

The company had also had its share of setbacks overseas. Wal-Mart took a $900 million charge after its forays into Germany and South Korea failed. Let's take a closer look at what might explain its 2006 exit from South Korea—a market it entered in 1998.

Wal-Mart was never successful in South Korea. They were slow in opening stores—failing not only in winning customers but also in building enough market share to press suppliers on pricing. The core of their problem was an inability to adapt to local markets. As noted by Na Hong Seok, an analyst in Seoul: "Wal-Mart is a typical example of a global giant who has failed to localize its operations in South Korea."

Wal-Mart put off South Korean consumers by sticking to Western marketing strategies that concentrated on dry goods, from electronics to clothing. Their rivals, on the other hand, focused on food and beverages, the segment that specialists say attracts South Koreans to hypermarkets. In South Korea, fresh, quality food is a key ingredient of success. It typically generates half of a store's revenues. To make matters worse, one of Wal-Mart's competitors, E-Mart, even owned its own farms that supplied its stores.

Wal-Mart also ran into problems with a membership approach that was similar to the one used by its Sam's warehouses. According to Song Kye-Hyon, a financial analyst: "It turned out to be a strategic flaw of Wal-Mart when it first adopted the Western policy of the membership where customers were required to pay a membership fee for shopping privileges."

Further, Wal-Mart had difficulty overcoming some of the mechanisms that some of its rivals had developed to create greater customer loyalty. Some employed green-capped young men who helped bring the shopping carts to the customers' cars in the parking lot. Further, rivals operated shuttle buses to go through neighborhoods to pick up customers and drop them off at their homes after they completed their shopping. Simply put, Wal-Mart did not adapt to the local market conditions by investing the resources necessary to achieve some level of parity on such customer service initiatives.

In the end, Wal-Mart continued to flounder until it sold all 16 of its South Korean outlets in May 2006 to Shinsgae, a local retailer. Consistent with its long-term problems in the South Korean market, Wal-Mart lost $10.4 million on revenues of $787 million in 2005—its last full year of operations. Wal-Mart's vice chairman, Michael Duke, summed up the situation quite well: "As we continue to focus our efforts where we have the greatest impact on our growth strategy, it became increasingly clear that in South Korea's environment it would be difficult for us to reach the scale we desired."

In this chapter we discuss how firms can create value and achieve competitive advantage in the global marketplace. We also discuss how firms can avoid pitfalls such as those experienced by Wal-Mart in South Korea and by other firms such as Tyco and Enron, which have stumbled in dealing with ethical issues. In our view, globalization and business ethics provide an important "context" that shapes how well firms perform in today's economy.

LO1 The effects of globalization and business ethics on today's organizations and on the nature of competition.

THE GLOBAL ECONOMY: A BRIEF OVERVIEW

Managers face many opportunities and risks when they diversify abroad.[2] The trade among nations has increased dramatically in recent years and it is estimated that by 2015, the trade *across* nations will exceed the trade within nations. In a variety of industries such as semiconductors, automobiles, commercial aircraft, telecommunications, computers, and consumer electronics, it is almost impossible to survive unless firms scan the world for competitors, customers, human resources, suppliers, and technology.[3]

GE's wind energy business illustrates the benefits of tapping into talent around the world. The firm has built research centers in China, Germany, India, and the United States.

"We did it," says CEO Jeffrey Immelt, "to access the best brains everywhere in the world." All four centers have played a key role in GE's development of huge 92-ton turbines. How did each contribute?[4]

- Chinese researchers in Shanghai design the microprocessors that control the pitch of the blade.
- Mechanical engineers from India (Bangladore) devise mathematical models to maximize the efficiency of materials in the turbine.
- Power-systems experts in the United States (Niskayuna, New York—which has researchers from 55 countries) do the design work.
- Technicians in Munich, Germany, have created a "smart" turbine that can calculate wind speeds and signal sensors in other turbines to pitch their blades to produce maximum electricity.

The rise of globalization—meaning the rise of market capitalism around the world—has undeniably contributed to the economic boom in America's New Economy, where knowledge is the key source of competitive advantage and value creation. It is estimated that it has brought phone service to about 300 million households in developing nations and a transfer of nearly $2 trillion from rich countries to poor countries through equity, bond investments, and commercial loans.[5]

Without doubt, there have been extremes in the effect of global capitalism on national economies and poverty levels around the world.[6] Clearly, the economies of East Asia have attained rapid growth, but there has been comparatively little progress in other areas of the world. For example, income in Latin America grew by only 6 percent in the past two decades when the continent was opening up to global capitalism. Average incomes in sub-Saharan Africa and the old Eastern European bloc have actually declined. Indeed, the World Bank estimates that the number of people living on $1 per day has *increased* to 1.3 billion over the past decade.

Such disparities in wealth among nations raise an important question: Why do some countries and their citizens enjoy the fruits of global capitalism while others remain or become more deeply mired in poverty? Or, why do some governments make the best use of inflows of foreign investment and know-how and others do not? There are many explanations. Among these are the need of governments to have track records of business-friendly policies to attract multinationals and local entrepreneurs to train workers, invest in modern technology, and nurture local suppliers and managers. Also, it means carefully managing the broader economic factors in an economy, such as interest rates, inflation, and unemployment, as well as a good legal system that protects property rights, strong educational systems, and a society where prosperity is widely shared.

The above policies are the type that East Asia—in locations such as Hong Kong, Taiwan, South Korea, and Singapore—has employed to evolve from the sweatshop economies of the 1960s and 1970s to industrial powers today. On the other hand, many countries have moved in the other direction. For example, in Guatemala only 52.0 percent of males complete fifth grade and an astonishing 39.8 percent of the population subsists on less than $1 per day.[7] (By comparison, the corresponding numbers for South Korea are 98 percent and less than 2 percent, respectively.)

Focus on . . . Strategy 2.1 provides an interesting perspective on global trade—marketing to the "bottom of the pyramid." This refers to the practice of a multinational firm targeting its goods and services to the nearly 5 billion poor people in the world who inhabit developing countries. Collectively, this represents a very large market with $14 trillion in purchasing power.

FOCUS ON… STRATEGY 2.1

Marketing to the "Bottom of the Pyramid"

Many executives wrongly believe that profitable opportunities to sell consumer goods exist only in countries where income levels are high. Even when they expand internationally, they often tend to limit their marketing to only the affluent segments within the developing countries. Such narrow conceptualizations of the market cause them to ignore the vast opportunities that exist at "the bottom of the pyramid," according to University of Michigan professor C. K. Prahalad. The *bottom of the pyramid* refers to the nearly 5 billion poor people who inhabit the developing countries. Surprisingly, they represent $14 trillion in purchasing power! And they are looking for products and services that can improve the quality of their lives such as clean energy, personal-care products, lighting, and medicines. Multinationals are missing out on growth opportunities if they ignore this vast segment of the market.

Innovative firms have found creative ways to serve the poor and still make a profit. Grameen Bank in Bangladesh is very different from the money center banks of London or New York. Pioneers of the concept of micro-credit, Grameen Bank (whose founder, Muhammad Yunus, won the 2006 Nobel Peace Prize) extends small loans—sometimes as small as $20—to thousands of struggling micro-entrepreneurs who have no collateral to offer. (The value of microcredit loans soared from $4 million to $1.3 billion between 1996 and 2006.) Not only are their loan recovery rates comparable to big banks, but they are also changing the lives of thousands of people while making a profit as well. Casas Bahias, the Brazilian retailer, has built a $2.5 billion-a-year chain selling to the poor who live in the *favelas,* the illegal shanty towns. Another amazing example is Aravind Eye Care, an Indian hospital that specializes in cataract surgeries. Today, they are the largest eye care facility in the world, performing more than 200,000 surgeries per year. The secret of their volume: The surgeries cost only about $25! A comparable surgery in the West costs $3,000. And best of all, Aravind has a return on equity of more than 75 percent!

As the above examples demonstrate, in order to sell to the bottom of the pyramid, managers must rethink their costs, quality, scale of operations, and even their use of capital. What prevents managers from selling to this vast market? Often they are victims of their own false assumptions. First, they think that the poor have no purchasing power. But $14 trillion can buy a lot. Second, they assume that poor people have no need for new technologies. We only have to see the demand for cell phones from entrepreneurs who run microbusinesses in villages in India to dispel this myth. Third, they assume that the poor have no use for their products and services. Shampoo, detergents, and banking satisfy universal needs, not just the needs of the rich. Fourth, they assume that managers may not be excited about working in these markets. Recent experience shows that this may be a more exciting environment than dogs fighting for fractions of market shares in the mature markets of the developed countries.

No one is helped by viewing the poor as the wretched of the earth. Instead, they are the latest frontier of opportunity for those who can meet their needs. A vast market that is barely tapped, the bottom of the pyramid offers enormous opportunities.

