# Exploring Business



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## Contents

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# Chapter 1: The Foundations of Business

## 1.1 Introduction

As the story of Apple suggests, today is an interesting time to study business. Advances in technology are bringing  rapid changes in the ways we produce and deliver goods and services. The Internet and other improvements in communication (such as smartphones, video conferencing, and social networking) now affect the way we do business. Companies are expanding international operations, and the workforce is more diverse than ever. Corporations are being held responsible for the behavior of their executives, and more people share the opinion that companies should be good corporate citizens. Plus—and this is a big plus—businesses today are facing the lingering effects of what many economists believe is the worst financial crisis since the Great Depression (Hilsenrath, et. al., 2008). Economic turmoil that began in the housing and mortgage industries as a result of troubled subprime mortgages quickly spread to the rest of the economy. In 2008, credit markets froze up and banks stopped making loans. Lawmakers tried to get money flowing again by passing a $700 billion Wall Street bailout, yet businesses and individuals were still denied access to needed credit. Without money or credit, consumer confidence in the economy dropped and consumers cut back their spending. Businesses responded by producing fewer products, and their sales and profits dropped. Unemployment rose as troubled companies shed the most jobs in five years, and 760,000 Americans marched to the unemployment lines[1]. The stock market reacted to the financial crisis and its stock prices dropped by 44 percent while millions of Americans watched in shock as their savings and retirement accounts took a nose dive. In fall 2008, even Apple, a company that had enjoyed strong sales growth over the past five years, began to cut production of its popular iPhone. Without jobs or cash, consumers would no longer flock to Apple's fancy retail stores or buy a prized iPhone (Gallagher, 2008). Things have turned around for Apple, which reported blockbuster sales for 2011 in part because of strong customer response to the iPhone 4S. But not all companies or individuals are doing so well. The economy is still struggling, unemployment is high (particularly for those ages 16 to 24), and home prices remain low.

As you go through the course with the aid of this text, you'll explore the exciting world of business. We'll introduce you to the various activities in which businesspeople engage—accounting, finance, information technology, management, marketing, and operations. We'll help you understand the roles that these activities play in an organization, and we'll show you how they work together. We hope that by exposing you to the things that businesspeople do, we'll help you decide whether business is right for you and, if so, what areas of business you'd like to study further.

[1]"How the Economy Stole the Election," *CNN.com*, http://money.cnn.com/galleries/2008/news/0810/gallery.economy_election/index.html (accessed January 21, 2012).

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Hilsenrath, J., Serena Ng, and Damian Paletta, "Worst Crisis Since '30s, With No End Yet in Sight," *Wall Street Journal*, Markets, September 18, 2008, http://online.wsj.com/article/SB122169431617549947.html (accessed January 21, 2012).

# 1.2 Getting Down to Business

1. Identify the main participants of business, the functions that most businesses perform, and the external forces that influence business activities.

A **business** is any activity that provides goods or services to consumers for the purpose of making a profit. When Steve Jobs and Steve Wozniak created Apple Computer in Jobs's family garage, they started a business. The product was the Apple I, and the company's founders hoped to sell their computers to customers for more than it cost to make and market them. If they were successful (which they were), they'd make a **profit**.

Before we go on, let's make a couple of important distinctions concerning the terms in our definitions. First, whereas Apple produces and sells *goods* (Mac, iPhone, iPod, iPad), many businesses provide *services*. Your bank is a service company, as is your Internet provider. Hotels, airlines, law firms, movie theaters, and hospitals are also service companies. Many companies provide both goods and services. For example, your local car dealership sells goods (cars) and also provides services (automobile repairs).

Second, some organizations are not set up to make profits. Many are established to provide social or educational services. Such **not-for-profit (or nonprofit) organizations** include the United Way of America, Habitat for Humanity, the Boys and Girls Clubs, the Sierra Club, the American Red Cross, and many colleges and universities. Most of these organizations, however, function in much the same way as a business. They establish goals and work to meet them in an effective, efficient manner. Thus, most of the business principles introduced in this text also apply to nonprofits.

## Business Participants and Activities

Let's begin our discussion of business by identifying the main participants of business and the functions that most businesses perform. Then we'll finish this section by discussing the external factors that influence a business's activities.

## Participants

Every business must have one or more *owners* whose primary role is to invest money in the business. When a business is being started, it's generally the owners who polish the business idea and bring together the resources (money and people) needed to turn the idea into a business. The owners also hire *employees* to work for the company and help it reach its goals. Owners and employees depend on a third group of participants—*customers*. Ultimately, the goal of any business is to satisfy the needs of its customers in order to generate a profit for the owners.

## Functional Areas of Business

Figure 1.1

Hospitals specialize in an intangible product—health care.



The activities needed to operate a business can be divided into a number of *functional areas*: management, operations, marketing, accounting, and finance. Let's briefly explore each of these areas.

## Management

Managers are responsible for the work performance of other people. **Management** involves planning for, organizing, staffing, directing, and controlling a company's resources so that it can achieve its goals. Managers *plan* by setting goals and developing strategies for achieving them. They *organize* activities and resources to ensure that company goals are met. They *staff* the organization with qualified employees and *direct* them to accomplish organizational goals. Finally, managers design *controls* for assessing the success of plans and decisions and take corrective action when needed.

## Operations

All companies must convert resources (labor, materials, money, information, and so forth) into goods or services. Some companies, such as Apple, convert resources into *tangible* products—Macs, iPhones, iPods, iPads. Others, such as hospitals, convert resources into *intangible* products—health care. The person who designs and oversees the transformation of resources into goods or services is called an **operations manager**. This individual is also responsible for ensuring that products are of high quality.

## Marketing

**Marketing** consists of everything that a company does to identify customers' needs and designs products to meet those needs. Marketers develop the benefits and features of products, including price and quality. They also decide on the best method of delivering products and the best means of promoting them to attract and keep customers. They manage relationships with customers and make them aware of the organization's desire and ability to satisfy their needs.

## Accounting

Managers need accurate, relevant, timely financial information, and accountants provide it. **Accountants** measure, summarize, and communicate financial and managerial information and advise other managers on financial matters. There are two fields of accounting. *Financial accountants* prepare financial statements to help users, both inside and outside the organization, assess the financial strength of the company. *Managerial accountants* prepare information, such as reports on the cost of materials used in the production process, for internal use only.

## Finance

**Finance** involves planning for, obtaining, and managing a company's funds. Finance managers address such questions as the following: How much money does the company need? How and where will it get the necessary money? How and when will it pay the money back? What should it do with its funds? What investments should be made in plant and equipment? How much should be spent on research and development? How should excess funds be invested? Good financial management is particularly important when a company is first formed, because new business owners usually need to borrow money to get started.

Figure 1.2 Business and Its Environment


## External Forces that Influence Business Activities

Apple and other businesses don't operate in a vacuum: they're influenced by a number of external factors. These include the economy, government, consumer trends, and public pressure to act as good corporate citizens. Figure 1.2 "Business and Its Environment" sums up the relationship among the participants in a business, its functional areas, and the external forces that influence its activities. One industry that's clearly affected by all these factors is the fast-food industry. A strong *economy* means people have more money to eat out at places where food standards are monitored by a *government* agency, the Food and Drug Administration. Preferences for certain types of foods are influenced by *consumer trends* (eating fried foods might be OK one year and out the next). Finally, a number of decisions made by the industry result from its *desire to be a good corporate citizen*. For example, several fast food chains have responded to environmental concerns by eliminating Styrofoam containers (Baron, 2006). As you move through this text, you'll learn more about these external influences on business. (Section 1.3 "What Is Economics?" will introduce in detail one of these external factors—the economy.)

- The main participants in a business are its owners, employees, and customers.
- Businesses are influenced by such external factors as the economy, government, consumer trends, and public pressure to act as good corporate citizens.
- The activities needed to run a business can be divided into five functional areas:





1. **Management** involves planning, organizing, staffing, directing, and controlling resources

to achieve organizational goals.

2. **Operations** transforms resources (labor, materials, money, and so on) into products.
3. **Marketing** works to identify and satisfy customers' needs.
4. **Finance** involves planning for, obtaining, and managing company funds.
5. **Accounting** entails measuring, summarizing, and communicating financial and managerial information.

1. **(AACSB) Analysis**
   The Martin family has been making guitars out of its factory in Nazareth, Pennsylvania, factory for more than 150 years. In 2004, Martin Guitar was proud to produce its millionth instrument. Go to http://www.martinguitar.com to link to the Martin Guitar Web site and read about the company's long history. You'll discover that, even though it's a family-run company with a fairly unique product, it operates like any other company. Identify the main activities or functions of Martin Guitar's business and explain how each activity benefits the company.
2. **(AACSB) Analysis**
   Name four external factors that have an influence on business. Give examples of the ways in which each factor can affect the business performance of two companies: Wal-Mart and Ford.

## References

Baron, D., "Facing-Off in Public," *Stanford Business*, April 15, 2006, http://www.gsb.stanford.edu/news/bmag/ sbsm0308/feature_face_off.shtml (accessed January 21, 2012).

## 1.3 What Is Economics?

1. Define *economics* and identify factors of production.
2. Explain how economists answer the three key economics questions.
3. Compare and contrast economic systems.

To appreciate how a business functions, we need to know something about the economic environment in which it operates. We begin with a definition of economics and a discussion of the resources used to produce goods and services.

## Resources: Inputs and Outputs

**Economics** is the study of the production, distribution, and consumption of goods and services.

**Resources** are the *inputs* used to produce *outputs*. Resources may include any or all of the following:

- Land and other natural resources
- Labor (physical and mental)
- Capital, including buildings and equipment
- Entrepreneurship

Resources are combined to produce goods and services. Land and natural resources provide the needed raw materials. Labor transforms raw materials into goods and services. Capital (equipment, buildings, vehicles, cash, and so forth) are needed for the production process. Entrepreneurship provides the skill and creativity needed to bring the other resources together to produce a good or service to be sold to the marketplace.

Because a business uses resources to *produce* things, we also call these resources **factors of production**. The factors of production used to produce a shirt would include the following:

- The land that the shirt factory sits on, the electricity used to run the plant, and the raw cotton from which the shirts are made
- The laborers who make the shirts
- The factory and equipment used in the manufacturing process, as well as the money needed to operate the factory
- The entrepreneurship skill used to coordinate the other resources to initiate the production process and







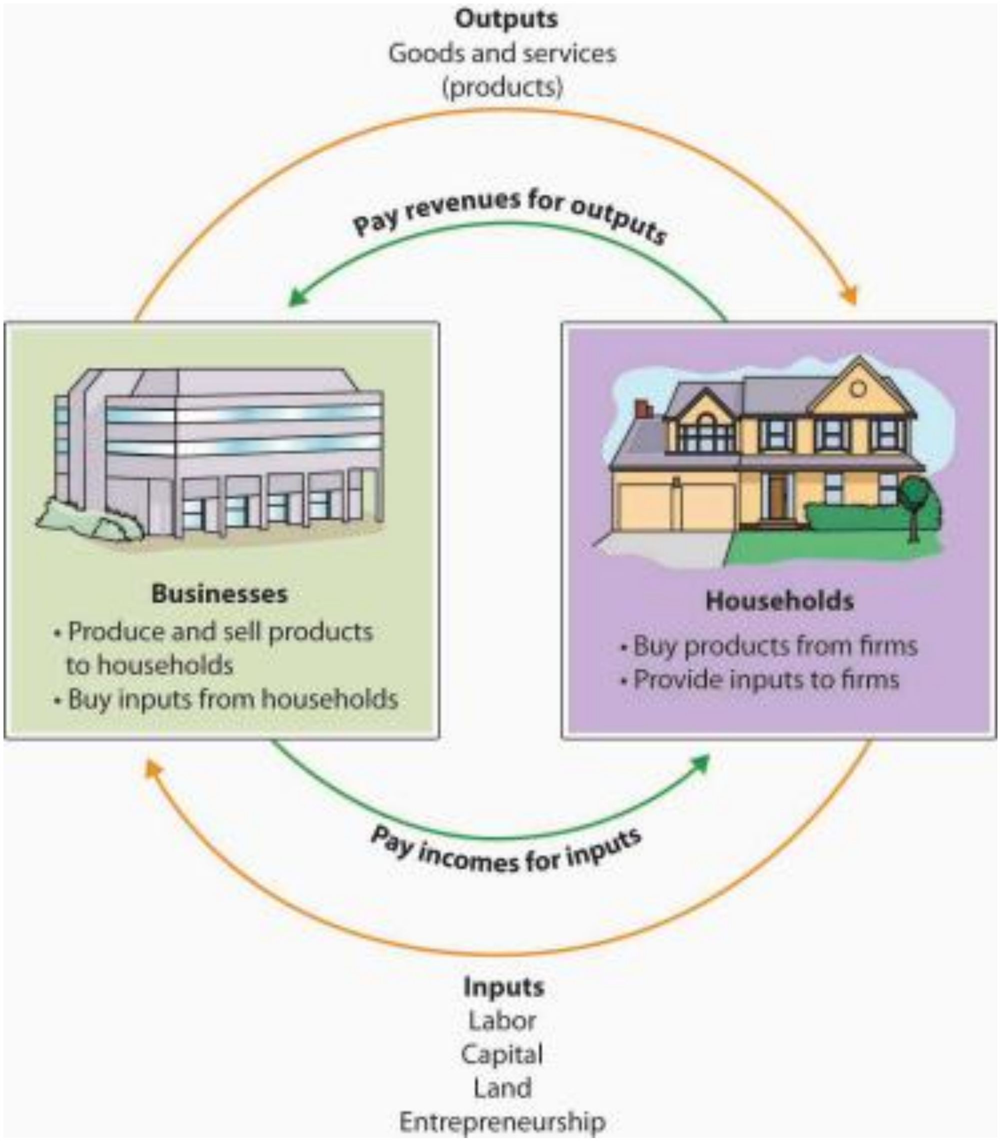
the distribution of the goods or services to the marketplace

## Input and Output Markets

Many of the factors of production (or resources) are provided to businesses by households. For example, households provide businesses with labor (as workers), land and buildings (as landlords), and capital (as investors). In turn, businesses pay households for these resources by providing them with income, such as wages, rent, and interest. The resources obtained from households are then used by businesses to produce goods and services, which are sold to the same households that provide businesses with revenue. The revenue obtained by businesses is then used to buy additional resources, and the cycle continues. This circular flow is described in Figure 1.3 "The Circular Flow of Inputs and Outputs", which illustrates the dual roles of households and businesses:

- Households not only provide factors of production (or resources) but also consume goods and services.
- Businesses not only buy resources but also produce and sell both goods and services.