Sources: Miller, C. C. 2006. Easy money. *Forbes* November 27: 134–138; Prahalad, C. K. 2004. Why selling to the poor makes for good business. *Fortune,* 150(9): 32–33; Overholt, A. 2005. A new path to profit. *Fast Company,* January: 25–26; and Prahalad, C. K. 2005. *The fortune at the bottom of the pyramid: Eradicating poverty through profits.* Philadelphia: Wharton School Publishing.

Next, we will address in more detail the question of why some nations and their industries are more competitive. This establishes an important context or setting for the remainder of the chapter. After we discuss why some *nations and their industries* outperform others, we will be better able to address the various strategies that *firms* can take to create competitive advantage when they expand internationally.

LO2 The sources of national advantage; that is, why an industry in a given country is more (or less) successful than the same industry in another country.

FACTORS AFFECTING A NATION'S COMPETITIVENESS

Michael Porter of Harvard University conducted a four-year study in which he and a team of 30 researchers looked at the patterns of competitive success in 10 leading trading nations. He concluded that there are four broad attributes of nations that individually, and as a system, constitute what is termed "the diamond of national advantage." In effect, these attributes jointly determine the playing field that each nation establishes and operates for its industries. These factors are:

- *Factor conditions.* The nation's position in factors of production, such as skilled labor or infrastructure, necessary to compete in a given industry.
- *Demand conditions.* The nature of home-market demand for the industry's product or service.
- *Related and supporting industries.* The presence or absence in the nation of supplier industries and other related industries that are internationally competitive.
- *Firm strategy, structure, and rivalry.* The conditions in the nation governing how companies are created, organized, and managed, as well as the nature of domestic rivalry.

We will now briefly discuss each of these factors.[8] Then we will provide an integrative example—the Indian software industry—to demonstrate how these attributes interact to explain India's high level of competitiveness in this industry.

FACTOR CONDITIONS[9]

Classical economics suggests that **factor conditions**—factors of production such as land, labor, and capital—are the building blocks that create usable consumer goods and services.[10] But this tells only part of the story when we consider the global aspects of economic growth. Companies in advanced nations seeking competitive advantage over firms in other nations *create* many of the factors of production. For example, a country or industry dependent on scientific innovation must have a skilled human resource pool to draw upon. This resource pool is not inherited; it is created through investment in industry-specific knowledge and talent. The supporting infrastructure of a country—that is, its transportation and communication systems as well as its banking system—are also critical.

factor conditions
A nation's position in factors of production.

To achieve competitive advantage, factors of production must be developed that are industry and firm specific. In addition, the pool of resources a firm or a country has at its disposal is less important than the speed and efficiency with which these resources are deployed. Thus, firm-specific knowledge and skills created within a country that are rare, valuable, difficult to imitate, and rapidly and efficiently deployed are the factors of production that ultimately lead to a nation's competitive advantage.

For example, the island nation of Japan has little land mass, making the warehouse space needed to store inventory prohibitively expensive. But by pioneering just-in-time inventory management, Japanese companies managed to create a resource from which they gained advantage over companies in other nations that spent large sums to warehouse inventory.

DEMAND CONDITIONS

Demand conditions refer to the demands that consumers place on an industry for goods and services. Consumers who demand highly specific, sophisticated products and services force firms to create innovative, advanced products and services to meet the demand. This consumer pressure presents challenges to a country's industries. But in response to these challenges, improvements to existing goods and services often result, creating conditions necessary for competitive advantage over firms in other countries.

demand conditions
The nature of home-market demand for the industry's product or service.

Demanding consumers push firms to move ahead of companies in other countries where consumers are less demanding and more complacent. Countries with demanding consumers drive firms in that country to meet high standards, upgrade existing products and services, and create innovative products and services. Thus, the conditions of

FOCUS ON... STRATEGY 2.2

India and the Diamond of National Advantage

Consider the following facts:

- SAP, the German software company, has developed new applications for notebook PCs at its 500-engineer Bangalore facility.
- General Electric plans to invest $100 million and hire 2,600 scientists to create the world's largest research and development lab in Bangalore, India.
- Microsoft plans to invest $400 million in new research partnerships in India.
- Over one-fifth of Fortune 1000 companies outsource their software requirements to firms in India.
- McKinsey & Co. projects that the Indian software and services industry will be an $87 billion business by 2008; $50 billion of this will be exported.
- For the past decade, the Indian software industry has grown at a 50 percent annual rate.
- More than 800 firms in India are involved in software services as their primary activity.
- Software and information technology firms in India are projected to employ 2.2 million people by 2008.

What is causing such global interest in India's software services industry? Porter's diamond of national advantage helps clarify this question. See Exhibit 2.1.

First, *factor conditions* are conducive to the rise of India's software industry. Through investment in human resource development with a focus on industry-specific knowledge, India's universities and software firms have literally created this essential factor of production. For example, India produces the second largest annual output of scientists and engineers in the world, behind only the United States. In a knowledge-intensive industry such as software, development of human resources is fundamental to both domestic and global success.

Second, *demand conditions* require that software firms stay on the cutting edge of technological innovation. India has already moved toward globalization of its software industry; consumer demand conditions in developed nations such as Germany, Denmark, parts of Southeast Asia, and the United States created the consumer demand necessary to propel India's software makers toward sophisticated software solutions.*

Third, India has the *supplier base as well as the related industries* needed to drive competitive rivalry and enhance

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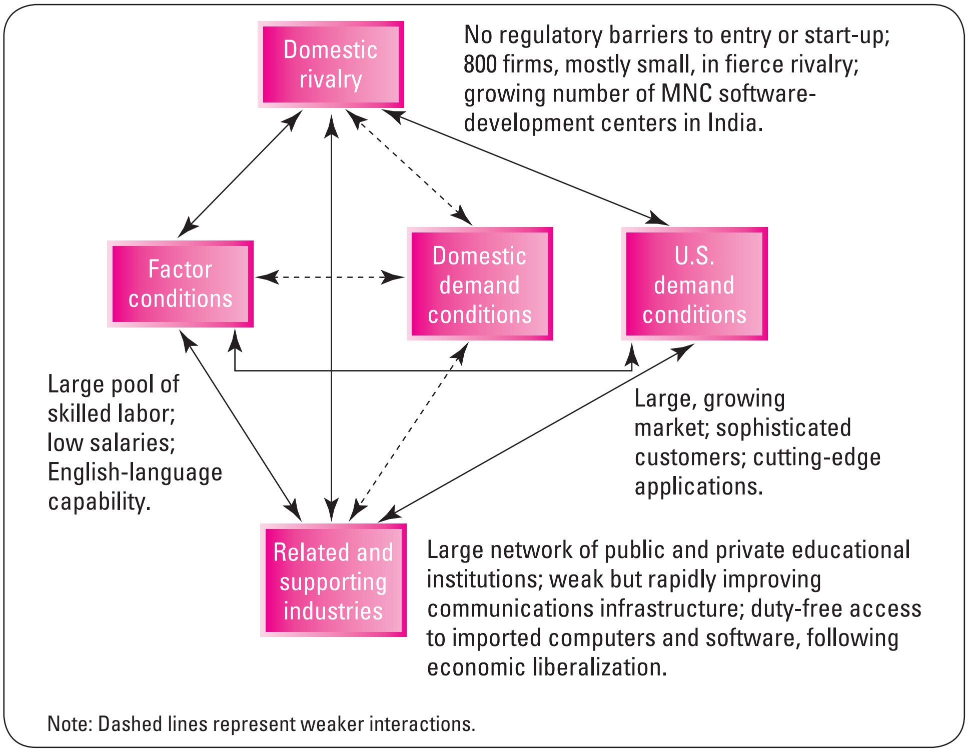

EXHIBIT 2.1 India's Diamond in Software

Source: From Kampur D. and Ramamurti R., "India's Emerging Competition Advantage in Services," *Academy of Management Executive: The Thinking Manager's Source.* Copyright © 2001 by Academy of Management. Reproduced with permission of Academy of Management via Copyright Clearance Center.

(continued)

competitiveness. In particular, information technology (IT) hardware prices declined rapidly in the 1990s. Furthermore, rapid technological change in IT hardware meant that late-comers like India were not locked into older-generation technologies. Thus, both the IT hardware and software industries could "leapfrog" older technologies. In addition, relationships among knowledge workers in these IT hardware and software industries offer the social structure for ongoing knowledge exchange, promoting further enhancement of existing products. Further infrastructure improvements are occurring rapidly.

Fourth, with over 800 firms in the software services industry in India, *intense rivalry forces firms to develop competitive strategies and structures.* Although firms like TCS, Infosys, and Wipro have become large, they were quite small only five years ago. And dozens of small and midsized companies are aspiring to catch up. This intense rivalry is one of the primary factors driving Indian software firms to develop overseas distribution channels, as predicted by Porter's diamond of national advantage.

*Although India's success cannot be explained in terms of its home market demand (according to Porter's model), the nature of the industry enables software to be transferred among different locations simultaneously by way of communications links. Thus, competitiveness of markets outside India can be enhanced without a physical presence in those markets.

Sources: Kripalani, M. 2002. Calling Bangladore: Multinationals are making it a hub for high-tech research *BusinessWeek,* November 25: 52–54; Kapur, D., & Ramamurti, R. 2001. India's emerging competitive advantage in services. 2001. *Academy of Management Executive,* 15(2): 20–33; World Bank. *World development report:* 6. New York: Oxford University Press; Reuters. 2001. Oracle in India push, taps software talent. *Washington Post Online,* July 3.

consumer demand influence how firms view a market, with more demanding consumers stimulating advances in products and services. This, in turn, helps a nation's industries to better anticipate future global demand conditions and proactively respond to product and service requirements.

Denmark, for instance, is known for its environmental awareness. Demand from consumers for environmentally safe products has spurred Danish manufacturers to become leaders in water pollution control equipment—products it successfully exported.

RELATED AND SUPPORTING INDUSTRIES

Related and supporting industries enable firms to manage inputs more effectively. For example, countries with a strong supplier base benefit by adding efficiency to downstream activities. A competitive supplier base helps a firm obtain inputs using cost-effective, timely methods, thus reducing manufacturing costs. Also, close working relationships with suppliers provide the potential to develop competitive advantages through joint research and development and the ongoing exchange of knowledge.

related and supporting industries
The presence, absence, and quality in the nation of supplier industries and other related industries that supply services, support, or technology to firms in the industry value chain.

Related industries offer similar opportunities through joint efforts among firms. In addition, related industries create the probability that new companies will enter the market, increasing competition and forcing existing firms to become more competitive through efforts such as cost control, product innovation, and novel approaches to distribution. Combined, these give the home country's industries a source of competitive advantage.

In the Italian footwear industry the supporting industries show how they can lead to national competitive advantage. In Italy, shoe manufacturers are geographically located near their suppliers. The manufacturers have ongoing interactions with leather suppliers and learn about new textures, colors, and manufacturing techniques while a shoe is still in the prototype stage. The manufacturers are able to project future demand and gear their factories for new products long before companies in other nations become aware of the new styles. Similarly, geographic proximity of industries related to the pharmaceutical industry (e.g., the dye industry) in Switzerland has given that nation a leadership position in this market, with firms such as Novartis, Hoffman LaRoche, and Sandoz using dyes from local manufacturers in many pharmaceutical products.

Starbucks, based in Seattle, Washington, has aggressively expanded its international operations. By 2007, it had several thousand coffeehouses in 36 countries outside of the United States. Above is one of its coffeehouses in Bangkok, Thailand.

FIRM STRATEGY, STRUCTURE, AND RIVALRY

firm strategy, structure, and rivalry
The conditions in the nation governing how companies are created, organized, and managed, as well as the nature of domestic rivalry.

Rivalry is particularly intense in nations with conditions of strong consumer demand, strong supplier bases, and high new entrant potential from related industries. This competitive rivalry in turn increases the efficiency with which firms develop, market, and distribute products and services within the home country. Domestic rivalry thus provides a strong impetus for firms to innovate and find new sources of competitive advantage.

Interestingly, this intense rivalry forces firms to look outside their national boundaries for new markets, setting up the conditions necessary for global competitiveness. Among all the points on Porter's diamond of national advantage, domestic rivalry is perhaps the strongest indicator of global competitive success. Firms that have experienced intense domestic competition are more likely to have designed strategies and structures that allow them to successfully compete in world markets.

In the United States, for example, intense rivalry has spurred companies such as Dell Computer to find innovative ways to produce and distribute its products. This is largely a result of competition from IBM and Hewlett-Packard.

Focus on . . . Strategy 2.2 on page 28 discusses India's software industry. It provides an integrative example of how Porter's "diamond" can help to explain the relative degree of success of an industry in a given country. Exhibit 2.1 illustrates India's "software diamond."

CONCLUDING COMMENT ON FACTORS AFFECTING A NATION'S COMPETITIVENESS

Porter drew his conclusions based on case histories of firms in more than 100 industries. Despite the differences in strategies employed by successful global competitors, a common theme emerged: Firms that succeeded in global markets had first succeeded in intensely competitive home markets. We can conclude that competitive advantage for global firms typically grows out of relentless, continuing improvement, and innovation.

Now that we have talked about the important role that nations play in international strategy, let's turn to the level of the individual firm.[11] In the next section, we will discuss a company's motivations and the risks associated with international expansion.

LO3 The potential benefits and risks of international expansion.

INTERNATIONAL EXPANSION: A COMPANY'S MOTIVATIONS AND RISKS

MOTIVATIONS FOR INTERNATIONAL EXPANSION

There are many motivations for a company to pursue international expansion. The most obvious one is to *increase the size of potential markets* for a firm's products and services.[12] By early 2007, the world's population exceeded 6.5 billion, with the United States

EXHIBIT 2.2

Populations of Selected Nations and the World

Country	March 2007 (in millions) (estimated)
China	1,320
India	1,107
United States	300
Japan	127
Germany	82
World Total	6,580

Source: www.geohive.com/global/pop_data2.php.

representing less than 5 percent. Exhibit 2.2 lists the population of the United States compared to other major markets abroad.

Many multinational firms are intensifying their efforts to market their products and services to countries such as India and China as the ranks of their middle classes have increased over the past decade. These include Procter & Gamble's success in achieving a 50 percent share in China's shampoo market as well as PepsiCo's impressive inroads in the Indian soft-drink market.[13] Let's take a brief look at China's emerging middle class:[14]

- China's middle class has finally attained a critical mass—between 35 million and 200 million people, depending on what definition is used. The larger number is preferred by Fan Gong, director of China's National Economic Research Institute, who fixes the lower boundary of "middle" as a family income of $10,000.
- The central government's emphasis on science and technology has boosted the rapid development of higher education, which is the incubator of the middle class.
- China may be viewed as a new example of economies of scale. Many American companies already have factories in China exporting goods. Now that there is a domestic market to go along with the export market, those factories can increase their output with little additional cost. That is one reason why many foreign companies' profits in China have been so strong in recent years.

Expanding a firm's global presence also automatically increases its scale of operations, providing it with a larger revenue and asset base. Such an increase in revenues and asset base potentially enables a firm to *attain economies of scale.* This provides multiple benefits. One advantage is the spreading of fixed costs such as research and development over a larger volume of production. Examples include the sale of Boeing's commercial aircraft and Microsoft's operating systems in many foreign countries.

A second advantage would be *reducing the costs of research and development as well as operating costs.* Recall Microsoft's software development operations and other firms in talent-rich India (see Strategy Spotlight 2.2). A final advantage would be the attainment of greater purchasing power by pooling purchases. For example, as McDonald's increases the number of outlets it has all over the world, it can place larger orders for equipment and supplies, thus increasing its bargaining power with suppliers.

International expansion can also *extend the life cycle of a product* that is in its maturity stage in a firm's home country but that has greater demand potential elsewhere. Products (and industries) generally go through a four-stage life cycle of introduction, growth, maturity, and decline. In recent decades, U.S. soft-drink producers such as Coca-Cola and PepsiCo have aggressively pursued international markets to attain levels of growth that simply would not be available in the United States. Similarly, personal computer manufacturers such as Dell and Hewlett-Packard have sought out foreign markets to offset the growing saturation in the U.S. market.

Finally, international expansion can enable a firm to *optimize the physical location for every activity in its value chain.* The value chain, which we will discuss in detail in Chapter 3, represents the various activities in which all firms must engage to produce products and services. They include primary activities, such as inbound logistics, operations, and marketing, as well as support activities, such as procurement, research and development, and human resource management. All firms have to make critical decisions as to where each activity will take place.[15] Optimizing the location for every activity in the value chain can yield one or more of three strategic advantages: performance enhancement, cost reduction, and risk reduction. We will now discuss each of these.

Performance Enhancement Microsoft's decision to establish a corporate research laboratory in Cambridge, England, is an example of a location decision that was guided mainly by the goal of building and sustaining world-class excellence in selected value-creating activities.[16] This strategic decision provided Microsoft with access to outstanding technical and professional talent. Location decisions can affect the quality with which any activity is performed in terms of the availability of needed talent, speed of learning, and the quality of external and internal coordination.

Cost Reduction Two location decisions founded largely on cost-reduction considerations are (1) Nike's decision to source the manufacture of athletic shoes from Asian countries such as China, Vietnam, and Indonesia, and (2) the decision of many multinational companies to set up production operations just south of the United States–Mexico border to access lower-cost labor. These operations are called *maquiladoras.* Such location decisions can affect the cost structure in terms of local manpower and other resources, transportation and logistics, and government incentives and the local tax structure.