Figure 1.3 The Circular Flow of Inputs and Outputs




## The Questions Economists Ask

Economists study the interactions between households and businesses and look at the ways in which the factors of production are combined to produce the goods and services that people need. Basically, economists try to answer three sets of questions:

1. *What goods and services should be produced to meet consumers' needs?* In what quantity? When should they be produced?
2. *How should goods and services be produced?* Who should produce them, and what resources, including technology, should be combined to produce them?
3. *Who should receive the goods and services produced?* How should they be allocated among consumers?





## Economic Systems

The answers to these questions depend on a country's **economic system—**the means by which a society (households, businesses, and government) makes decisions about allocating resources to produce products and about distributing those products. The degree to which individuals and business owners, as opposed to the government, enjoy freedom in making these decisions varies according to the type of economic system. Generally speaking, economic systems can be divided into two systems: *planned systems* and *free market systems*.

## Planned Systems

In a planned system, the government exerts control over the allocation and distribution of all or some goods and services. The system with the highest level of government control is **communism**. In theory, a communist economy is one in which the government owns all or most enterprises. Central planning by the government dictates which goods or services are produced, how they are produced, and who will receive them. In practice, pure communism is practically nonexistent today, and only a few countries (notably North Korea and Cuba) operate under rigid, centrally planned economic systems.

Under **socialism**, industries that provide essential services, such as utilities, banking, and health care, may be government owned. Other businesses are owned privately. Central planning allocates the goods and services produced by government-run industries and tries to ensure that the resulting wealth is distributed equally. In contrast, privately owned companies are operated for the purpose of making a profit for their owners. In general, workers in socialist economies work fewer hours, have longer vacations, and receive more health care, education, and child-care benefits than do workers in capitalist economies. To offset the high cost of public services, taxes are generally steep. Examples of socialist countries include Sweden and France.

## Free Market System

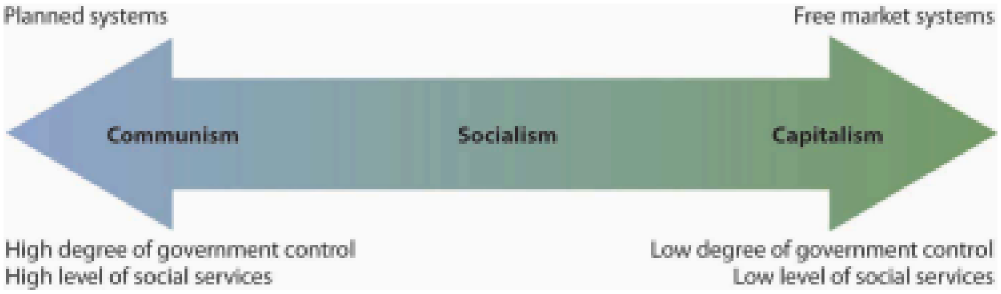
The economic system in which most businesses are owned and operated by individuals is the **free market system**, also known as **capitalism**. As we will see next, in a free market, *competition* dictates how goods and services will be allocated. Business is conducted with only limited government involvement. The economies of the United States and other countries, such as Japan, are based on capitalism.

## How Economic Systems Compare

In comparing economic systems, it's helpful to think of a continuum with communism at one end and pure capitalism at the other, as in Figure 1.4 "The Spectrum of Economic Systems". As you move from left to right, the amount of government control over business diminishes. So, too, does the level of social services, such as health care, child-care services, social security, and unemployment benefits.



Figure 1.4 The Spectrum of Economic Systems




## Mixed Market Economy

Though it's possible to have a pure communist system, or a pure capitalist (free market) system, in reality many economic systems are mixed. A **mixed market economy** relies on both markets and the government to allocate resources. We've already seen that this is what happens in socialist economies in which the government controls selected major industries, such as transportation and health care, while allowing individual ownership of other industries. Even previously communist economies, such as those of Eastern Europe and China, are becoming more mixed as they adopt capitalistic characteristics and convert businesses previously owned by the government to private ownership through a process called **privatization**.

## The U.S. Economic System

Like most countries, the United States features a mixed market system: though the U.S. economic system is primarily a free market system, the federal government controls some basic services, such as the postal service and air traffic control. The U.S. economy also has some characteristics of a socialist system, such as providing social security retirement benefits to retired workers.

The free market system was espoused by Adam Smith in his book *The Wealth of Nations*, published in 1776[1]. According to Smith, competition alone would ensure that consumers received the best products at the best prices. In the kind of competition he assumed, a seller who tries to charge more for his product than other sellers won't be able to find any buyers. A job-seeker who asks more than the going wage won't be hired. Because the "invisible hand" of competition will make the market work effectively, there won't be a need to regulate prices or wages.

Almost immediately, however, a tension developed among free market theorists between the principle of *laissez faire*—leaving things alone—and government intervention. Today, it's common for the U.S. government to intervene in the operation of the economic system. For example, government exerts influence on the food and pharmaceutical industries through the Food and Drug Administration, which protects consumers by preventing unsafe or mislabeled products from reaching the market.

To appreciate how businesses operate, we must first get an idea of how prices are set in competitive markets. Thus, Section 1.4 "Perfect Competition and Supply and Demand" begins by describing how markets establish prices in an environment of *perfect competition*.

- **Economics** is the study of the production, distribution, and consumption of goods and services.
- Economists address these three questions: (1) What goods and services should be produced to meet consumer needs? (2) How should they be produced, and who should produce them? (3) Who should receive goods and services?
- The answers to these questions depend on a country's **economic system**. The primary economic systems that exist today are planned and free market systems.
- In a planned system, such as **communism** and **socialism**, the government exerts control over the production and distribution of all or some goods and services.
- In a **free market system**, also known as **capitalism**, business is conducted with only limited government involvement. Competition determines what goods and services are produced, how they are produced, and for whom.

1. If you started a business that made surfboards, what factors of production would you need to make your product? Where would you get them? Where would you find the money you'd need to pay for additional resources?
2. Which three key questions do economists try to answer? Will answers to these questions differ, depending on whether they're working in the United States or in Cuba? Explain your answer.

[1]According to many scholars, *The Wealth of Nations* not only is the most influential book on free-market capitalism but remains relevant today.

## 1.4 Perfect Competition and Supply and Demand

1. Describe perfect competition, and explain how supply and demand interact to set prices in a free market system.

Under a mixed economy, such as we have in the United States, businesses make decisions about which goods to produce or services to offer and how they are priced. Because there are many businesses making goods or providing services, customers can choose among a wide array of products. The competition for sales among businesses is a vital part of our economic system. Economists have identified four types of competition—*perfect competition*, *monopolistic competition*, *oligopoly*, and *monopoly*. We'll introduce the first of these—perfect competition—in this section and cover the remaining three in the following section.

## Perfect Competition

Figure 1.5








Produce, like these apples, is a standardized product available from numerous businesses.



**Perfect competition** exists when there are many consumers buying a standardized product from numerous small businesses. Because no seller is big enough or influential enough to affect price, sellers and buyers accept the going price. For example, when a commercial fisher brings his fish to the local market, he has little control over the price he gets and must accept the going market price.

## The Basics of Supply and Demand

To appreciate how perfect competition works, we need to understand how buyers and sellers interact in a market to set prices. In a market characterized by perfect competition, price is determined through the mechanisms of *supply* and *demand*. Prices are influenced both by the supply of products from sellers and by the demand for products by buyers.

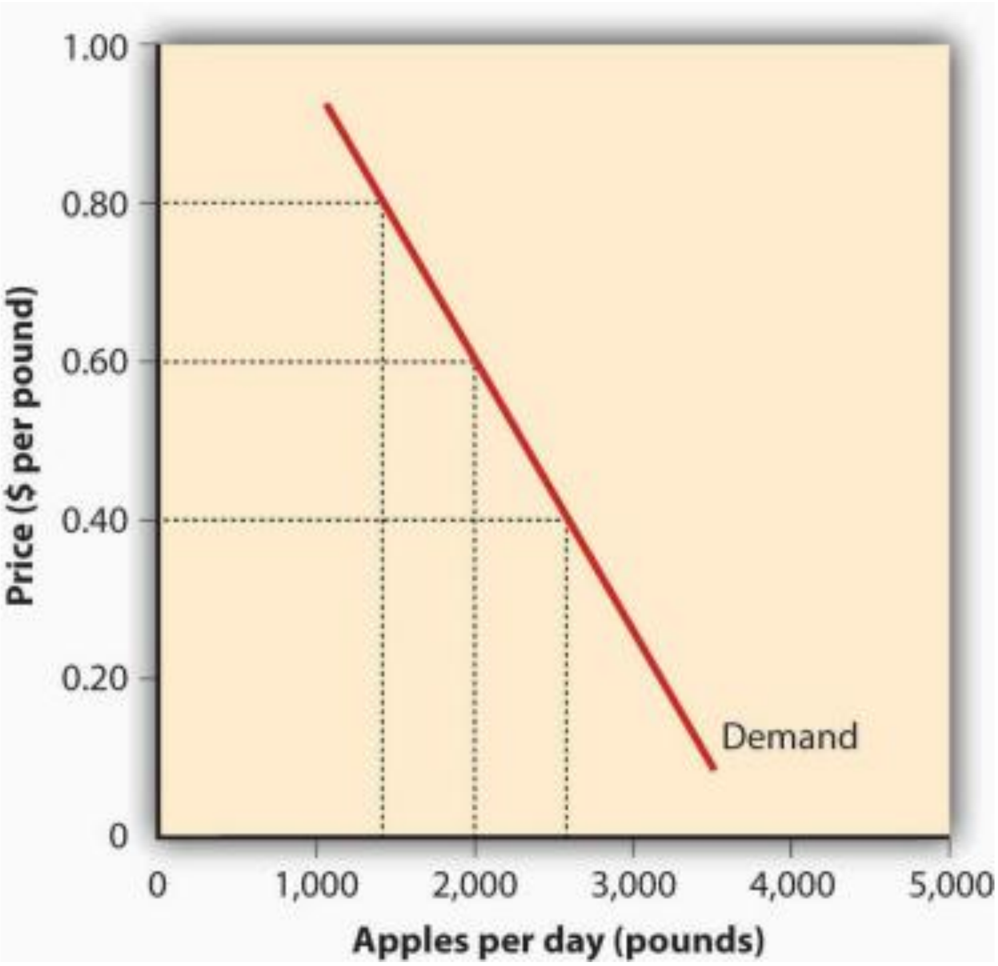
To illustrate this concept, let's create a *supply and demand schedule* for one particular good sold at one point in time. Then we'll define *demand* and create a *demand curve* and define *supply* and create a *supply curve*. Finally, we'll see how supply and demand interact to create an *equilibrium price*—the price at which buyers are willing to purchase the amount that sellers are willing to sell.

## Demand and the Demand Curve

**Demand** is the quantity of a product that buyers are willing to purchase at various prices. The quantity of a product that people are willing to buy depends on its price. You're typically willing to buy *less* of a product when prices *rise* and *more* of a product when prices *fall*. Generally speaking, we find products more attractive at lower prices, and we buy more at lower prices because our income goes further.

Figure 1.6 The Demand Curve



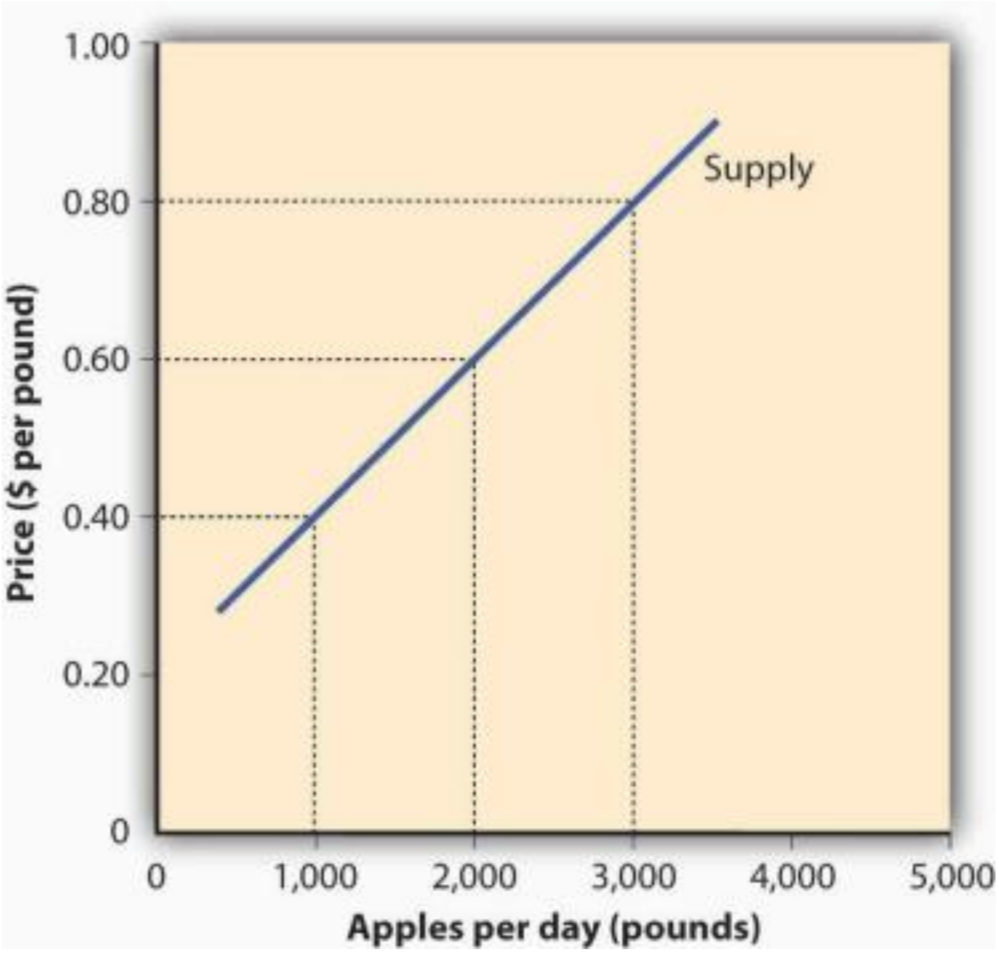



Using this logic, we can construct a **demand curve** that shows the quantity of a product that will be demanded at different prices. Let's assume that the diagram in Figure 1.6 "The Demand Curve" represents the daily price and quantity of apples sold by farmers at a local market. Note that as the price of apples goes down, buyers' demand goes up. Thus, if a pound of apples sells for $0.80, buyers will be willing to purchase only fifteen hundred pounds per day. But if apples cost only $0.60 a pound, buyers will be willing to purchase two thousand pounds. At $0.40 a pound, buyers will be willing to purchase twenty-five hundred pounds.