Managing across borders can lead to challenging ethical dilemmas. One issue that has received a good deal of attention in the recent business press is the issue of child labor. Focus on . . . Strategy 2.3 discusses how two multinational companies have taken different approaches to address this issue.

Risk Reduction Given the erratic swings in the exchange ratios between the U.S. dollar and the Japanese yen (in relation to each other as well as other major currencies), an important basis for cost competition between Ford and Toyota has been their relative ingenuity at managing currency risks. One of the ways for such competitors to manage currency risks has been to spread the high-cost elements of their manufacturing operations across a few select and carefully chosen locations around the world. Location decisions such as these can affect the overall risk profile of the firm with respect to currency, economic, and political risks.[17]

POTENTIAL RISKS OF INTERNATIONAL EXPANSION

When a company expands its international operations, it does so to increase its profits or revenues. As with any other investment, however, there are also potential risks.[18] To help companies assess the risk of entering foreign markets, rating systems have been developed to evaluate political, economic, and financial and credit risks.[19] *Euromoney* magazine publishes a semiannual "Country Risk Rating" that evaluates political, economic, and other risks that entrants potentially face. Exhibit 2.3 depicts a sample of country risk ratings, published by the World Bank, from the 178 countries that *Euromoney* evaluates. Note that the lower the score, the higher the country's expected level of risk.

Next we will discuss the four main types of risk: political risk, economic risk, currency risk, and management risk.

FOCUS ON... STRATEGY 2.3

Child Labor: How Two Companies Have Addressed This Issue

It is interesting to consider how multinational companies have taken different approaches to address the issue of child labor in their overseas operations. Nike, for example, has revised its code of conduct a few times since 1992, including increasing the minimum age from 14 to 18 years for footwear factory workers and from 14 to 16 for equipment and apparel, which is quite a bit higher than other company codes and the International Labor Organization's (ILO) convention. The company also has started an internal compliance program, supplemented with external monitoring. However, this does not seem to have silenced the staunchest critics. Nike's Web site reflects the way in which the company tries to openly address this critique, providing ample information about the monitoring of facilities and the dilemmas the company faces after the introduction of its latest code.

Chiquita Banana almost completely follows the SA 8000 standard, including all references to international conventions, but with a few modifications, primarily to take account of workplace issues specific to agriculture. (The SA 8000 standard is developed by the Council on Economic Priorities Accreditation Agency and is widely recognized and accepted. It is based on ILO and United Nations conventions.) The company's strict child labor provisions do not apply to family farms or to small-scale holdings in the seasonal, nonbanana business, which do not regularly employ hired workers. This is also meant to allow for employment of a farmer's own children in seasonal activities. In line with its standard, Chiquita Banana tries to address the problem associated with children found to be working in supplying factories by giving "adequate support to enable such children to attend and remain in school until no longer a child."

Source: Kolk, A., & Tulder, R. V. 2004. Ethics in international business: Multinational approaches to child labor. *Journal of World Business,* 39: 49–60.

Political and Economic Risk Generally speaking, the business climate in the United States is very favorable. However, some countries around the globe may be hazardous to the health of corporate initiatives because of **political risk.**[20] Forces such as social unrest, military turmoil, demonstrations, and even violent conflict and terrorism can pose serious threats.[21] Consider, for example, the ongoing tension and violence in the Middle East between Israelis and Palestinians, and the social and political unrest in Indonesia.[22] Because such conditions increase the likelihood of destruction of property and disruption of operations as well as nonpayment for goods and services, countries that are viewed as

political risk
Potential threat to a firm's operations in a country due to ineffectiveness of the domestic political system.

EXHIBIT 2.3

A Sample of International Country Risk Rankings

Rank	Country	Total Risk Assessment	Economic Performance	Political Risk	Total of Debt Indicators	Total of Credit and Access to Finance Indicators
1	Luxembourg	99.51	25.00	24.51	20.00	30.00
2	Switzerland	98.84	23.84	25.00	20.00	30.00
3	United States	98.37	23.96	24.41	20.00	30.00
40	China	71.27	18.93	16.87	19.73	15.74
55	Poland	57.12	18.56	13.97	9.36	15.23
63	Vietnam	52.04	14.80	11.91	18.51	6.82
86	Russia	42.62	11.47	8.33	17.99	4.83
114	Albania	34.23	8.48	5.04	19.62	1.09
161	Mozambique	21.71	3.28	2.75	13.85	1.83
178	Afghanistan	3.92	0.00	3.04	0.00	0.88

Source: Adapted from worldbank.org/html/prddr/trans/so96/art7.htm.

high risk are less attractive for most types of business. Typical exceptions include providers of munitions and counterintelligence services.

The laws, and the enforcement of laws, associated with the protection of intellectual property rights can be a major potential **economic risk** in entering new countries. Microsoft, for example, has lost billions of dollars in potential revenue through piracy of its software products in many countries, including China. Other areas of the globe, such as the former Soviet Union and some eastern European nations, have piracy problems as well. Firms rich in intellectual property have encountered financial losses as imitations of their products have grown due to a lack of law enforcement of intellectual property rights.[23]

economic risk
Potential threat to a firm's operations in a country due to economic policies and conditions, including property rights laws and enforcement of those laws.

Focus on . . . Strategy 2.4 discusses an ethical problem that presents a severe threat to global trade—piracy. As we will see, estimates are that counterfeiting accounts for between 5 percent and 7 percent of global merchandise trade—the equivalent of as much as $512 billion a year. And the potential corrosive effects include health and safety, not just economic, damage.

Currency Risks Currency fluctuations can pose substantial risks. A company with operations in several countries must constantly monitor the exchange rate between its own currency and that of the host country to minimize **currency risks.** Even a small change in the exchange rate can result in a significant difference in the cost of production or net profit when doing business overseas. When the U.S. dollar appreciates against other currencies, for example, U.S. goods can be more expensive to consumers in foreign countries. At the same time, however, appreciation of the U.S. dollar can have negative implications for American companies that have branch operations overseas. The reason for this is that profits from abroad must be exchanged for dollars at a more expensive rate of exchange, reducing the amount of profit when measured in dollars. For example, consider an American firm doing business in Italy. If this firm had a 20 percent profit in euros at its Italian center of operations, this profit would be totally wiped out when converted into U.S. dollars if the euro had depreciated 20 percent against the U.S. dollar. (U.S. multinationals typically engage in sophisticated "hedging strategies" to minimize currency risk. The discussion of this is beyond the scope of this section.)

currency risk
Potential threat to a firm's operations in a country due to fluctuations in the local currency's exchange rate.

Management Risks **Management risks** may be considered the challenges and risks that managers face when they must respond to the inevitable differences that they encounter in foreign markets (as was the case in our opening example of Volkswagen). These take a variety of forms: culture, customs, language, income levels, customer preferences, distribution systems, and so on.[24] As we will note later in the chapter, even in the case of apparently standard products, some degree of local adaptation will become necessary.

management risk
Potential threat to a firm's operations in a country due to the problems that managers have making decisions in the context of foreign markets.

Differences in cultures across countries can also pose unique challenges for managers.[25] Cultural symbols can evoke deep feelings.[26] For example, in a series of advertisements aimed at Italian vacationers, Coca-Cola executives turned the Eiffel Tower, Empire State Building, and the Tower of Pisa into the familiar Coke bottle. So far, so good. However, when the white marble columns of the Parthenon that crowns the Acropolis in Athens were turned into Coke bottles, Greeks became outraged. Why? Greeks refer to the Acropolis as the "holy rock," and a government official said the Parthenon is an "international symbol of excellence" and that "whoever insults the Parthenon insults international culture." Coca-Cola apologized for the ad. Below are a few examples of how culture varies across nations and some of the implications for business.[27]

- (Ecuador) Dinners at Ecuadorian homes last for many hours. Expect drinks and appetizers around 8:00 p.m., with dinner not served until 11:00 p.m. or midnight. You will dismay your hosts if you leave as early as 1:00 a.m. A party at an Ecuadorian home

FOCUS ON… STRATEGY 2.4

Piracy: A Key Threat to World Trade

Counterfeiting has grown to become a major threat to multinational corporations. "We've seen a massive increase in the last five years, and there is a risk that it will spiral out of control," claims Anthony Simon, marketing chief of Unilever Bestfoods. "It is no longer a cottage industry."

The figures are astounding. The World Customs Organization estimates that counterfeiting accounts for about 5 percent to 7 percent of global merchandise trade—equivalent to as much as $512 billion. Seizures of fakes by United States customs jumped 46 percent last year as counterfeiters boosted exports to Western markets. Unilever Groups says that knockoffs of its shampoos, soaps, and teas are growing at a rate of 30 percent annually.

Such counterfeiting can also have health and safety implications. The World Health Organization says up to 10 percent of medicines worldwide are counterfeit—a deadly hazard that could be costing the pharmaceutical industry $46 billion a year. "You won't die from purchasing a pair of counterfeit blue jeans or a counterfeit golf club. You can die from taking counterfeit pharmaceutical products. And there's no doubt that people have died in China from bad medicine," says John Theirault, head of global security for American pharmaceutical giant, Pfizer. And, sadly, cases like the one in China, where fake baby formula recently killed 60 infants, have investigators stepping up enforcement at U.S. ports. Injuries from overheating counterfeit cell phone batteries purchased right on Verizon store shelves sparked a recall. According to Hal Stratton, of the Consumer Product Safety Commission, "We know of at least one apartment fire that's occurred. We know of at least one burn situation of someone's face that's occurred." And bogus car parts are a $12 billion market worldwide. "Counterfeiting has gone from a local nuisance to a global threat," says Hanns Glatz, DaimlerChrysler's point man on intellectual property.

China is the key to any solution. Given the country's economic power, its counterfeiting is turning into quite the problem itself, accounting for nearly two-thirds of all fake and pirated goods worldwide. Dan Chow, a law professor at Ohio State University who specializes in Chinese counterfeiting provides some perspective: "We have never seen a problem of this size and magnitude in world history. There's more counterfeiting going on in China now than we've ever seen anywhere. We know that 15 to 20 percent of all goods in China are counterfeit."

Source: Engardio, P. & Yang, C. 2006. The runaway trade giant. *BusinessWeek.* April 24: 30–32; Letzing, J. 2007. Antipiracy group makes list of worst-offendor nations. www.marketwatch. February 12: np. Balfour, F. 2005. Fake! *BusinessWeek,* February 7: 54–64; Anonymous. 2005. Editorial. *BusinessWeek,* February 7: 96; and Simon, B. 2004. The world's greatest fakes. www.cbsnews. com, August 8.

will begin late and end around 4:00 a.m. or 5:00 a.m. Late guests may sometimes be served breakfast before they leave.

- (France) Words in French and English may have the same roots but different meanings or connotations. For example, a French person might "demand" something because demander in French means "to ask."
- (Hong Kong) Negotiations occur over cups of tea. Always accept an offer of tea whether you want it or not. When you are served, wait for the host to drink first.
- (Singapore) Singaporeans associate all of the following with funerals—do not give them as gifts: straw sandals, clocks, a stork or crane, handkerchiefs, or gifts or wrapping paper where the predominant color is white, black, or blue.

We have addressed several of the motivations and risks associated with international expansion. A major recent trend has been the dispersion of the value chains of multinational corporations across different countries; that is, the various activities that constitute the value chain of a firm are now spread across several countries and continents. Such dispersion of value occurs mainly through increasing offshoring and outsourcing. We now address some of the primary associated benefits and costs.

GLOBAL DISPERSION OF VALUE CHAINS: OUTSOURCING AND OFFSHORING

A report issued by the World Trade Organization describes the production of a particular U.S. car as follows: "30 percent of the car's value goes to Korea for assembly, 17.5 percent to Japan for components and advanced technology, 7.5 percent to Germany for design, 4 percent to Taiwan and Singapore for minor parts, 2.5 percent to U.K. for advertising and marketing services, and 1.5 percent to Ireland and Barbados for data processing. This means that only 37 percent of the production value is generated in the U.S."[28] Similarly, in the production of a Barbie doll, Mattel purchases plastic and hair from Taiwan and Japan, the molds from the United States, the doll clothing from China, and paint from the United States and assembles the product in Indonesia and Malaysia for sales worldwide. In today's economy these are not isolated examples. Instead, we are increasingly witnessing two interrelated trends: *outsourcing and offshoring.*

outsourcing
Using other firms to perform value-creating activities that were previously performed in-house.

Outsourcing occurs when a firm decides to utilize other firms to perform value-creating activities that were previously performed in-house.[29] In some cases, it may be a new activity that the firm is perfectly capable of doing, but it still chooses to have someone else perform the function for cost or quality reasons. Outsourcing can be to either a domestic company or a foreign firm.

offshoring
Shifting a value-creating activity from a domestic location to a foreign location.

Offshoring takes place when a firm decides to shift an activity that they were previously performing in a domestic location to a foreign location. For example, both Microsoft and Intel now have R&D facilities in India, employing a large number of Indian scientists and engineers. In many cases, offshoring and outsourcing go together; that is, a firm may outsource an activity to a foreign supplier, thereby causing the work to be offshored as well.

Spending on offshore information technology will nearly triple between 2004 and 2010 to $60 billion, according to research firm Gartner.[30] And offshore employment in information technology (IT), banking, and six other areas will double to 1.2 million (from 2003 to 2008), says the McKinsey Global Institute.

The recent explosion in the volume of outsourcing and offshoring is due to a variety of factors. Up until the 1960s, for most companies, the entire value chain was in one location. Further, the production took place close to where the customers were in order to keep transportation costs under control. In the case of service industries, it was generally believed that offshoring was not possible because the producer and consumer had to be present at the same place at the same time. After all, a haircut could not be performed if the barber and the client were separated!

In the case of manufacturing industries, the rapid decline in transportation and coordination costs has enabled firms to disperse their value chains over different locations. For example, Nike's R&D takes place in the United States, raw materials are procured from a multitude of countries, actual manufacturing takes place in China or Indonesia, advertising is produced in the United States, and sales and service take place in practically all the countries. Each value-creating activity is performed in the location where the cost is the lowest or the quality is the best. Without finding optimal locations for each activity and the resultant dispersion of the value chain, Nike could not have attained its position as the world's largest shoe company.

The experience of the manufacturing sector was repeated in the service sector as well by the mid-1990s. A trend that began with the outsourcing of low-level programming and data entry work to countries such as India and Ireland suddenly grew manyfold, encompassing a variety of white collar and professional activities ranging from call-centers to R&D. Now, the technical support lines of a large number of U.S. firms are answered from call centers in faraway locations. The cost of a long distance call from the United States to India has decreased from about $3 to $0.03 in the last 20 years, thereby making it possible to have call centers located in countries like India where a combination of low labor costs and English proficiency presents an ideal mix of factor conditions. Bangalore, India, in recent years, has emerged as a location where more and more U.S. tax returns are prepared.

In India, U.S.–trained and licensed radiologists interpret chest X-rays and CT scans from U.S. hospitals for half the cost. The advantages from offshoring go beyond mere cost savings today. In many specialized occupations in science and engineering, there is a shortage of qualified professionals in developed countries whereas countries like India, China, and Singapore have what seems like an inexhaustible supply.[31]

For most of the 20th century, domestic companies catered to the needs of local populations. However, with the increasing homogenization of customer needs around the world and the institutionalization of free trade and investment as a global ideology (especially after the creation of the WTO), competition has become truly global. Each company has to keep its costs low in order to survive. They also must find the best suppliers and the most skilled workers as well as locate each stage of the value chain in places where factor conditions are most conducive.

LO1 The effects of globalization and business ethics on today's organizations and on the nature of competition.

Next, we turn our attention to the second key contextual factor facing executives: business ethics. We first discuss corporate governance and stakeholder management. We then examine the need for social responsibility.

LO4 The vital role of corporate governance and stakeholder management as well as how "symbiosis" can be achieved among an organization's stakeholders.

CORPORATE GOVERNANCE AND STAKEHOLDER MANAGEMENT

Most business enterprises that employ more than a few dozen people are organized as corporations. As you recall from your finance classes, the overall purpose of a corporation is to maximize the long-term return to the owners (shareholders). Thus, we may ask: Who is really responsible for fulfilling this purpose? Robert Monks and Neil Minow, in addressing this issue, provide a useful definition of **corporate governance** as "the relationship among various participants in determining the direction and performance of corporations. The primary participants are (1) the shareholders, (2) the management (led by the chief executive officer), and (3) the board of directors."[32] This relationship is illustrated in Exhibit 2.4.

corporate governance The relationship among various participants in determining the direction and performance of corporations. The primary participants are (1) the shareholders, (2) the management, and (3) the board of directors.