## Supply and the Supply Curve

**Supply** is the quantity of a product that sellers are willing to sell at various prices. The quantity of a product that a business is willing to sell depends on its price. Businesses are *more* willing to sell a product when the price *rises* and *less* willing to sell it when prices *fall*. Again, this fact makes sense: businesses are set up to make profits, and there are larger profits to be made when prices are high.

Figure 1.7 The Supply Curve

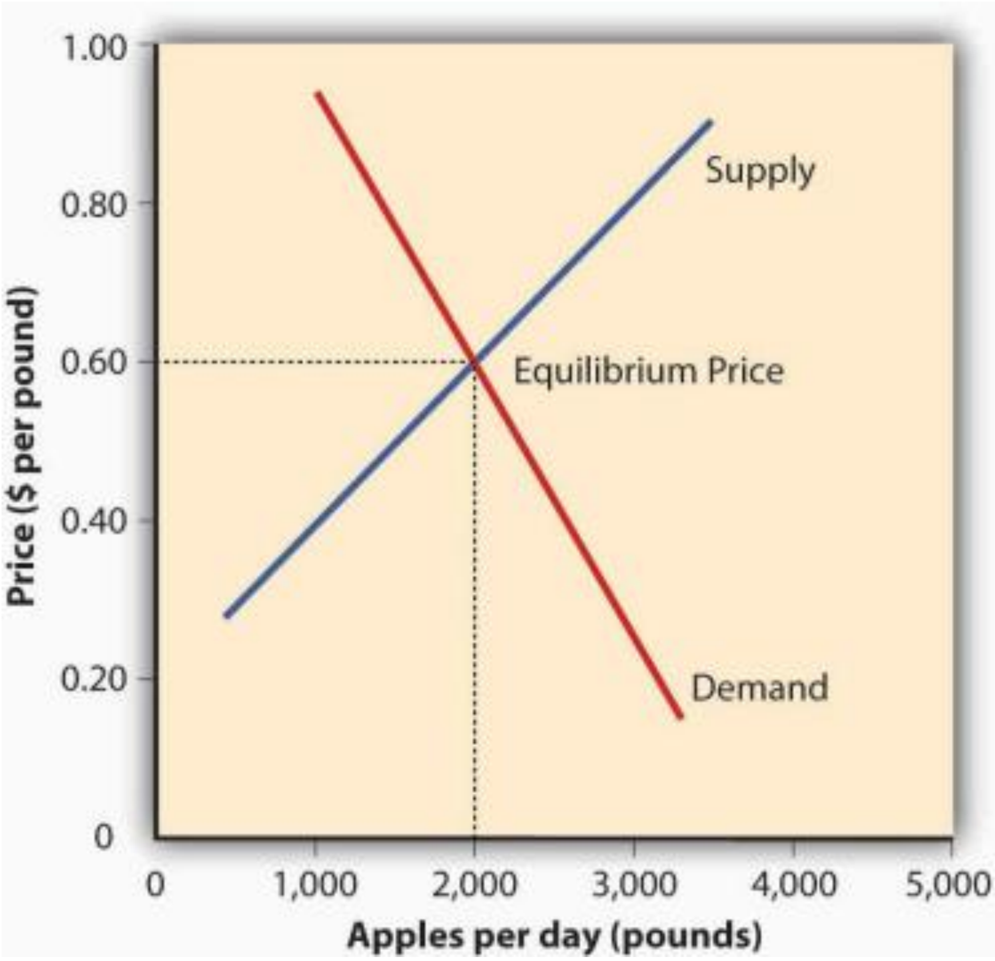



Now we can construct a **supply curve** that shows the quantity of apples that farmers would be willing to sell at different prices, regardless of demand. As you can see in Figure 1.7 "The Supply Curve", the supply curve goes in the opposite direction from the demand curve: as prices rise, the quantity of apples that farmers are willing to sell also goes up. The supply curve shows that farmers are willing to sell only a thousand pounds of apples when the price is $0.40 a pound, two thousand pounds when the price is $0.60, and three thousand pounds when the price is $0.80.

## Equilibrium Price

We can now see how the market mechanism works under perfect competition. We do this by plotting both the supply curve and the demand curve on one graph, as we've done in Figure 1.8 "The Equilibrium Price". The point at which the two curves intersect is the **equilibrium price**. At this point, buyers' demand for apples and sellers' supply of apples is in equilibrium.

Figure 1.8 The Equilibrium Price




You can see in Figure 1.8 "The Equilibrium Price" that the supply and demand curves intersect at the price of $0.60 and quantity of two thousand pounds. Thus, $0.60 is the equilibrium price: at this price, the quantity of apples demanded by buyers equals the quantity of apples that farmers are willing to supply. If a farmer tries to charge more than $0.60 for a pound of apples, he won't sell very many and his profits will go down. If, on the other hand, a farmer tries to charge less than the equilibrium price of $0.60 a pound, he will sell more apples but his profit per pound will be less than at the equilibrium price.

What have we learned in this discussion? We've learned that without outside influences, markets in an environment of perfect competition will arrive at an equilibrium point at which both buyers and sellers are satisfied. But we must be aware that this is a very simplistic example. Things are much more complex in the real world. For one thing, markets rarely operate without outside influences. Sometimes, sellers supply more of a product than buyers are willing to purchase; in that case, there's a *surplus*. Sometimes, they don't produce enough of a product to satisfy demand; then we have a *shortage*.

Circumstances also have a habit of changing. What would happen, for example, if income rose and buyers were willing to pay more for apples? The demand curve would change, resulting in an increase in equilibrium price. This outcome makes intuitive sense: as demand increases, prices will go up. What would happen if apple crops were larger than expected because of favorable weather conditions? Farmers might be willing to sell apples at lower prices. If so, the supply curve would shift, resulting in another change in equilibrium price: the increase in supply would bring down prices.

- In a free market system, buyers and sellers interact in a market to set prices.
- When the market is characterized by **perfect competition**, many small companies sell identical products. Because no company is large enough to control price, each simply accepts the market price. The price is determined by supply and demand.
- **Supply** is the quantity of a product that sellers are willing to sell at various prices.
- **Demand** is the quantity of a product that buyers are willing to purchase at various prices.
- The quantity of a product that people will buy depends on its price: they'll buy more when the price is low and less when it's high.
- Price also influences the quantity of a product that producers are willing to supply: they'll sell more of a product when prices are high and less when they're low.
- In a competitive market, the decisions of buyers and sellers interact until the market reaches an **equilibrium price**—the price at which buyers are willing to buy the same amount that sellers are willing to sell.

(AACSB) Analysis

You just ran across three interesting statistics: (1) the world's current supply of oil is estimated to be 1.3 trillion barrels; (2) the worldwide use of oil is thirty billion barrels a year; and (3) at this rate of consumption, we'll run out of oil in forty-three years. Overcoming an initial sense of impending catastrophe, you remember the discussion of supply and demand in this chapter and realize that things aren't as simple as they seem. After all, many factors affect both the supply of oil and the demand for products made from it, such as gasoline. These factors will influence when (and if) the world runs out of oil. Answer the following questions, and provide explanations for your answers:

1. What's the major factor that affects the *supply* of oil? (*Hint*: It's the same major factor affecting the *demand* for oil.)
2. If producers find additional oil reserves, what will happen to the price of oil?
3. If producers must extract oil from more-costly wells, what will happen to the price that you pay to fill up your gas tank?
4. If China's economy continues to expand rapidly, what will happen to the price of oil?
5. If drivers in the United States start favoring fuel-efficient cars over SUVs, will gas be cheaper or more expensive?
6. In your opinion, will oil producers be able to supply enough oil to meet the increasing demand for oil related products, such as gasoline?

## 1.5 Monopolistic Competition, Oligopoly, and Monopoly

1. Describe monopolistic competition, oligopoly, and monopoly.

Economists have identified four types of competition—*perfect competition*, *monopolistic competition*, *oligopoly*, and *monopoly*. Perfect competition was discussed in the last section; we'll cover the remaining three types of competition here.

## Monopolistic Competition

In **monopolistic competition**, we still have many sellers (as we had under perfect competition). Now, however, they don't sell identical products. Instead, they sell *differentiated* products—products that differ somewhat, or are *perceived* to differ, even though they serve a similar purpose. Products can be differentiated in a number of ways, including quality, style, convenience, location, and brand name. Some people prefer Coke over Pepsi, even though the two products are quite similar. But what if there was a substantial price difference between the two? In that case, buyers could be persuaded to switch from one to the other. Thus, if Coke has a big promotional sale at a supermarket chain, some Pepsi drinkers might switch (at least temporarily).

How is product differentiation accomplished? Sometimes, it's simply geographical; you probably buy gasoline at the station closest to your home regardless of the brand. At other times, perceived differences between products are promoted by advertising designed to convince consumers that one product is different from another—and better than it. Regardless of customer loyalty to a product, however, if its price goes too high, the seller will lose business to a competitor. Under monopolistic competition, therefore, companies have only limited control over price.

## Oligopoly

**Oligopoly** means few sellers. In an oligopolistic market, each seller supplies a large portion of all the products sold in the marketplace. In addition, because the cost of starting a business in an oligopolistic industry is usually high, the number of firms entering it is low.

Companies in oligopolistic industries include such large-scale enterprises as automobile companies and airlines. As large firms supplying a sizable portion of a market, these companies have some control over the prices they charge. But there's a catch: because products are fairly similar, when one company lowers prices, others are







often forced to follow suit to remain competitive. You see this practice all the time in the airline industry: When American Airlines announces a fare decrease, Continental, United Airlines, and others do likewise. When one automaker offers a special deal, its competitors usually come up with similar promotions.

## Monopoly

In terms of the number of sellers and degree of competition, monopolies lie at the opposite end of the spectrum from perfect competition. In perfect competition, there are many small companies, none of which can control prices; they simply accept the market price determined by supply and demand. In a **monopoly**, however, there's only one seller in the market. The market could be a geographical area, such as a city or a regional area, and doesn't necessarily have to be an entire country.

There are few monopolies in the United States because the government limits them. Most fall into one of two categories: *natural* and *legal*. **Natural monopolies** include public utilities, such as electricity and gas suppliers. Such enterprises require huge investments, and it would be inefficient to duplicate the products that they provide. They inhibit competition, but they're legal because they're important to society. In exchange for the right to conduct business without competition, they're regulated. For instance, they can't charge whatever prices they want, but they must adhere to government-controlled prices. As a rule, they're required to serve all customers, even if doing so isn't cost efficient.

A **legal monopoly** arises when a company receives a patent giving it exclusive use of an invented product or process. Patents are issued for a limited time, generally twenty years (United States Patent and Trademark Office, 2006). During this period, other companies can't use the invented product or process without permission from the patent holder. Patents allow companies a certain period to recover the heavy costs of researching and developing products and technologies. A classic example of a company that enjoyed a patent-based legal monopoly is Polaroid, which for years held exclusive ownership of instant-film technology (Bellis, 2006). Polaroid priced the product high enough to recoup, over time, the high cost of bringing it to market. Without competition, in other words, it enjoyed a monopolistic position in regard to pricing.

- There are four types of competition in a free market system: perfect competition, monopolistic competition, oligopoly, and monopoly.
- Under **monopolistic competition**, many sellers offer differentiated products—products that differ slightly but serve similar purposes. By making consumers aware of product differences, sellers exert some control over price.
- In an **oligopoly**, a few sellers supply a sizable portion of products in the market. They exert some control over price, but because their products are similar, when one company lowers prices, the others follow.
- In a **monopoly**, there is only one seller in the market. The market could be a geographical area, such as a city or a regional area, and does not necessarily have to be an entire country. The single seller is able to control prices.
- Most monopolies fall into one of two categories: *natural* and *legal*.



- **Natural monopolies** include public utilities, such as electricity and gas suppliers. They inhibit competition, but they're legal because they're important to society.
- A **legal monopoly** arises when a company receives a patent giving it exclusive use of an invented product or process for a limited time, generally twenty years.

Identify the four types of competition, explain the differences among them, and provide two examples of each. (Use examples different from those given in the text.)

# References

Bellis, M., "Inventors-Edwin Land-Polaroid Photography-Instant Photography/Patents," April 15, 2006, http://inventors.about.com/library/inventors/blpolaroid.htm (accessed January 21, 2012).

United States Patent and Trademark Office, *General Information Concerning Patents*, April 15, 2006, http://www.uspto.gov/web/offices/pac/doc/general/index.html#laws (accessed January 21, 2012).



## 1.6 Measuring the Health of the Economy

1. Understand the criteria used to assess the status of the economy.

Every day, we are bombarded with economic news. We're told that the economy is struggling, unemployment is high, home prices are low, and consumer confidence is down. As a student learning about business, and later as a business manager, you need to understand the nature of the U.S. economy and the terminology that we use to describe it. You need to have some idea of where the economy is heading, and you need to know something about the government's role in influencing its direction.

## Economic Goals

All the world's economies share three main goals:

1. Growth
2. High employment
3. Price stability

Let's take a closer look at each of these goals, both to find out what they mean and to show how we determine whether they're being met.

## Economic Growth

One purpose of an economy is to provide people with goods and services—cars, computers, video games, houses, rock concerts, fast food, amusement parks. One way in which economists measure the performance of an economy is by looking at a widely used measure of total output called **gross domestic product (GDP)**. GDP is defined as the market value of all goods and services produced by the economy in a given year. In the United States, it's calculated by the Department of Commerce. GDP includes only those goods and services produced domestically; goods produced outside the country are excluded. GDP also includes only those goods and services that are produced for the final user; intermediate products are excluded. For example, the silicon chip that goes into a computer (an intermediate product) would not count, even though the finished computer would.





By itself, GDP doesn't necessarily tell us much about the state of the economy. But *change* in GDP does. If GDP (after adjusting for inflation) goes up, the economy is growing. If it goes down, the economy is contracting.

## The Business Cycle

The economic ups and downs resulting from expansion and contraction constitute the **business cycle**. A typical cycle runs from three to five years but could last much longer. Though typically irregular, a cycle can be divided into four general phases of *prosperity*, *recession*, *depression* (which the cycle generally skips), and *recovery*:

• During *prosperity*, the economy expands, unemployment is low, incomes rise, and consumers buy more products. Businesses respond by increasing production and offering new and better products.

• Eventually, however, things slow down. GDP decreases, unemployment rises, and because people have less money to spend, business revenues decline. This slowdown in economic activity is called a **recession**. Economists often say that we're entering a recession when GDP goes down for two consecutive quarters.

Figure 1.9

Ian Lamont – Local and national newspapers – 

- Generally, a recession is followed by a *recovery* in which the economy starts growing again.





- If, however, a recession lasts a long time (perhaps a decade or so), while unemployment remains very high and production is severely curtailed, the economy could sink into a **depression**. Though not impossible, it's unlikely that the United States will experience another severe depression like that of the 1930s. The federal government has a number of economic tools (some of which we'll discuss shortly) with which to fight any threat of a depression.

## Full Employment

To keep the economy going strong, people must spend money on goods and services. A reduction in personal expenditures for things like food, clothing, appliances, automobiles, housing, and medical care could severely reduce GDP and weaken the economy. Because most people earn their spending money by working, an important goal of all economies is making jobs available to everyone who wants one. In principle, **full employment** occurs when everyone who wants to work has a job. In practice, we say that we have "full employment" when about 95 percent of those wanting to work are employed.

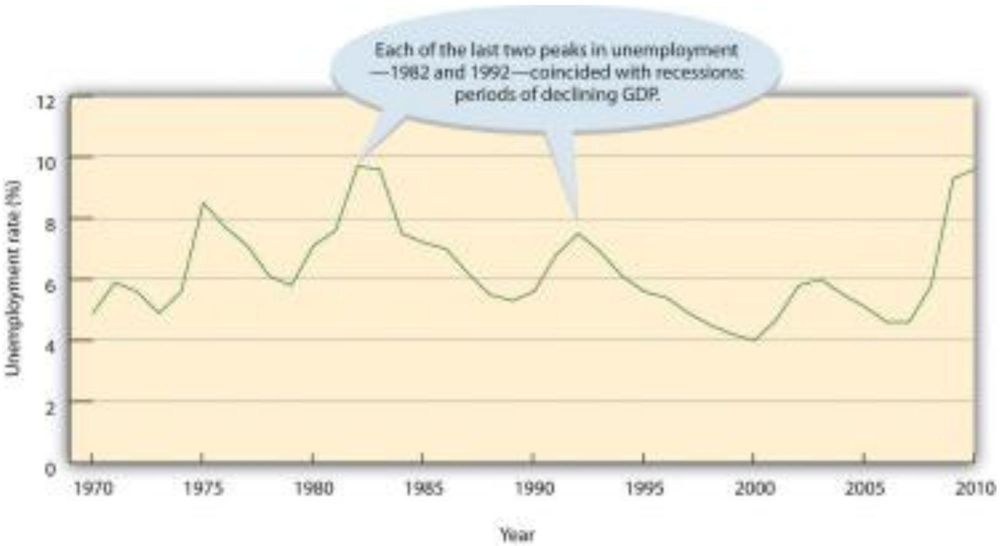
## The Unemployment Rate

The U.S. Department of Labor tracks unemployment and reports the **unemployment rate**: the percentage of the labor force that's unemployed and actively seeking work. The unemployment rate is an important measure of economic health. It goes up during recessionary periods because companies are reluctant to hire workers when demand for goods and services is low. Conversely, it goes down when the economy is expanding and there is high demand for products and workers to supply them.

Figure 1.10 "The U.S. Unemployment Rate, 1970–2010" traces the U.S. unemployment rate between 1970 and 2010. If you want to know the current unemployment rate, go to the CNNMoney Web site (CNNMoney.com) and click on "Economy" and then on "Job Growth."

Figure 1.10 The U.S. Unemployment Rate, 1970–2010

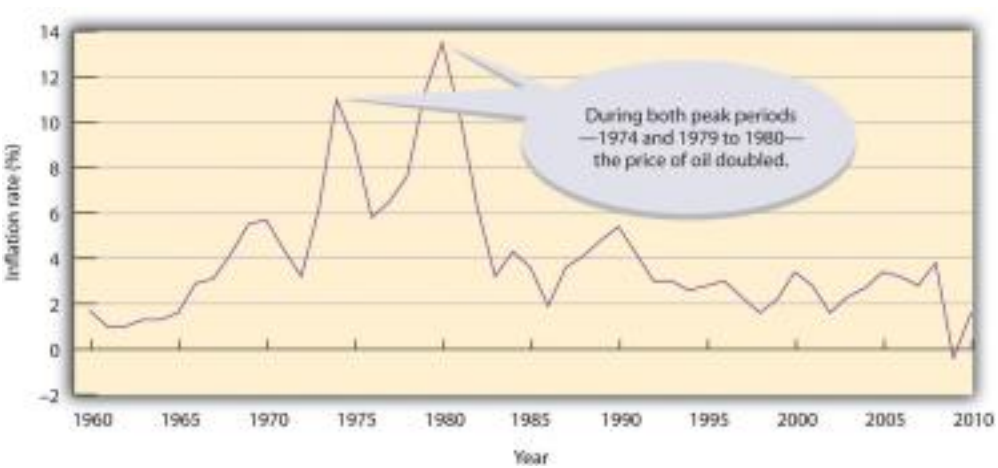





## Price Stability

A third major goal of all economies is maintaining **price stability**. Price stability occurs when the average of the prices for goods and services either doesn't change or changes very little. Rising prices are troublesome for both individuals and businesses. For individuals, rising prices mean you have to pay more for the things you need. For businesses, rising prices mean higher costs, and, at least in the short run, businesses might have trouble passing on higher costs to consumers. When the overall price level goes up, we have **inflation**. Figure 1.11 "The U.S. Inflation Rate, 1960–2010" shows inflationary trends in the U.S. economy since 1960. When the price level goes down (which rarely happens), we have **deflation**.

Figure 1.11 The U.S. Inflation Rate, 1960–2010




## The Consumer Price Index

The most widely publicized measure of inflation is the **consumer price index (CPI)**, which is reported monthly





by the Bureau of Labor Statistics. The CPI measures the rate of inflation by determining price changes of a hypothetical basket of goods, such as food, housing, clothing, medical care, appliances, automobiles, and so forth, bought by a typical household.

The CPI base period is 1982 to 1984, which has been given an average value of 100. Table 1.1 "Selected CPI Values, 1950–2010" gives CPI values computed for selected years. The CPI value for 1950, for instance, is 24. This means that $1 of typical purchases in 1982 through 1984 would have cost $0.24 in 1950. Conversely, you would have needed $2.18 to purchase the same $1 worth of typical goods in 2010. The difference registers the effect of inflation. In fact, that's what an *inflation rate* is—*the percentage change in a price index*.

You can find out the current CPI by going to the CNNMoney Web site (CNNMoney.com) and click on "Economy" and then on "Inflation (CPI)."

Table 1.1 Selected CPI Values, 1950–2010

| **Year** | 1950 | 1960 | 1970 | 1980 | 1990 | 2000 | 2001 | 2002 |
|---|---|---|---|---|---|---|---|---|
| **CPI** | 24.1 | 29.1 | 38.8 | 82.4 | 130.7 | 172.2 | 177.1 | 179.9 |
| **Year** | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 |
| **CPI** | 184.0 | 188.9 | 195.3 | 201.6 | 207.3 | 215.3 | 214.15 | 218.1 |

## Economic Forecasting

In the previous section, we introduced several measures that economists use to assess the performance of the economy at a given time. By looking at changes in GDP, for instance, we can see whether the economy is growing. The CPI allows us to gauge inflation. These measures help us understand where the economy stands today. But what if we want to get a sense of where it's headed in the future? To a certain extent, we can forecast future economic trends by analyzing several leading economic indicators.

## Economic Indicators

An **economic indicator** is a statistic that provides valuable information about the economy. There's no shortage of economic indicators, and trying to follow them all would be an overwhelming task. Thus, economists and businesspeople track only a select few, including those that we'll now discuss.

# Lagging and Leading Indicators

Statistics that report the status of the economy a few months in the past are called **lagging economic indicators**.


One such indicator is *average length of unemployment*. If unemployed workers have remained out of work for a long time, we may infer that the economy has been slow. Indicators that predict the status of the economy three to twelve months in the future are called **leading economic indicators**. If such an indicator rises, the economy is likely to expand in the coming year. If it falls, the economy is likely to contract.

To predict where the economy is headed, we obviously must examine several leading indicators. It's also helpful to look at indicators from various sectors of the economy—labor, manufacturing, and housing. One useful indicator of the outlook for future jobs is the number of new *claims for unemployment insurance*. This measure tells us how many people recently lost their jobs. If it's rising, it signals trouble ahead because unemployed consumers can't buy as many goods and services as they could if they had paychecks.

To gauge the level of goods to be produced in the future (which will translate into future sales), economists look at a statistic called *average weekly manufacturing hours*. This measure tells us the average number of hours worked per week by production workers in manufacturing industries. If it's on the rise, the economy will probably improve. For assessing the strength of the housing market, *building permits* is often a good indicator. An increase in this statistic—which tells us how many new housing units are being built—indicates that the economy is improving. Why? Because increased building brings money into the economy not only through new home sales but also through sales of furniture and appliances to furnish them.

Finally, if you want a measure that combines all these economic indicators, as well as others, a private research firm called the Conference Board publishes a U.S. *leading index*. To get an idea of what leading economic indicators are telling us about the state of the economy today, go to the Conference Board site at http://www.conference-board.org and click on "U.S. Indicators" and then "leading economic index."

Consumer Confidence Index

The Conference Board also publishes a **consumer confidence index** based on results of a monthly survey of five thousand U.S. households. The survey gathers consumers' opinions on the health of the economy and their plans for future purchases. It's often a good indicator of consumers' future buying intent. For information on current consumer confidence, go to the Conference Board site at http://www.conference-board.org and click on "consumer confidence."

- All economies share three goals: growth, high employment, and price stability.
- *Growth*. An economy provides people with goods and services, and economists measure its performance by studying the **gross domestic product (GDP)**—the market value of all goods and services produced by the economy in a given year.
- If GDP goes up, the economy is growing; if it goes down, the economy is contracting.
- *High employment*. Because most people earn their money by working, a goal of all economies is making jobs available to everyone who wants one.
- The U.S. government reports an **unemployment rate**—the percentage of the labor force that's

unemployed and actively seeking work.





- The unemployment rate goes up during recessionary periods and down when the economy is expanding.
    - *Price stability*. When the average prices of products either don't change or change very little, **price stability** occurs.
    - When overall prices go up, we have **inflation**; when they go down, we have **deflation**.
    - The **consumer price index (CPI)** measures inflation by determining the change in prices of a hypothetical basket of goods bought by a typical household.
- To get a sense of where the economy is headed in the future, we use statistics called **economic indicators**.
    - Indicators that, like *average length of unemployment*, report the status of the economy a few months in the past are **lagging economic indicators**.
    - Those, like *new claims for unemployment insurance*, that predict the status of the economy three to twelve months in the future are **leading economic indicators**.

1. **(AACSB) Analysis**

Congratulations! You entered a sweepstakes and won a fantastic prize: a trip around the world. There's only one catch: you have to study the economy of each country (from the list below) that you visit, and identify the current phase of its business cycle. Be sure to explain your responses.

- *Country 1.* While the landscape is beautiful and the weather is superb, a lot of people seem unhappy. Business is slow, and production has dropped steadily for the past six months. Revenues are down, companies are laying off workers, and there's less money around to spend.
- *Country 2.* Here, people are happily busy. Almost everyone has a job and makes a good income. They spend freely, and businesses respond by offering a steady outflow of new products.
- *Country 3.* Citizens of this country report that, for a while, life had been tough; lots of people were jobless, and money was tight. But things are getting much better. Workers are being called back to their jobs, production is improving, and people are spending again.
- *Country 4.* This place makes you so depressed that you can't wait to get back home. People seem defeated, mostly because many have been without jobs for a long time. Lots of businesses have closed down, and those that have managed to stay open are operating at reduced capacity.

2. What are the three main economic goals of most economies, including the economy of the United States? What economic measures do we examine to determine whether or how well these goals are being met?

# 1.7 Government's Role in Managing the Economy

1. Discuss the government's role in managing the economy.

In every country, the government takes steps to help the economy achieve the goals of growth, full employment, and price stability. In the United States, the government influences economic activity through two approaches: monetary policy and fiscal policy. Through **monetary policy**, the government exerts its power to regulate the money supply and level of interest rates. Through **fiscal policy**, it uses its power to tax and to spend.