The board of directors (BOD) are the elected representatives of the shareholders. They are charged with ensuring that the interests and motives of management are aligned with those of the owners (i.e., shareholders). In many cases, the BOD is diligent in fulfilling its purpose. For example, Intel Corporation, the giant $35 billion maker of microprocessor

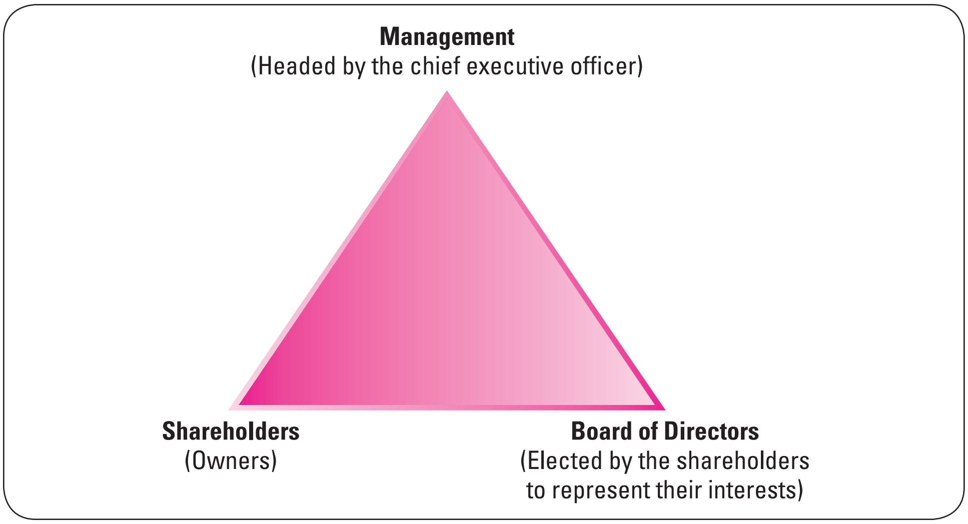

EXHIBIT 2.4 **The Key Elements of Corporate Governance**

chips, is widely recognized as an excellent example of sound governance practices. Its BOD has established guidelines to ensure that its members are independent (i.e., not members of the executive management team and do not have close personal ties to top executives) so that they can provide proper oversight, it has explicit guidelines on the selection of director candidates (to avoid "cronyism"), and it provides detailed procedures for formal evaluations of both directors and the firm's top officers.[33] Such guidelines serve to ensure that management is acting in the best interests of shareholders.[34]

Recently, there has been much criticism as well as cynicism by both citizens and the business press about the poor job that management and the BODs of large corporations are doing. We only have to look at the recent scandals at firms such as Arthur Andersen, WorldCom, Enron, Tyco, and ImClone Systems.[35] Such malfeasance has led to an erosion of the public's trust in the governance of corporations. For example, a recent Gallup poll found that 90 percent of Americans felt that people leading corporations could not be trusted to look after the interests of their employees, and only 18 percent thought that corporations looked after their shareholders. Forty-three percent, in fact, believed that senior executives were in it only for themselves. In Britain, that figure, according to another poll, was an astonishing 95 percent.[36] Perhaps worst of all, in another study, 60 percent of directors (the very people who decide how much executives should earn) felt that executives were "dramatically overpaid"![37]

Concerns about corporate governance led the U.S. Congress to pass the Sarbanes-Oxley Act in 2002. The legislation was an effort to restore investor confidence in how publicly traded companies are managed and how they report financial information. It requires U.S. corporations to abide by many stringent measures, including:

- CEOs and chief financial officers must fully reveal off-balance-sheet finances and vouch for the accuracy of the information provided.
- Executives must promptly reveal the sale of shares in firms they manage and are not allowed to sell shares when other employees cannot.
- Corporate lawyers must report to senior managers any violations of securities laws within the organization.

Although the Sarbanes-Oxley Act has improved investor confidence, the costs of meeting its requirements are substantial. Large corporations are estimated to spend an average of $35 million a year on compliance, while medium-sized firms spend an average of $3.1 million. Small firms find compliance particularly burdensome because they have a smaller revenue base to pay the needed costs.[38]

Next we examine how governance mechanisms can solve these problems.

GOVERNANCE MECHANISMS: ALIGNING THE INTERESTS OF OWNERS AND MANAGERS

A key characteristic of the modern corporation is the separation of ownership from control. To minimize the potential for managers to act in their own self-interest,or "opportunistically," the owners can implement some governance mechanisms.[39] There are two primary means of monitoring the behavior of managers. These include (1) a committed and involved *board of directors* that acts in the best interests of the shareholders to create long-term value and (2) *shareholder activism,* wherein the owners view themselves as share *owners* instead of share *holders* and become actively engaged in the governance of the corporation. As we will see later in this section, shareholder activism has increased dramatically in recent years. Finally, there are managerial incentives, sometimes called "contract-based outcomes," which consist of *reward and compensation agreements.* Here the goal is to carefully craft managerial incentive packages to align the interests of management with those of the stockholders.

A Committed and Involved Board of Directors The **board of directors** acts as a fulcrum between the owners and controllers of a corporation. In effect, they are the intermediaries who provide a balance between a small group of key managers in the firm based at the corporate headquarters and a sometimes vast group of shareholders. In the United States, the law imposes on the board a strict and absolute fiduciary duty to ensure that a company is run consistently with the long-term interests of the owners—the shareholders. The reality, as we have seen, is somewhat more ambiguous.[40]

board of directors
A group that has a fiduciary duty to ensure that the company is run consistently with the long-term interests of the owners, or shareholders, of a corporation and that acts as an intermediary between the shareholders and management.

The Business Roundtable, representing the largest U.S. corporations, describes the duties of the board as follows:

1. Select, regularly evaluate, and, if necessary, replace the chief executive officer. Determine management compensation. Review succession planning.
2. Review and, where appropriate, approve the financial objectives, major strategies, and plans of the corporation.
3. Provide advice and counsel to top management.
4. Select and recommend to shareholders for election an appropriate slate of candidates for the board of directors; evaluate board processes and performance.
5. Review the adequacy of the systems to comply with all applicable laws/regulations.[41]

Given these principles, what makes for a good board of directors? According to the Business Roundtable, the most important quality is a board of directors who are active, critical participants in determining a company's strategies.[42] That does not mean board members should micromanage or circumvent the CEO. Rather, they should provide strong oversight going beyond simply approving the CEO's plans. A board's primary responsibilities are to ensure that strategic plans undergo rigorous scrutiny, evaluate managers against high performance standards, and take control of the succession process.

Although boards in the past were often dismissed as CEOs' rubber stamps, increasingly they are playing a more active role by forcing out CEOs who cannot deliver on performance. According to a recent study by the consulting firm Booz Allen Hamilton, the rate of CEO departures for performance reasons has more than tripled, from 1.3 percent to 4.2 percent, between 1995 and 2002.[43] And the trend has continued. In 2006, turnover among CEOs increased 30 percent over the previous year.[44] Well-known CEOs like Gerald M. Levin of AOL Time Warner and Jack M. Greenberg of McDonald's paid the price for poor financial performance by being forced to leave. Others, such as Bernard Ebbers of WorldCom, Inc., and Dennis Kozlowski of Tyco International, lost their jobs due to scandals. "Deliver or depart" is clearly the new message from the boards.

Another key component of top-ranked boards is director independence.[45] Governance experts believe that a majority of directors should be free of all ties to either the CEO or the company. That means a minimum of "insiders" (past or present members of the management team) should serve on the board, and that directors and their firms should be barred from doing consulting, legal, or other work for the company.[46] Interlocking directorships—in which CEOs and other top managers serve on each other's boards—are not desirable. But perhaps the best guarantee that directors act in the best interests of shareholders is the simplest: Most good companies now insist that directors own significant stock in the company they oversee.[47]

Exhibit 2.5 provides some suggestions for how boards of directors can improve their practices.

EXHIBIT 2.5

Best Practice Ideas: The New Rules for Directors

Issue	Suggestion
Pay Companies will disclose full details of CEO payouts for the first time in their 2007 SEC filings. Activist investors are already drawing up hit lists of companies where CEO paychecks are out of step with performance.	**Know the math** Before okaying any financial package, directors must make sure they can explain the numbers. They need to adopt the mind-set of an activist investor and ask, "What's the harshest criticism someone could make about this package?"
Strategy Boards have been so focused on compliance that duties like strategy and leadership oversight too often get short shrift. Only 59% of directors in a recent study rated their board favorably on setting strategy.	**Make It a Priority** To avoid spending too much time on compliance issues, strategy has to move up to the beginning of the meeting. Annual one-, two- or three-day off-site meetings on strategy alone are becoming standard for good boards.
Financials Although 95% of directors in the recent study said they were doing a good job of monitoring financials, the number of earnings restatements hit a new high in 2006, after breaking records in 2004 and 2005.	**Put in the Time** Even nonfinancial board members need to monitor the numbers and keep a close eye on cash flows. Audit committee members: Prepare to spend 300 hours a year on committee responsibilities.
Crisis Management Some 120 companies are under scrutiny for options backdating, and the 100 largest companies have replaced 56 CEOs in the past five years, nearly double the terminations in the prior five years.	**Dig in** The increased scrutiny on boards means that a perfunctory review will not suffice if a scandal strikes. Directors can no longer afford to defer to management in a crisis. They must roll up their sleeves and move into watchdog mode.

Source: Byrnes, N., & Sassen, J. 2007. Board of hard knocks. *BusinessWeek*. January 22: 36–39.