## Monetary Policy

Monetary policy is exercised by the Federal Reserve System ("the Fed"), which is empowered to take various actions that decrease or increase the money supply and raise or lower short-term interest rates, making it harder or easier to borrow money. When the Fed believes that inflation is a problem, it will use *contractionary policy* to decrease the money supply and raise interest rates. When rates are higher, borrowers have to pay more for the money they borrow, and banks are more selective in making loans. Because money is "tighter"—more expensive to borrow—demand for goods and services will go down, and so will prices. In any case, that's the theory.

Figure 1.12

The Fed will typically tighten or decrease the money supply during inflationary periods, making it harder to borrow money.



To counter a recession, the Fed uses *expansionary policy* to increase the money supply and reduce interest rates. With lower interest rates, it's cheaper to borrow money, and banks are more willing to lend it. We then say that money is "easy." Attractive interest rates encourage businesses to borrow money to expand production and encourage consumers to buy more goods and services. In theory, both sets of actions will help the economy escape or come out of a recession.

## Fiscal Policy

Fiscal policy relies on the government's powers of spending and taxation. Both taxation and government spending can be used to reduce or increase the total supply of money in the economy—the total amount, in other words, that businesses and consumers have to spend. When the country is in a recession, the appropriate policy is to increase spending, reduce taxes, or both. Such expansionary actions will put more money in the hands of businesses and consumers, encouraging businesses to expand and consumers to buy more goods and services. When the economy is experiencing inflation, the opposite policy is adopted: the government will decrease spending or increase taxes, or both. Because such contractionary measures reduce spending by businesses and consumers, prices come down and inflation eases.

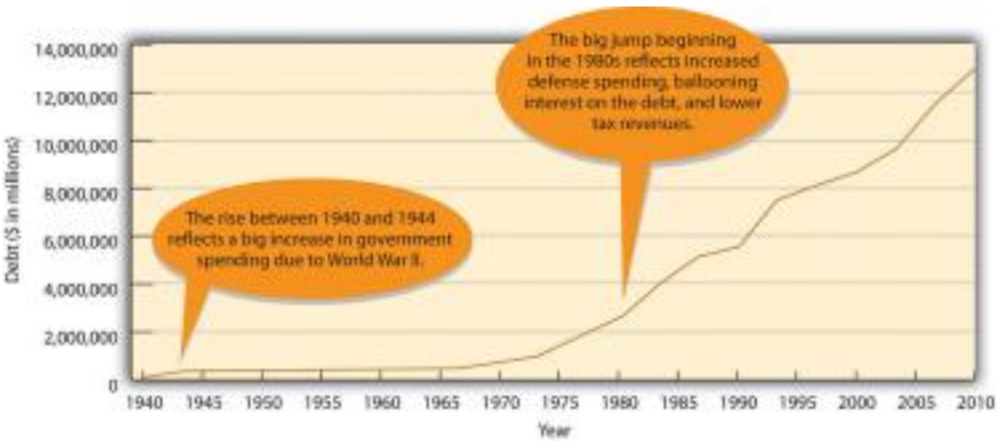


## The National Debt

If, in any given year, the government takes in more money (through taxes) than it spends on goods and services (for things such as defense, transportation, and social services), the result is a budget *surplus*. If, on the other hand, the government spends more than it takes in, we have a budget *deficit* (which the government pays off by borrowing through the issuance of Treasury bonds). Historically, deficits have occurred much more often than surpluses; typically, the government spends more than it takes in. Consequently, the U.S. government now has a total **national debt** of more than $14 *trillion*.

As you can see in Figure 1.13 "The U.S. National Debt, 1940–2010", this number has risen dramatically in the last sixty-five years. The significant jump that starts in the 1980s reflects several factors: a big increase in government spending (especially on defense), a substantial rise in interest payments on the debt, and lower tax rates. As of this writing, your share is $46,146.21. If you want to see what the national debt is today—and what your current share is—go on the Web to the U.S. National Debt Clock (http://www.brillig.com/debt_clock).

Figure 1.13 The U.S. National Debt, 1940–2010




## Macroeconomics and Microeconomics

In the preceding discussion, we've touched on two main areas in the field of economics: (1) *macroeconomics*, or the study of the economy as a whole, and (2) *microeconomics*, or the study of the economic choices made by individual consumers or businesses. Macroeconomics examines the economy-wide effect of inflation, while microeconomics considers such decisions as the price you're willing to pay to go to college. Macroeconomics investigates overall trends in imports and exports, while microeconomics explains the price that teenagers are willing to pay for concert tickets. Though they are often regarded as separate branches of economics, we can gain a richer understanding of the economy by studying issues from both perspectives. As we've seen in this chapter, for instance, you can better understand the overall level of activity in an economy (a macro issue) through an understanding of supply and demand (a micro issue).



- The U.S. government uses two types of policies—monetary policy and fiscal policy—to influence economic performance. Both have the same purpose: to help the economy achieve growth, full employment, and price stability.
- **Monetary policy** is used to control the money supply and interest rates.
- It's exercised through an independent government agency called the Federal Reserve System ("the

Fed"), which has the power to control the money supply and interest rates.

- When the Fed believes that inflation is a problem, it will use *contractionary policy* to decrease the money supply and raise interest rates. To counter a recession, it will use *expansionary policy* to increase the money supply and reduce interest rates.
- **Fiscal policy** uses the government's power to spend and tax.
- When the country is in a recession, the government will increase spending, reduce taxes, or do both to expand the economy.
- When we're experiencing inflation, the government will decrease spending or increase taxes, or both.
- When the government takes in more money in a given year (through taxes) than it spends, the result is a *surplus*.
- When the opposite happens—government spends more money than it takes in—we have a *deficit*.
- The cumulative sum of deficits is the **national debt**—the total amount of money owed by the federal government.

1. Let's say that you're the Fed chairperson and that the country is in a recession. What actions should the Fed take to pull the country out of the recession? What would you advise government officials to do to improve the economy? Justify your recommendations.
2. Browsing through your college's catalog, you notice that all business majors must take two economics courses: macroeconomics and microeconomics. Explain what's covered in each of these courses. In what ways will the things you learn in each course help you in the future?

# 1.8 Cases and Problems

The "Economy" section of the CNNMoney Web site provides current information on a number of economic indicators. Go to http://money.cnn.com and click on "Economy" and then on "Jobs," and find answers to the following questions:

1. You read in the chapter that an important goal of all economies is to make jobs available to everyone who wants one. Review the CNNMoney discussion on job growth and then answer the following questions:
   a. Is the current level of unemployment rising or falling?
   b. What do economists expect will happen to unemployment rates in the near future?
   c. Is the current level of unemployment a burden or an asset to the economy? In what ways?
2. Do you remember the first dollar you earned? Maybe you earned it delivering newspapers, shoveling snow, mowing lawns, or babysitting. How much do you think that dollar is worth today? Go to the WestEgg site at http://www.westegg.com/inflation and find the answer to this question. After determining the current value of your first dollar, explain how the calculator was created. (*Hint*: Apply what you know about CPI.)

**Is a Career in Economics for You?**

Are you wondering what a career in economics would be like? Go to the U.S. Department of Labor Web site (http://www.bls.gov/oco/ocos055.htm) and review the occupational outlook for economists. Look for answers to the following questions:

1. What issues interest economists?
2. What kinds of jobs do government economists perform? What about those who work in private industry? In education?
3. What educational background and training is needed for these jobs?
4. What is the current job outlook for economists?
5. What is the entry-level salary for an economist with a bachelor's degree? With a master's degree?

**How Much Is That CD in the Window?**

The early 1990s were a good time to buy CDs, mainly because discounters such as Wal-Mart and Best Buy were accumulating customers by dropping prices from $15 to $10. They were losing money, but they figured that the policy







still made good business sense. Why? They reasoned that while customers were in the store to shop for CDs, they'd find other, more profitable products.

The policy was a windfall for CD buyers, but a real problem for traditional music retailers such as Tower Records. With discounters slashing prices, CD buyers were no longer willing to pay the prices asked by traditional music retailers. Sales plummeted and companies went out of business.

Ultimately, the discounters' strategy worked: stores such as Wal-Mart and Best Buy gained customers who once bought CDs at stores like Tower Records.

Let's pause at this point to answer the following questions:

1. Does selling a product at below cost make business sense?
2. Whom does it hurt? Whom does it help?
3. Is it ethical?

Let's continue and find out how traditional music retailers responded to this situation.

They weren't happy, and neither were the record companies. Both parties worried that traditional retailers would put pressure on them to reduce the price that they charged for CDs so that retailers could lower their prices and compete with discounters. The record companies didn't want to lower prices. They just wanted things to return to "normal"—to the world in which CDs sold for $15 each.

Most of the big record companies and several traditional music retailers got together and made a deal affecting every store that sold CDs. The record companies agreed with retail chains and other CD outlets to charge a minimum advertised price for CDs. Any retailer who broke ranks by advertising below-price CDs would incur substantial financial penalties. Naturally, CD prices went up.

Now, think about the following:

1. Does the deal made between the record companies and traditional retailers make business sense?
2. Whom does it hurt? Whom does it help?
3. Is it ethical?
4. Is it legal?

Get together in groups of four selected by your instructor and pick any three items from the following list:

- Pint of milk
- Gallon of gas
- Roundtrip airline ticket between Boston and San Francisco
- Large pizza
- Monthly cost of an Internet connection
- CD by a particular musician
- Two-day DVD rental
- Particular brand of DVD player
- Quarter-pound burger

Outside of class, each member of the team should check the prices of the three items, using his or her own sources. At



the next class meeting, get together and compare the prices found by team members. Based on your findings, answer the following questions as a group:

1. Are the prices of given products similar, or do they vary?
2. Why do the prices of some products vary while those of others are similar?
3. Can any price differences be explained by applying the concepts of supply and demand or types of competition?

**Life Is Good in France (if You Have *Le Job*)**

A strong economy requires that people have money to spend on goods and services. Because most people earn their money by working, an important goal of all economies is making jobs available to everyone who wants one. A country has "full employment" when 95 percent of those wanting work are employed. Unfortunately, not all countries achieve this goal of full employment. France, for example, often has a 10 percent unemployment rate overall and a 20 percent unemployment rate among young people.

Does this mean that France isn't trying as hard as the United States to achieve full employment? A lot of people in France would say yes.

Let's take a quick trip to France to see what's going on economically. The day is March 19, 2006, and more than a million people are marching through the streets to protest a proposed new employment law that would make it easier for companies to lay off workers under the age of twenty-six during their first two years of employment. Granted, the plan doesn't sound terribly youth-friendly, but, as usual, economic issues are never as clear-cut as they seem (or as we'd like them to be).

To gain some further insight into what's going on in France, go to a *BusinessWeek* Web site (http://www.businessweek.com/globalbiz/content/mar2006/gb20060321_896473.htm) and read the article "Job Security Ignites Debate in France." Then answer the following questions:

1. Why does the French government support the so-called First Employment Contract? Who's supposed to be helped by the law?
2. Which two groups are most vocal in protesting the law? Why?
3. If you were a long-time worker at a French company, would you support the new law? Why, or why not?
4. If you were a young French person who had just graduated from college and were looking for your first job, would you support the law? Why, or why not?
5. What do you think of France's focus on job security? Does the current system help or hurt French workers? Does it help or hurt recent college graduates?
6. Does the French government's focus on job security help or hinder its economy? Should the

government be  so heavily involved in employment matters?



# Chapter 2: Business Ethics and Social Responsibility

## 2.1 Misgoverning Corporations: An Overview

1. Define business ethics and explain what it means to act ethically in business.
2. Explain how you can recognize an ethical organization.

The WorldCom situation is not an isolated incident. The boom years of the 1990s were followed by revelations of massive corporate corruption, including criminal schemes at companies such as Enron, Adelphia, and Tyco. In fall 2001, executives at Enron, an energy supplier, admitted to accounting practices concocted to overstate the company's income over a period of four years. In the wake of the company's collapse, stock prices plummeted from $90 to $1 a share, inflicting massive financial losses on the investment community. Thousands of employees lost not only their jobs but their retirement funds, as well (Kadlec, 2002). Before the Enron story was off the front pages, officials at Adelphia, the nation's sixth-largest cable company, disclosed that founder and CEO John Rigas had treated the publicly owned firm as a personal piggy bank, siphoning off billions of dollars to support his family's extravagant lifestyle and bankrupting the company in the process (Lieberman, 2004). Likewise, CEO Dennis Koslowzki of conglomerate Tyco International was apparently confused about what was his and what belonged to the company. Besides treating himself to a $30 million estate in Florida and a $7 million Park Avenue apartment, Koslowzki indulged in a taste for expensive office accessories—such as a $15,000 umbrella stand, a $17,000 traveling toilette box, and a $2,200 wastebasket—that eventually drained $600 million from company coffers[1].

As crooked as these CEOs were, Bernie Madoff, founder of Bernard L. Madoff Investment Securities and former chairman of the NASDAQ stock exchange, makes them seem like dime-store shoplifters[2]. Madoff is alleged to have run a giant Ponzi scheme (Langan, 2008) that cheated investors of up to $65 billion. His wrongdoings won him a spot at the top of *Time Magazine*'s Top 10 Crooked CEOs. According to the SEC charges, Madoff convinced investors to give him large sums of money. In return, he gave them an impressive 8 percent to 12 percent return a year. But Madoff never really invested their money. Instead, he kept it for himself. He got funds to pay the first investors their return (or their money back if they asked for it) by bringing in new investors. Everything was going smoothly until the fall of 2008, when the stock market plummeted and many of his investors asked for their money back. As he no longer had their money, the game was over and he had to admit that the whole thing was just one big lie. Thousands of investors, including many of his wealthy friends, not-so-rich retirees who trusted him with their life savings, and charitable foundations, were financially ruined. All those harmed by Madoff either directly or indirectly were pleased when he was sentenced to jail for one-hundred and fifty years.