Shareholder Activism As a practical matter, there are so many owners of the largest American corporations that it makes little sense to refer to them as "owners" in the sense of individuals becoming informed and involved in corporate affairs. However, even an individual shareholder has several rights, including (1) the right to sell the stock, (2) the right to vote the proxy (which includes the election of board members), (3) the right to bring suit for damages if the corporation's directors or managers fail to meet their obligations, (4) the right to certain information from the company, and (5) certain residual rights following the company's liquidation (or its filing for reorganization under bankruptcy laws), once creditors and other claimants are paid off.[48]

Collectively, shareholders have the power to direct the course of corporations.[49] This may involve acts such as being party to shareholder action suits and demanding that key issues be brought up for proxy votes at annual board meetings. In addition, the power of shareholders has intensified in recent years because of the increasing influence of large institutional investors such as mutual funds (e.g., T. Rowe Price and Fidelity Investments) and retirement systems such as TIAA-CREF (for university faculty members and school administrative staff).[50] Institutional investors hold approximately 50 percent of all listed corporate stock in the United States.

Shareholder activism refers to actions by large shareholders, both institutions and individuals, to protect their interests when they feel that managerial actions diverge from shareholder value maximization.

shareholder activism
Actions by large stockholders to protect their interests when they feel that managerial actions of a corporation diverge from shareholder value maximization.

Many institutional investors are aggressive in protecting and enhancing their investments. In effect, they are shifting from traders to owners. They are assuming the role of permanent shareholders and rigorously analyzing issues of corporate governance. In the process they are reinventing systems of corporate monitoring and accountability.[51]

Managerial Rewards and Incentives One of the most critical roles of the board of directors is to create incentives that align the interests of the CEO and top executives with the interests of owners of the corporation—long-term shareholder returns.[52] After all, shareholders rely on CEOs to adopt policies and strategies that maximize the value of their shares.[53] A combination of three basic policies may create the right monetary incentives for CEOs to maximize the value of their companies:

1. Boards can require that the CEOs become substantial owners of company stock.
2. Salaries, bonuses, and stock options can be structured so as to provide rewards for superior performance and penalties for poor performance.
3. Threat of dismissal for poor performance can be a realistic outcome.

ZERO SUM OR SYMBIOSIS? TWO ALTERNATE PERSPECTIVES OF STAKEHOLDER MANAGEMENT

Generating long-term returns for the shareholders is the primary goal of a publicly held corporation. As noted by former Chrysler vice chairman Robert Lutz, "We are here to serve the shareholder and create shareholder value. I insist that the only person who owns the company is the person who paid good money for it."[54]

Despite the primacy of generating shareholder value, managers who focus solely on the interests of the owners of the business will often make poor decisions that lead to negative, unanticipated outcomes. For example, decisions such as mass layoffs to increase profits, ignoring issues related to conservation of the natural environment to save money, and exerting excessive pressure on suppliers to lower prices can certainly harm the firm in the long run. Such actions would likely lead to negative outcomes such as alienated employees, increased governmental oversight and fines, and disloyal suppliers.

Clearly, in addition to *shareholders,* there are other *stakeholders* (e.g. suppliers, customers) who must be explicitly taken into account in the strategic management process.[55] A stakeholder can be defined as an individual or group, inside or outside the company, that has a stake in and can influence an organization's performance. Each stakeholder group makes various claims on the company. Exhibit 2.6 provides a list of major stakeholder groups and the nature of their claims on the company.

There are two opposing ways of looking at the role of stakeholder management in the strategic management process.[56] The first one can be termed "zero sum." In this view, the role of management is to look upon the various stakeholders as competing for the organization's resources. In essence, the gain of one individual or group is the loss of another individual or group. For example, employees want higher wages (which drive down profits), suppliers want higher prices for their inputs and slower, more flexible delivery times (which drive up costs), customers want fast deliveries and higher quality (which drive up costs), the community at large wants charitable contributions (which take money from company goals), and so on. This zero-sum thinking is rooted, in part, in the traditional conflict between workers and management, leading to the formation of

EXHIBIT 2.6

An Organization's Key Stakeholders and the Nature of Their Claim

Stakeholder Group	Nature of Claim
Stockholders	Dividends, capital appreciation
Employees	Wages, benefits, safe working environment, job security
Suppliers	Payment on time, assurance of continued relationship
Creditors	Payment of interest, repayment of principal
Customers	Value, warranties
Government	Taxes, compliance with regulation
Communities	Good citizenship behavior such as charities, employment, nonpollution

unions and sometimes ending in adversarial union–management negotiations and long, bitter strikes.

Although there will always be some conflicting demands, there is value in exploring how the organization can achieve mutual benefit through *stakeholder symbiosis,* which recognizes that stakeholders are dependent upon each other for their success and well-being.[57] That is, managers acknowledge the interdependence among employees, suppliers, customers, shareholders, and the community at large. Consider Outback Steakhouse:[58]

> Outback Steakhouse asked their employees to identify on a six-point scale how strongly they agreed or disagreed that Outback's principles and beliefs (P&Bs) were practiced in their particular restaurants. The turnover rate of the hourly employees in the group most strongly agreeing that the P&Bs were their stores' guiding ethos was half what it was in the group most strongly disagreeing. Five times as many customers in the strongly agreeing group indicated that they were likely to return. Further, at the strongly agreeing group's restaurants, revenues were 8.9% higher, cash flow was 27% higher, and pretax profit was 48% higher. Not surprisingly, the survey is now mandatory for Outback managers.

LO5 The importance of social responsibility including environmental sustainability.

SOCIAL RESPONSIBILITY AND ENVIRONMENTAL SUSTAINABILITY: MOVING BEYOND THE IMMEDIATE STAKEHOLDERS

Organizations cannot ignore the interests and demands of stakeholders such as citizens and society in general that are beyond its immediate constituencies—customers, owners, suppliers, and employees. That is, they must consider the needs of the broader community at large and act in a socially responsible manner.[59]

Social responsibility is the expectation that businesses or individuals will strive to improve the overall welfare of society.[60] From the perspective of a business, this means that managers must take active steps to make society better by virtue of the business being in existence.[61] Similar to norms and values, actions that constitute socially responsible behavior tend to change over time. In the 1970s affirmative action was a high priority and during the 1990s and up to the present time, the public has been concerned about environmental quality. Many firms have responded to this by engaging in recycling and reducing waste. And in the wake of the 2001 terrorist attacks on New York City and the Pentagon, as well as the continuing threat from terrorists worldwide, a new kind of priority has arisen: the need to be vigilant concerning public safety.

Today, demands for greater corporate responsibility have accelerated.[62] These include corporate critics, social investors, activists, and, increasingly, customers who claim to

FOCUS ON... STRATEGY 2.5

American Express: Using Cause-Related Marketing Effectively

American Express has benefited in terms of favorable public relations as well as financially from its cause-related marketing initiatives. Back in 1983, in connection with the restoration of the Statue of Liberty project, it promised that it would contribute to this initiative a portion of the amount that consumers charged on their American Express cards. The resulting campaign made marketing history. AmEx eventually donated $1.7 million to the cause. AmEx card use increased 28 percent and new card applications increased 17 percent. Cause-related marketing has grown significantly, from $125 million in 1990 to $991 million in 2004, and the figure is expected to continue to increase.

According to a recent Cone Corporate Citizenship Study, cause-related marketing can both reinforce consumer relationships as well as strengthen employee morale. For example, 84% of respondents said they would likely switch brands to one associated with a good cause and 92% of Americans said that they have a more positive image of companies and products that support causes. Similarly, 57% of employees wish that their company would do more to support a social issue and 75% of Americans would consider a company's commitment to social issues when deciding where to work.

Sources: Vogel, D. J. 2005. Is there a market for virtue? The business case for corporate social responsibility. *California Management Review,* 47 (4): 19–36; and 2002 Cone Corporate Citizenship Study Cone, Inc.

assess corporate responsibility when making purchasing decisions. Such demands go well beyond product and service quality.[63] They include a focus on issues such as labor standards, environmental sustainability, financial and accounting reporting, procurement, and environmental practices. At times, a firm's reputation can be tarnished by exceedingly poor judgment on the part of one of its managers.[64]

> In 2006, Judith Regan, a publisher at HarperCollins, was set to publish a book, *If I Did It,* with O. J. Simpson detailing how he would have committed the 1995 murder of his ex-wife Nicole Brown Simpson and her friend, Ron Goldman. The book was characterized by Regan as his "confession," and it earned the world's outrage as an "evil sweeps stunt" that will likely be remembered as a low point in American culture. Regan's boss, News Corporation Chairman Rupert Murdoch, cancelled the book and the TV special that was also planned. But this was not before preorders for *If I Did It* cracked the Top 20 on Amazon.com. Not surprisingly, Judith Regan was fired.

A key stakeholder group that appears to be particularly susceptible to corporate social responsibility (CSR) initiatives is its customers.[65] Surveys indicate a strong positive relationship between CSR behaviors and consumers' reactions to a firm's products and services. For example:

- Corporate Citizenship's poll conducted by Cone Communications found that "84 percent of Americans say they would be likely to switch brands to one associated with a good cause, if price and quality are similar."[66]
- Hill & Knowlton/Harris's Interactive poll reveals that "79 percent of Americans take corporate citizenship into account when deciding whether to buy a particular company's product and 37 percent consider corporate citizenship an important factor when making purchasing decisions."[67]

Such findings are consistent with a large body of research that confirms the positive influence of CSR on consumers' company evaluations and product purchase intentions across a broad range of product categories.

Cause-related marketing is another example of the growing link between corporate social responsibility and financial objectives. Such marketing generally features promotions in which a portion of the purchase price of a product or service is donated to a social

Solar cells can be organized into arrays, such as this one to provide electric power for industrial, commercial, and residential customers. Solar power is a more sustainable, environmentally friendly option than nuclear power plants or coal- and oil-fired power plants.

cause: It essentially links marketing and corporate philanthropy. Focus on . . . Strategy 2.5 discusses how American Express became one of the pioneers of this emerging trend and significantly benefited.

The Triple Bottom Line: Incorporating Financial as well as Environmental and Social Costs Many companies are now measuring what has been called a "triple bottom line," which involves assessing financial, social, and environmental performance. Shell, NEC, and Procter & Gamble, among other corporations, have recognized that failing to account for the environmental and social costs of doing business poses risks to the company and its community.[68]

The environmental revolution has been almost four decades in the making.[69] It has changed forever how companies do business. In the 1960s and 1970s, companies were in a state of denial regarding their firms' impact on the natural environment. However, a series of visible ecological problems created a groundswell for strict governmental regulation. In the United States, Lake Erie was "dead," and in Japan, people were dying of mercury poisoning. Clearly, the effects of global warming are being felt throughout the world. Some other examples are:[70]

- Ice roads are melting, so Canadian diamond miners must airlift equipment at great cost instead of trucking it in.
- More severe storms and rising seas mean oil companies must build stronger rigs, and cities must build higher seawalls.
- The loss of permafrost and protective sea ice may force villages like Alaska's Shismaref to relocate.
- Yukon River salmon—and fisheries—are threatened by a surge of parasites associated with a jump in water temperature.
- Later winters have let beetles spread in British Columbia killing 22 million acres of pine forests, an area the size of Maine.
- In the country of Mali, in Africa, crops are threatened. The rainy season is now too short for rice, and the dry season is too hot for potatoes.

Stuart Hart, writing in the *Harvard Business Review,* addresses the magnitude of problems and challenges associated with the natural environment:

FOCUS ON... STRATEGY 2.6

How Adobe Systems Benefits from "Being Green"

In June 2006, Adobe Systems, the $2 billion software maker, became the first firm to receive a platinum award from the nonprofit U.S. Green Building Council. Platinum certification of Adobe's buildings was based on ratings in six categories: sustainability; water efficiency; energy efficiency and atmospheric quality; use of materials and resources; indoor environmental quality; and innovations in upgrades, operations, and maintenance.

Thus, Adobe's San Jose headquarters is the greenest corporate site on record in the United States. What is more impressive is that Adobe earned the honor by retrofitting its two existing office towers (approximately 1 million square feet); most of the 151 buildings that have received the council's gold ratings (a "step down" from platinum) are new structures.

By installing everything from motion detectors to waterless urinals, the firm has reduced its electricity use by 35% and its gas consumption by 41% since 2001. In addition, it conserves 295,000 gallons of water each month. And during this time, headcount has shot up 80%!

Adobe is proving that building "green" isn't just good citizenship—it is profitable. Adobe has invested approximately $650,000 for energy and environmental retrofits since 2001. The retrofits on the two office towers have resulted in approximately $720,000 savings to date, for a total return on investment of approximately 115 percent. Randy Knox III, Adobe's director of real estate, facilities, and security, comments: "This isn't some pie-in-the-sky kind of thing the enviros are pushing. It really works."

Sources: Nachtigal, J. 2006. It's easy and cheap being green. *BusinessWeek,* October 16: 53; Warner, J. 2006. Adobe headquarters awarded highest honors from U.S. green building council. December 6: *Adobe Press Release;* and Juran, K. 2006. Adobe wins top California flex your power! Award for energy efficiency. July 3*: Adobe Press Release.*

> The challenge is to develop a *sustainable global economy:* an economy that the planet is capable of supporting indefinitely. Although we may be approaching ecological recovery in the developed world, the planet as a whole remains on an unsustainable course. Increasingly, the scourges of the late twentieth century—depleted farmland, fisheries, and forests; choking urban pollution; poverty; infectious disease; and migration—are spilling over geopolitical borders. The simple fact is this: in meeting our needs, we are destroying the ability of future generations to meet theirs . . . corporations are the only organizations with the resources, the technology, the global reach, and, ultimately, the motivation to achieve sustainability.[71]

Environmental sustainability is now a value embraced by the most competitive and successful multinational companies.[72] The McKinsey Corporation's survey of more than 400 senior executives of companies around the world found that 92 percent agreed with former Sony President Akio Morita's contention that the environmental challenge will be one of the central issues in the 21st century.[73] Virtually all executives acknowledged their firm's responsibility to control pollution, and 83 percent agreed that corporations have an environmental responsibility for their products even after they are sold.

For many successful firms, environmental values are now becoming a central part of their cultures and management processes. And, as noted earlier, environmental impacts are being audited and accounted for as the "third bottom line." According to one 2004 corporate report, "If we aren't good corporate citizens as reflected in a Triple Bottom Line that takes into account social and environmental responsibilities along with financial ones—eventually our stock price, our profits, and our entire business could suffer."[74] And according to a KPMG study of 350 firms: "More big multinational firms are seeing the benefits of improving their environmental performance . . . Firms are saving money and boosting share performance by taking a close look at how their operations impact the environment. . . . Companies see that they can make money as well." Focus on . . . Strategy 2.6 discusses how Adobe Systems benefits financially from its environmental initiatives.

SUMMARY

We live in a highly interconnected global community. Two of the dominant features of this context are that many of the best opportunities for profits lie beyond the boundaries of a firm's home country and that there are increased pressures for firms to act in ways that outsiders view as ethical. In essence, globalization and business ethics provide a context within which the strategic management process takes place.

LO1, LO2 The first section of the chapter addressed the factors that determine a nation's competitiveness in a particular industry. The framework was developed by Professor Michael Porter. He identified four dimensions—factor conditions, demand characteristics, related and supporting industries, and firm strategy, structure, and rivalry—that collectively shape the competitive process in the international arena.

LO3 Next, we discussed the potential benefits and risks associated with a firm's overseas expansion efforts. The benefits include increasing the size of a firm's customer base, achieving economies of scale, extending a product's life cycle, and optimizing the location of activities within a firm's value chain. Key potential pitfalls include political and economic risks, currency risks, and management risks. We also addressed some of the challenges and opportunities associated with offshoring and outsourcing.

LO1, LO4 We then turned our attention to business ethics. We began this section by introducing the concepts of corporate governance and stakeholder management. Governance refers to efforts by a firm's owners to ensure that executives act appropriately in their role as leaders of the firm. Stakeholders are groups such as owners, customers, suppliers, employees, and society at large for whom the firm is important. Successful firms go beyond an overriding focus on just satisfying owners. Instead, they recognize the inherent conflicts among stakeholders' interests and work to develop "symbiosis"—that is, interdependence and mutual benefit—among them.

LO5 In the final section, we noted that executives must also recognize the need to act in a socially responsible manner. They also should address issues related to environmental sustainability in their strategic actions. Overall, globalization and business ethics must be taken into account throughout the strategic management process.

KEY TERMS

factor conditions 27
demand conditions 27
related and supporting industries (national advantage) 29
firm strategy, structure, and vivalry (national advantage) 30
political risk 33
economic risk 34
currency risk 34
management risk 34
outsourcing 36
offshoring 36
corporate governance 37
board of directors 39
shareholder activism 41

SUMMARY REVIEW QUESTIONS

1. What is national advantage, and what are its sources?
2. What is globalization, and why does it matter to companies?
3. What is corporate governance? What are its three key elements and how can it be improved?
4. How can "symbiosis" be achieved among a firm's stakeholders?

APPLICATION QUESTIONS

1. What national advantages do firms based in the United States enjoy? How do these advantages provide an edge in the international arena?
2. Many companies choose to have their goods manufactured overseas, where labor costs are low. Is this just good strategic thinking, or are there ethical issues involved as well?
3. Select a company that interests you. Using the Internet, what are some recent demands that stakeholders have placed on this company? Can you find examples of how the company is trying to develop symbiosis among its stakeholders?
4. Some critics believe that executives engage in social responsibility in an effort to manage impressions, while others believe that executives who pursue social responsibility sincerely want to improve society. With which side do you agree, and why? More generally, does it matter why good is being done?

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