Are these cases merely aberrations? A *Time*/CNN poll conducted in the midst of all these revelations found that 72 percent of those surveyed don't think so. They believe that breach of investor and employee trust represents an ongoing, long-standing pattern of deceptive behavior by officials at a large number of companies (Gibbs, et. al., 2002). If they're right, then a lot of questions need to be answered. Why do such incidents happen (and with such apparent regularity)? Who are the usual suspects? How long until the next corporate bankruptcy record is set? What action can be taken—by individuals, organizations, and the government—to discourage such behavior?

## The Idea of Business Ethics

It's in the best interest of a company to operate ethically. Trustworthy companies are better at attracting and keeping customers, talented employees, and capital. Those tainted by questionable ethics suffer from dwindling customer bases, employee turnover, and investor mistrust.

Let's begin this section by addressing one of the questions that we posed previously: What can individuals, organizations, and government agencies do to foster an environment of ethical and socially responsible behavior in business? First, of course, we need to define two terms: *business ethics* and *social responsibility*. They're often used interchangeably, but they don't mean the same thing.

## What Is Ethics?

You probably already know what it means to be **ethical**: to know right from wrong and to know when you're practicing one instead of the other. At the risk of oversimplifying, then, we can say that **business ethics** is the application of ethical behavior in a business context. Acting ethically in business means more than simply obeying applicable laws and regulations: It also means being honest, doing no harm to others, competing fairly, and declining to put your own interests above those of your company, its owners, and its workers. If you're in business you obviously need a strong sense of what's right and what's wrong (not always an easy task). You need the personal conviction to *do* what's right, even if it means doing something that's difficult or personally disadvantageous.

## What Is Social Responsibility?

**Corporate social responsibility** deals with actions that affect a variety of parties in a company's environment. A socially responsible company shows concern for its **stakeholders**—anyone who, like owners, employees, customers, and the communities in which it does business, has a "stake" or interest in it. We'll discuss corporate responsibility later in the chapter. At this point, we'll focus on ethics.

## How Can You Recognize an Ethical Organization?

One goal of anyone engaged in business should be to foster ethical behavior in the organizational environment. How do we know when an organization is behaving ethically? Most lists of ethical organizational activities include the following criteria:



- Treating employees, customers, investors, and the public fairly
- Making fairness a top priority

- Holding every member personally accountable for his or her action
- Communicating core values and principles to all members
- Demanding and rewarding integrity from all members in all situations (Axelrod, 2004)

Whether you work for a business or for a nonprofit organization, you probably have a sense of whether your employer is ethical or unethical. Employees at companies that consistently make *Business Ethics* magazine's list of the "100 Best Corporate Citizens" regard the items on the previous list as business as usual in the workplace. Companies that routinely win good-citizenship awards include Procter & Gamble, Hewlett-Packard, Intel, Avon Products, Cisco Systems, and Merck[3].

By contrast, employees with the following attitudes tend to suspect that their employers aren't as ethical as they should be:

- They consistently feel uneasy about the work they do.
- They object to the way they're treated.
- They're uncomfortable about the way coworkers are treated.
- They question the appropriateness of management directives and policies (Axelrod, 2004).

Figure 2.1

In the early 1990s, many Sears automotive customers were surprised by hefty repair bills. Their complaints raised red flags with law enforcement officials and forced Sears to refund $60 million.

Kevin McShane – The Receipt For My New Socks Is Longer Than My New Socks – CC BY-NC 2.0.





In the early 1990s, many workers in Sears automotive service centers shared suspicions about certain policies, including the ways in which they were supposed to deal with customers. In particular, they felt uncomfortable with a new compensation plan that rewarded them for selling alignments, brake jobs, shock absorbers, and other parts and services. Those who met quotas got bonuses; those who didn't were often fired. The results shouldn't be surprising: In their zeal to meet quotas and keep their jobs, some employees misled customers into believing they needed parts and services when, in fact, they were not needed. Before long, Sears was flooded with complaints from customers—as were law-enforcement officials—in more than forty states. Sears denied any intent to deceive customers but was forced not only to eliminate sales commissions but also to pay out $60 million in refunds.

## Why Study Ethics?

Ideally, prison terms, heavy fines, and civil suits should put a damper on corporate misconduct, but, unfortunately, many experts suspect that this assumption may be a bit optimistic. Whatever the condition of the ethical environment in the near future, one thing seems clear: The next generation entering business—which includes most of you—will find a world much different than the one that waited for the previous generation. Recent history tells us in no uncertain terms that today's business students, many of whom are tomorrow's business leaders, need a much sharper understanding of the difference between what is and isn't ethically acceptable. As a business student, one of your key tasks is learning how to recognize and deal with the ethical challenges that will confront you.

Moreover, knowing right from wrong will make you more marketable as a job candidate. Asked what he looked for in a new hire, Warren Buffet, the world's most successful investor, replied: "I look for three things. The first is personal integrity, the second is intelligence, and the third is a high energy level." He paused and then added: "But if you don't have the first, the second two don't matter."[4]

- It's in a company's best interest to act ethically. Trustworthy companies are better able to attract and keep customers, talented employees, and capital.
- **Business ethics** is the application of ethical behavior in a business context.
- Acting ethically in business means more than just obeying laws and regulations. It also means being honest, doing no harm to others, competing fairly, and declining to put your own interests above those of your employer and coworkers.
- To act ethically in business situations, you need a good idea of what's right and wrong (not always an easy task).
- You also need the personal conviction to do what's right even if it means doing something that's difficult or personally disadvantageous.
- Ethical organizations treat employees, customers, investors, and the public fairly. They make fairness a top priority, communicate core values to those in the organization, and demand and reward integrity from all members while holding them accountable for their actions.

Is Honesty Academic?



**(AACSB) Analysis**

Just as businesses have codes of conduct for directing employee behavior in job-related activities, so, too, do colleges and universities have codes of conduct to guide students' academic behavior. They're called various things—*honor codes*, *academic integrity policies*, *policies on academic honesty*, *student codes of conduct*—but they all have the same purpose: to promote academic integrity and to create a fair and ethical environment for all students.

At most schools, information on academic integrity is available from one of the following sources:

- The school Web site (probably under the tab "Dean of Students" or "Student Life")
- The student handbook
- Printed materials available through the Dean of Students' office

Assignment

Locate information on your school's academic integrity policies and answer the following questions:

1. What behaviors violate academic integrity?
2. What happens if you're accused of academic dishonesty?
3. What should you do if you witness an incident of academic dishonesty?

[1]"Tyco Wants Its Money Back," *CNNMoney*, September 17, 2002, http://money.cnn.com/2002/09/17/news/ companies/tyco/index.htm (accessed January 22, 2012).

[2]"Top 10 Crooked CEOs," Time Specials, Time.com, http://www.time.com/time/specials/packages/article/ 0,28804,1903155_1903156_1903160,00.html (accessed July 25, 2011).

[3]"100 Best Corporate Citizens for 2010," *Corporate Responsibility Magazine*, no. 11, Spring 2011, http://thecro.com/content/100-best-corporate-citizens (accessed September 5, 2011).

[4]Quoted by Adrian Gostick and Dana Telford, *The Integrity Advantage* (Salt Lake City: Gibbs Smith, 2003), 3–4.

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## 2.2 The Individual Approach to Ethics

1. Specify the steps that you would take to solve an ethical dilemma and make an ethical decision.

Betty Vinson didn't start out at WorldCom with the intention of going to jail. She undoubtedly knew what the right behavior was, but the bottom line is that she didn't *do* it. How can you make sure that you do the right thing in the business world? How should you respond to the kinds of challenges that you'll be facing? Because your actions in the business world will be strongly influenced by your moral character, let's begin by assessing your current moral condition. Which of the following best applies to you (select one)?

1. I'm always ethical.
2. I'm mostly ethical.
3. I'm somewhat ethical.
4. I'm seldom ethical.
5. I'm never ethical.

Now that you've placed yourself in one of these categories, here are some general observations. Few people put themselves below the second category. Most of us are ethical most of the time, and most people assign themselves to category number two—"I'm *mostly* ethical." Why don't more people claim that they're *always* ethical? Apparently, most people realize that being ethical all the time takes a great deal of moral energy. If you placed yourself in category number two, ask yourself this question: How can I change my behavior so that I can move up a notch? The answer to this question may be simple. Just ask yourself an easier question: How would I like to be treated in a given situation (Maxwell, 2003)?

Unfortunately, practicing this philosophy might be easier in your personal life than in the business world. Ethical challenges arise in business because business organizations, especially large ones, have multiple stakeholders and because stakeholders make conflicting demands. Making decisions that affect multiple stakeholders isn't easy even for seasoned managers; and for new entrants to the business world, the task can be extremely daunting. Many managers need years of experience in an organization before they feel comfortable making decisions that affect various stakeholders. You can, however, get a head start in learning how to make ethical decisions by looking at two types of challenges that you'll encounter in the business world: *ethical dilemmas* and *ethical decisions*.







## Addressing Ethical Dilemmas

An **ethical dilemma** is a morally problematic situation: You have to pick between two or more acceptable but often opposing alternatives that are important to different groups. Experts often frame this type of situation as a "right-versus-right" decision. It's the sort of decision that Johnson & Johnson (known as J&J) CEO James Burke had to make in 1982 (Kaplan, 2012). On September 30, twelve-year-old Mary Kellerman of Chicago died after her parents gave her Extra-Strength Tylenol. That same morning, twenty-seven-year-old Adam Janus, also of Chicago, died after taking Tylenol for minor chest pain. That night, when family members came to console his parents, Adam's brother and his wife took Tylenol from the same bottle and died within forty-eight hours. Over the next two weeks, four more people in Chicago died after taking Tylenol. The actual connection between Tylenol and the series of deaths wasn't made until an off-duty fireman realized from news reports that every victim had taken Tylenol. As consumers panicked, J&J pulled Tylenol off Chicago-area retail shelves. Researchers discovered Tylenol capsules containing large amounts of deadly cyanide. Because the poisoned bottles came from batches originating at different J&J plants, investigators determined that the tampering had occurred after the product had been shipped.

So J&J wasn't at fault. But CEO Burke was still faced with an extremely serious dilemma: Was it possible to respond to the tampering cases without destroying the reputation of a highly profitable brand? Burke had two options:

- He could recall only the lots of Extra-Strength Tylenol that were found to be tainted with cyanide. This was the path followed by Perrier executives in 1991 when they discovered that cases of bottled water had been poisoned with benzine. This option favored J&J financially but possibly put more people at risk.
- Burke could order a nationwide recall—of all bottles of Extra-Strength Tylenol. This option would reverse the priority of the stakeholders, putting the safety of the public above stakeholders' financial interests.

Burke opted to recall all 31 million bottles of Extra-Strength Tylenol on the market. The cost to J&J was $100 million, but public reaction was quite positive. Less than six weeks after the crisis began, Tylenol capsules were reintroduced in new tamper-resistant bottles, and by responding quickly and appropriately, J&J was eventually able to restore the Tylenol brand to its previous market position. When Burke was applauded for moral courage, he replied that he'd simply adhered to the long-standing J&J credo that put the interests of customers above those of other stakeholders. His only regret was that the tamperer was never caught (Weber, 1999).

If you're wondering what your thought process should be if you're confronted with an ethical dilemma, you could do worse than remember the mental steps listed in Figure 2.2 "How to Face an Ethical Dilemma"—which happen to be the steps that James Burke took in addressing the Tylenol crisis:

1. ***Define the problem:*** How to respond to the tampering case without destroying the reputation of the Tylenol brand.
2. ***Identify feasible options:*** (1) Recall only the lots of Tylenol that were found to be tainted with cyanide or (2) order a nationwide recall of all bottles of Extra-Strength Tylenol.



3. ***Assess the effect of each option on stakeholders:*** Option 1 (recalling only the tainted lots of Tylenol) is cheaper but puts more people at risk. Option 2 (recalling all bottles of Extra-Strength Tylenol) puts the safety of the public above stakeholders' financial interests.
4. ***Establish criteria for determining the most appropriate action:*** Adhere to the J&J credo, which puts the interests of customers above those of other stakeholders.
5. ***Select the best option based on the established criteria:*** In 1982, Option 2 was selected, and a nationwide recall of all bottles of Extra-Strength Tylenol was conducted.

Figure 2.2 How to Face an Ethical Dilemma

## Making Ethical Decisions

In contrast to the "right-versus-right" problem posed by an ethical dilemma, an **ethical decision** entails a "right versus-wrong" decision—one in which there is a right (ethical) choice and a wrong (unethical or illegal) choice.





When you make a decision that's unmistakably unethical or illegal, you've committed an **ethical lapse**. Betty Vinson, for example, had an ethical lapse when she caved in to her bosses' pressure to cook the WorldCom books. If you're presented with what appears to be this type of choice, asking yourself the questions in Figure 2.3 "How to Avoid an Ethical Lapse" will increase your odds of making an ethical decision.

Figure 2.3 How to Avoid an Ethical Lapse

To test the validity of this approach, let's take a point-by-point look at Betty Vinson's decisions:

1. Her actions were clearly illegal.
2. They were unfair to the workers who lost their jobs and to the investors who suffered financial losses (and also to her family, who shared her public embarrassment).
3. She definitely felt bad about what she'd done.
4. She was embarrassed to tell other people what she had done.
5. Reports of her actions appeared in her local newspaper (and just about every other newspaper in the



country).

So Vinson could have answered our five test questions with five yeses. To simplify matters, remember the following rule of thumb: If you answer yes to *any one of these five questions*, odds are that you're about to do something you shouldn't.

## Revisiting Johnson & Johnson

As discussed earlier in this section, Johnson & Johnson received tremendous praise for the actions taken by its CEO, James Burke, in response to the 1982 Tylenol catastrophe. But things change. To learn how a company can destroy its good reputation, let's fast forward to

2008 and revisit J&J and its credo, which states, “We believe our first responsibility is to the doctors, nurses and patients, to mothers and fathers and all others who use our products and services. In meeting their needs everything we do must be of high quality” (Credo, Johnson & Johnson, 2011). How could a company whose employees believed so strongly in its credo find itself under criminal and congressional investigation for a series of recalls due to defective products? (Kimes, 2010) In a three-year period, the company recalled twenty-four products, including Children’s, Infants’ and Adults’ Tylenol, Motrin, and Benadryl (McNeil Product Recall Informations, 2011); 1-Day Acuvue TruEye contact lenses sold outside the U.S. (Berkrot, 2010); and hip replacements (New York Times, 2010).

Unlike the 1982 J&J Tylenol recall, no one died from the defective products, but customers were certainly upset to find they had purchased over-the-counter medicines for themselves and their children that were potentially contaminated with dark particles or tiny specks of metal (Kimes, 2010); contact lenses that contained a type of acid that caused stinging or pain when inserted in the eye (Rockoff & Kamp, 2010); and defective hip implants that required patients to undergo a second hip replacement (Singer, 2010).

Who bears the responsibility for these image-damaging blunders? We’ll identify two individuals who were at least partially responsible for the decline of J&J’s reputation: The first is the current CEO—William Weldon—who has been criticized for being largely invisible and publicly absent during the recalls (Kimes, 2010). Additionally, he admitted that he did not understand the consumer division where many of the quality control problems originated (Kimes, 2010). Some members of the board of directors were not pleased with his actions (or inactions) and were upset at the revenue declines from the high-profile recalls. Consequently, Weldon was given only a 3 percent raise for 2011, and his end-of-year bonus was cut by 45 percent. But don’t cry for him: His annual compensation for the year (including salary, bonus, and stock options) was $23 million—down from $26 million in the previous year (Perrone, 2011).

The second individual who was at least partially responsible for the decline of J&J’s reputation is Colleen Goggins, Worldwide Chairman of J&J’s Consumer Group, who was in charge of the factories that produced many of the recalled products. She was heavily criticized by fellow employees for her excessive cost-cutting measures and her propensity to replace experienced scientists with new hires (Kimes, 2010). In addition, she was implicated in an unbelievably foolish and extremely unethical behavior to avoid publically disclosing another J&J recall of a defective product.

Here is the story behind the unethical scheme: After learning that J&J had released packets of

Motrin that 



did not dissolve correctly, the company hired contractors to go into convenience stores and secretly buy up every pack of Motrin on the shelves. The instructions given to the contractors were the following: “You should simply ‘act’ like a regular customer while making these purchases. THERE MUST BE NO MENTION OF THIS BEING A RECALL OF THE PRODUCT!” (Kimes, 2010) In May 2010, when Goggins appeared before a congressional committee investigating the “phantom recall,” she testified that she was not aware of the behavior of the contractors (Silverman, 2010) and that she had “no knowledge of instructions to contractors involved in the phantom recall to not tell store employees what they were doing." In her September 2010 testimony to the House Committee on Oversight and Government Reform, she acknowledged that the company wrote those instructions. She also told the committee she was retiring. This had to be a major disappointment for her. Before J&J started falling apart, she was a contender to take over as CEO when Weldon retired. But, as is true with Weldon, don't shed too many tears for her. Goggins departed from J&J a wealthy woman after cashing in one-third of her shares of company stock for $3 million[1].

From a right-versus-wrong point of view, both Weldon and Goggins acted inappropriately. Their actions caused harm to others, including consumers, employees, and investors. They most likely felt badly about what happened, were embarrassed to discuss the situation with others, and regretted the fact that almost every newspaper in the country carried the story of J&J's downfall.

Regardless of whom is to blame, the bottom line is this: What was once an admired company is tarnished. J&J went from a most admired company to a struggling company that will require more than a Band-Aid to heal its business wounds (Kimes, 2010). Whether J&J can regain the public's trust is a question that no one can answer at this time. At this point, consumers have a right to ask the questions: Should I pay a premium for J&J products given the company's recent track record of poor quality control?

## What to Do When the Light Turns Yellow

Like our five questions, some ethical problems are fairly straightforward. Others, unfortunately, are more complicated, but it will help to think of our five-question test as a set of signals that will warn you that you're facing a particularly tough decision—that you should think carefully about it and perhaps consult someone else. The situation is like approaching a traffic light. Red and green lights are easy; you know what they mean and exactly what to do. Yellow lights are trickier. Before you decide which pedal to hit, try posing our five questions. If you get a single yes, you'll be much better off hitting the brake (Online Ethics Center for Engineering and Science, 2006).

- Businesspeople face two types of ethical challenges: ethical dilemmas and ethical decisions.
- An **ethical dilemma** is a morally problematic situation in which you must choose between two or more alternatives that aren't equally acceptable to different groups.
- Such a dilemma is often characterized as a "right-versus-right" decision and is usually solved in a series of five steps:

facts. 2. Identify feasible options.



1. Define the problem and collect the relevant

3. Assess the effect of each option on **stakeholders** (owners, employees, customers, communities).
4. Establish criteria for determining the most appropriate option.
5. Select the best option, based on the established criteria.

- An **ethical decision** entails a "right-versus-wrong" decision—one in which there's a right (ethical) choice and a wrong (unethical or downright illegal) choice.

• When you make a decision that's unmistakably unethical or illegal, you've committed an **ethical lapse**.

• If you're presented with what appears to be an ethical decision, asking yourself the following questions will improve your odds of making an ethical choice:

1. Is the action illegal?
2. Is it unfair to some parties?
3. If I take it, will I feel bad about it?
4. Will I be ashamed to tell my family, friends, coworkers, or boss about my action?
5. Would I want my decision written up in the local newspaper?

If you answer yes to any one of these five questions, you're probably about to do something that you shouldn't.

Explain the difference between an ethical dilemma and an ethical decision. Then provide an example of each. Describe an ethical lapse and provide an example.

[1]"J&J's Colleen Goggins Sells Nearly $3M in Stock," Citibizlist, September 14, 2010 (accessed August 16, 2011).

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## 2.3 Identifying Ethical Issues

1. Identify ethical issues that you might face in business, and analyze rationalizations for unethical behavior.

Make no mistake about it: When you enter the business world, you'll find yourself in situations in which you'll have to choose the appropriate behavior. How, for example, would you answer questions like the following?

- Is it OK to accept a pair of sports tickets from a supplier?
- Can I buy office supplies from my brother-in-law?
- Is it appropriate to donate company funds to my local community center?
- If I find out that a friend is about to be fired, can I warn her?
- Will I have to lie about the quality of the goods I'm selling?
- Can I take personal e-mails and phone calls at work?
- What do I do if I discover that a coworker is committing fraud?

Obviously, the types of situations are numerous and varied. Fortunately, we can break them down into a few basic categories: *bribes*, *conflicts of interest*, *conflicts of loyalty*, *issues of honesty and integrity*, and *whistle-blowing*. Let's look a little more closely at each of these categories.

## Bribes versus Gifts

It's not uncommon in business to give and receive small gifts of appreciation. But when is a gift unacceptable? When is it really a bribe? If it's OK to give a bottle of wine to a corporate client during the holidays, is it OK to give a case of wine? If your company is trying to get a big contract, is it appropriate to send a gift to the key decision maker? If it's all right to invite a business acquaintance to dinner or to a ball game, is it also all right to offer the same person a fully paid weekend getaway?

There's often a fine line between a gift and a bribe. The questions that we've just asked, however, may help in drawing it, because they raise key issues in determining how a gesture should be interpreted: the cost of the item, the timing of the gift, the type of gift, and the connection between the giver and the receiver. If you're on the receiving end, it's a good idea to refuse any item that's overly generous or given for the purpose of influencing







a decision. But because accepting even small gifts may violate company rules, the best advice is to check on company policy.

JCPenney's "Statement of Business Ethics," for instance, states that employees can't accept any cash gifts or any noncash gifts except those that have a value below $50 and that are generally used by the giver for promotional purposes. Employees can attend paid-for business functions, but other forms of entertainment, such as sports events and golf outings, can be accepted only if it's practical for the Penney's employee to reciprocate. Trips of several days can't be accepted under any circumstances (JCPenney Co., 2006).

## Conflicts of Interest

**Conflicts of interest** occur when individuals must choose between taking actions that promote their personal interests over the interests of others or taking actions that don't. A conflict can exist, for example, when an employee's own interests interfere with, or have the potential to interfere with, the best interests of the company's stakeholders (management, customers, owners). Let's say that you work for a company with a contract to cater events at your college and that your uncle owns a local bakery. Obviously, this situation could create a conflict of interest (or at least give the appearance of one—which, by the way, is a problem in itself). When you're called on to furnish desserts for a luncheon, you might be tempted to throw some business your uncle's way even if it's not in the best interest of the catering company that you work for.

What should you do? You should probably disclose the connection to your boss, who can then arrange things so that your personal interests don't conflict with the company's. You may, for example, agree that if you're assigned to order products like those that your uncle makes, you're obligated to find another supplier. Or your boss may make sure that someone else orders bakery products.

The same principle holds that an employee shouldn't use private information about an employer for personal financial benefit. Say that you learn from a coworker at your pharmaceutical company that one of its most profitable drugs will be pulled off the market because of dangerous side effects. The recall will severely hurt the company's financial performance and cause its stock price to plummet. Before the news becomes public, you sell all the stock you own in the company. What you've done isn't merely unethical: It's called **insider trading**, it's illegal, and you could go to jail for it.

## Conflicts of Loyalty

Sometimes you find yourself in a bind between being loyal either to your employer or to a friend or family member. Perhaps you just learned that a coworker, a friend of yours, is about to be downsized out of his job. You also happen to know that he and his wife are getting ready to make a deposit on a house near the company headquarters. From a work standpoint, you know that you shouldn't divulge the information. From a friendship standpoint, though, you feel it's your duty to tell your friend. Wouldn't he tell you if the situation were reversed? So what do you do? As tempting as it is to be loyal to your friend, you shouldn't. As an employee, your primary responsibility is to your employer. You might be able to soften your dilemma by convincing a manager with the appropriate authority to tell your friend the bad news before he puts down his deposit.



## Issues of Honesty and Integrity

Master investor Warren Buffet once told a group of business students the following:

> I cannot tell you that honesty is the best policy. I can't tell you that if you behave with perfect honesty and integrity somebody somewhere won't behave the other way and make more money. But honesty is a good policy. You'll do fine, you'll sleep well at night and you'll feel good about the example you are setting for your coworkers and the other people who care about you" (Gostick & Telford, 2003).

If you work for a company that settles for its employees' merely obeying the law and following a few internal regulations, you might think about moving on. If you're being asked to deceive customers about the quality or value of your product, you're in an ethically unhealthy environment.

Think about this story:

> A chef put two frogs in a pot of warm soup water. The first frog smelled the onions, recognized the danger, and immediately jumped out. The second frog hesitated: The water felt good, and he decided to stay and relax for a minute. After all, he could always jump out when things got too hot (so to speak). As the water got hotter, however, the frog adapted to it, hardly noticing the change. Before long, of course, he was the main ingredient in frog-leg soup" (Gostick & Telford, 2003).

So, what's the moral of the story? Don't sit around in an ethically toxic environment and lose your integrity a little at a time; get out before the water gets too hot and your options have evaporated.

Fortunately, a few rules of thumb can guide you. We've summed them up in Figure 2.4 "How to Maintain Honesty and Integrity".

Figure 2.4 How to Maintain Honesty and Integrity

## Whistle-Blowing

As we've seen, the misdeeds of Betty Vinson and her accomplices at WorldCom didn't go undetected. They caught the eye of Cynthia Cooper, the company's director of internal auditing. Cooper, of course, could have looked the other way, but instead she summoned up the courage to be a **whistle-blower**—an individual who exposes illegal or unethical behavior in an organization. Like Vinson, Cooper had majored in accounting at Mississippi State and was a hard-working, dedicated employee. Unlike Vinson, however, she refused to be bullied by her boss, CFO Scott Sullivan. In fact, she had tried to tell not only Sullivan but also auditors from the huge Arthur Andersen accounting firm that there was a problem with WorldCom's books. The auditors dismissed her warnings, and when Sullivan angrily told her to drop the matter, she started cleaning out her office. But she didn't relent. She and her team worked late each night, conducting an extensive, secret investigation. Two months later, Cooper had evidence to take to Sullivan, who told her once again to back off. Again, however, she stood up to him, and though she regretted the consequences for her WorldCom coworkers, she reported the scheme to the



company's board of directors. Within days, Sullivan was fired and the largest accounting fraud in history became public.

As a result of Cooper's actions, executives came clean about the company's financial situation. The conspiracy of fraud was brought to an end, and though public disclosure of WorldCom's problems resulted in massive stock price declines and employee layoffs, investor and employee losses would have been greater without Cooper's intervention.

Even though Cooper did the right thing, the experience wasn't exactly gratifying. A lot of people applauded her action, but many coworkers shunned her; some even blamed *her* for the company's troubles. She's never been thanked by any senior executive at WorldCom. Five months after the fraud went public, new CEO Michael Capellas assembled what was left of the demoralized workforce to give them a pep talk on the company's future. The senior management team mounted the stage and led the audience in a rousing rendition of "If you're happy and you know it, clap your hands!" Cynthia Cooper wasn't invited (Gostick & Telford, 2003).

Whistle-blowing often means career suicide. A survey of two hundred whistle-blowers conducted by the National Whistleblower Center found that half of them had been fired for blowing the whistle (National Whistleblower Center, 2002). Even those who get to keep their jobs experience painful repercussions. As long as they stay, some people will treat them (as one whistle-blower puts it) "like skunks at a picnic"; if they leave, they're frequently blackballed in the industry (Dwyer, et. al., 2002). On a positive note, there's the 2002 Sarbanes-Oxley Act, which protects whistle-blowers under federal law.

For her own part, Cynthia Cooper doesn't regret what she did. As she told a group of students at Mississippi State: "Strive to be persons of honor and integrity. Do not allow yourself to be pressured. Do what you know is right even if there may be a price to be paid" (Waller, 2003). If your company tells employees to do whatever it takes, push the envelope, look the other way, and "be sure that we make our numbers," you have three choices: go along with the policy, try to change things, or leave. If your personal integrity is part of the equation, you're probably down to the last two choices (Gostick & Telford, 2003).

## Refusing to Rationalize

Despite all the good arguments in favor of doing the right thing, why do many reasonable people act unethically (at least at times)? Why do good people make bad choices? According to one study, there are four common rationalizations for justifying misconduct: (Gellerman, 2003)

1. *My behavior isn't really illegal or immoral*. Rationalizers try to convince themselves that an action is OK if it isn't downright illegal or blatantly immoral. They tend to operate in a gray area where there's no clear evidence that the action is wrong.

2. *My action is in everyone's best interests*. Some rationalizers tell themselves: "I know I lied to make the deal, but it'll bring in a lot of business and pay a lot of bills." They convince themselves that they're expected to act in a certain way, forgetting the classic parental parable about jumping off a cliff just because your friends are (Gostick & Telford, 2003).

3. *No one will find out what I've done*. Here, the self-questioning comes down to "If I didn't get

caught, 



did I really do it?" The answer is yes. There's a simple way to avoid succumbing to this rationalization: Always act as if you're being watched.

4. *The company will condone my action and protect me*. This justification rests on a fallacy. Betty Vinson may honestly have believed that her actions were for the good of the company and that her boss would, therefore, accept full responsibility (as he promised). When she goes to jail, however, she'll go on her own.

Here's another rule of thumb: If you find yourself having to rationalize a decision, it's probably a bad one. Over time, you'll develop and hone your ethical decision-making skills.

- When you enter the business world, you'll find yourself in situations in which you'll have to choose the appropriate behavior.
- You'll need to know how to distinguish a bribe from an acceptable gift.
- You'll encounter situations that give rise to a **conflict of interest**—situations in which you'll have to choose between taking action that promotes your personal interest and action that favors the interest of others.
- Sometimes you'll be required to choose between loyalty to your employer and loyalty to a friend or family member.
- In business, as in all aspects of your life, you should act with honesty and integrity.
- At some point in your career, you might become aware of wrongdoing on the part of others and will have to decide whether to report the incident and become a **whistle-blower**—an individual who exposes illegal or unethical behavior in an organization.
- Despite all the good arguments in favor of doing the right thing, some businesspeople still act unethically (at least at times). Sometimes they use one of the following rationalizations to justify their conduct:

    1. The behavior isn't really illegal or immoral.
    2. The action is in everyone's best interests.

3. No one will find out what I've done.

4. The company will condone my action and protect me.

1. **(AACSB) Analysis**

Each December, *Time* magazine devotes its cover to the person who has made the biggest impact on the world that year. *Time*'s 2002 pick was not one person, but three: Cynthia Cooper (WorldCom), Coleen Rowley (the FBI), and Sherron Watkins (Enron). All three were whistle-blowers. We detailed Cynthia Cooper's courage in exposing fraud at WorldCom in this chapter, but the stories of the other two whistle-blowers are equally worthwhile. Go to the Time.com Web site (http://www.time.com/time/magazine/article/0,9171,1003988,00.html) and read a posted story about Rowley, or visit the Time.com Web site (http://www.time.com/time/magazine/article/0,9171,1003992,00.html) and read a posted story about Watkins. Then answer the following questions:



- What wrongdoing did the whistle-blower expose?
- What happened to her when she blew the whistle? Did she experience retaliation?
- Did she do the right thing? Would you have blown the whistle? Why or why not?

2. **(AACSB) Analysis**

You own a tax-preparation company with ten employees who prepare tax returns. In walking around the office, you notice that several of your employees spend a lot of time making personal use of their computers, checking personal e mails, or shopping online. After doing an Internet search on employer computer monitoring, respond to these questions: Is it unethical for your employees to use their work computers for personal activities? Is it ethical for you to monitor computer usage? Do you have a legal right to do it? If you decide to monitor computer usage in the future, what rules would you make, and how would you enforce them?

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## 2.4 The Organizational Approach to Ethics

1. Specify actions that managers can take to create and sustain ethical organizations.

Ethics is more than a matter of individual behavior; it's also about organizational behavior. Employees' actions aren't based solely on personal values alone: They're influenced by other members of the organization, from top managers and supervisors to coworkers and subordinates. So how can ethical companies be created and sustained? In this section, we'll examine some of the most reasonable answers to this question.

# Ethical Leadership

Organizations have unique *cultures*—ways of doing things that evolve through shared values and beliefs. An organization's culture is strongly influenced by senior executives, who tell members of the organization what's considered acceptable behavior and what happens if it's violated. In theory, the tone set at the top of the organization promotes ethical behavior, but sometimes (as at Enron) it doesn't.

Before its sudden demise, Enron fostered a growth-at-any-cost culture that was defined by the company's top executives. Said one employee, "It was all about taking profits now and worrying about the details later. The Enron system was just ripe for corruption." Coupled with the relentless pressure to generate revenue—or at least to look as if you were generating it—was a climate that discouraged employees from questioning the means by which they were supposed to do it. There may have been chances for people to speak up, but no one did. "I don't think anyone started out with a plan to defraud the company," reflects another ex-employee. "Everything at Enron seemed to start out right, but somewhere something slipped. People's mentality switched from focusing on the future good of the company to 'let's just do it today.'" (Fowler, 2002)

## Exercising Ethical Leadership

Leaders should keep in constant touch with subordinates about ethical policies and expectations. They should be available to help employees identify and solve ethical problems, and should encourage them to come forward with concerns. They're responsible for minimizing opportunities for wrongdoing and for exerting the controls needed to enforce company policies. They should also think of themselves as role models. Subordinates look to their supervisors to communicate policies and practices regarding ethical behavior, and as a rule, actions speak more loudly than words: If managers behave ethically, subordinates will probably do the same.





This is exactly the message that senior management at Martin Marietta (now a part of Lockheed Martin) sent to members of their organization. A leading producer of construction components, the company at the time was engaged in a tough competitive battle over a major contract. Because both Martin Marietta and its main competitor were qualified to do the work, the job would go to the lower bid. A few days before bids were due, a package arrived at Martin Marietta containing a copy of the competitor's bid sheet (probably from a disgruntled employee trying to sabotage his or her employer's efforts). The bid price was lower than Martin Marietta's. In a display of ethical backbone, executives immediately turned the envelope over to the government and informed the competitor. No, they didn't change their own bid in the meantime, and, no, they didn't get the job. All they got was an opportunity to send a clear message to the entire organization (Augustine, 2006).

By the same token, leaders must be willing to hold subordinates accountable for their conduct and to take appropriate action. The response to unethical behavior should be prompt and decisive. One CEO of a large company discovered that some of his employees were "dumpster diving" in the trash outside a competitor's offices (which is to say, they were sifting around for information that would give them a competitive advantage). The manager running the espionage operation was a personal friend of the CEO's, but he was immediately fired, as were his "operatives." The CEO then informed his competitor about the venture and returned all the materials that had been gathered. Like the top managers at Martin Marietta, this executive sent a clear message to people in his organization: namely, that deviations from accepted behavior would not be tolerated (Austine, 2006).

It's always possible to send the wrong message. In August 2004, newspapers around the country carried a wire service story titled "Convicted CEO Getting $2.5 Million Salary While He Serves Time." Interested readers found that the board of directors of Fog Cutter Capital Group had agreed to pay CEO Andrew Wiederhorn (and give him a bonus) while he served an eighteen-month federal-prison term for bribery, filing false tax returns, and financially ruining his previous employer (from which he'd also borrowed $160 million). According to the board, they couldn't afford to lose a man of Wiederhorn's ability. The entire episode ended up on TheStreet.com's list of "The Five Dumbest Things on Wall Street This Week." (McCall, 2006)

## Tightening the Rules

In response to the recent barrage of corporate scandals, more large companies have taken additional steps to encourage employees to behave according to specific standards and to report wrongdoing. Even companies with excellent reputations for integrity have stepped up their efforts.

## Codes of Conduct

Like many firms, Hershey Foods now has a formal **code of conduct**: a document describing the principles and guidelines that all employees must follow in the course of all job-related activities. It's available on the company intranet and in printed form and, to be sure that everyone understands it, the company offers a training program. The Hershey code covers such topics as the use of corporate funds and resources, conflict of interest, and the protection of proprietary information. It explains how the code will be enforced, emphasizing that violations won't be tolerated. It encourages employees to report wrongdoing and provides instructions on reporting violations





(which are displayed on posters and printed on wallet-size cards). Reports can be made though a Concern Line, by e-mail, or by regular mail; they can be anonymous; and retaliation is also a serious violation of company policy (Hershey Foods, 2006).

- Ethics is more than a matter of individual behavior; it's also about organizational behavior. Employees' actions aren't based solely on personal values; they're also influenced by other members of the organization.
- Organizations have unique *cultures*—ways of doing things that evolve through shared values and beliefs.
- An organization's culture is strongly influenced by top managers, who are responsible for letting members of the organization know what's considered acceptable behavior and what happens if it's violated.
- Subordinates look to their supervisors as role models of ethical behavior. If managers act ethically, subordinates will probably do the same.
- Those in positions of leadership should hold subordinates accountable for their conduct and take appropriate action.
- Many organizations have a formal **code of conduct** that describes the principles and guidelines that all members must follow in the course of job-related activities.

1. **(AACSB) Analysis**
   You're the CEO of a company that sells golf equipment, including clubs, bags, and balls. When your company was started and had only a handful of employees, you were personally able to oversee the conduct of your employees. But with your current workforce of nearly fifty, it's time to prepare a formal code of conduct in which you lay down some rules that employees must follow in performing job-related activities. As a model for your own code, you've decided to use Macy's Code of Business Conduct and Ethics. Go to the company's Web site (http://www.federated-fds.com/investors/governance/documents/code_of_business_conduct_and_ethics.pdf) to view its posted code of business conduct. Your

document won't be as thorough as Macy's, but it will cover the following areas: (1) conflicts of interest; (2) acceptance of gifts, services, or entertainment; (3) protection of confidential information; (4) use of company funds or assets for personal purposes; (5) competing fairly and ethically; and (6) adherence to code. Draw up a code of conduct for your company.

2. **(AACSB) Reflective Skills**
   Think of someone whom you regard as an ethical leader. It can be anyone connected with you—a businessperson, educator, coach, politician, or family member. Explain why you believe the individual is ethical in his or her leadership.

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## 2.5 Corporate Social Responsibility

1. Define *corporate social responsibility* and explain how organizations are responsible to their stakeholders.

**Corporate social responsibility** refers to the approach that an organization takes in balancing its responsibilities toward different stakeholders when making legal, economic, ethical, and social decisions. What motivates companies to be "socially responsible" to their various stakeholders? We hope it's because they want to do the right thing, and for many companies, "doing the right thing" is a key motivator. The fact is, it's often hard to figure out what the "right thing" is: What's "right" for one group of stakeholders isn't necessarily just as "right" for another. One thing, however, is certain: Companies today are held to higher standards than ever before. Consumers and other groups consider not only the quality and price of a company's products but also its character. If too many groups see a company as a poor corporate citizen, it will have a harder time attracting qualified employees, finding investors, and selling its products. Good corporate citizens, by contrast, are more successful in all these areas.

Figure 2.6 "The Corporate Citizen" presents a model of corporate responsibility based on a company's relationships with its *stakeholders*. In this model, the focus is on managers—not owners—as the principals involved in all these relationships. Here, owners are the stakeholders who invest risk capital in the firm in expectation of a financial return. Other stakeholders include employees, suppliers, and the communities in which the firm does business. Proponents of this model hold that customers, who provide the firm with revenue, have a special claim on managers' attention. The arrows indicate the two-way nature of corporation-stakeholder relationships: All stakeholders have some claim on the firm's resources and returns, and it's management's job to make decisions that balance these claims (Baron, D. P., 2003).

Figure 2.6 The Corporate Citizen

Let's look at some of the ways in which companies can be "socially responsible" in considering the claims of various stakeholders.

## Owners

Owners invest money in companies. In return, the people who run a company have a responsibility to increase the value of owners' investments through profitable operations. Managers also have a responsibility to provide owners (as well as other stakeholders having financial interests, such as creditors and suppliers) with accurate, reliable information about the performance of the business. Clearly, this is one of the areas in which WorldCom managers fell down on the job. Upper-level management purposely deceived shareholders by presenting them with fraudulent financial statements.

## Fiduciary Responsibilities

Finally, managers have a **fiduciary responsibility** to owners: They're responsible for safeguarding the company's assets and handling its funds in a trustworthy manner. This is a responsibility that was ignored by top executives at both Adelphia and Tyco, whose associates and families virtually looted company assets. To enforce managers' fiduciary responsibilities for a firm's financial statements and accounting records, the Sarbanes-Oxley Act of 2002 requires CEOs and CFOs to attest to their accuracy. The law also imposes penalties on corporate officers, auditors, board members, and any others who commit fraud.

## Employees

Companies are responsible for providing employees with safe, healthy places to work—as well as environments that are free from sexual harassment and all types of discrimination. They should also offer appropriate wages and benefits. In the following sections, we'll take a closer look at each of these areas of responsibility.

## Safety and Health

Figure 2.7 Workplace Deaths by Event or Exposure, 2010

Though it seems obvious that companies should guard workers' safety and health, a lot of them simply don't. For over four decades, for example, executives at Johns Manville suppressed evidence that one of its products, asbestos, was responsible for the deadly lung disease developed by many of its workers (Gellerman, 2003). The company concealed chest X-rays from stricken workers, and executives decided that it was simply cheaper to pay workers' compensation claims (or let workers die) than to create a safer work environment. A New Jersey court was quite blunt in its judgment: Johns Manville, it held, had made a deliberate, cold-blooded decision to do nothing to protect at-risk workers, in blatant disregard of their rights (Gellerman, 2003).

About four in one hundred thousand U.S. workers die in workplace "incidents" each year. The Department of Labor categorizes deaths caused by conditions like those at Johns Manville as "exposure to harmful substances or environments." How prevalent is this condition as a cause of workplace deaths? See Figure 2.7 "Workplace Deaths by Event or Exposure, 2010", which breaks down workplace fatalities by cause. Some jobs are more dangerous than others. For a comparative overview based on workplace deaths by occupation, see Figure 2.8 "Workplace Deaths by Industry, 2010".

Figure 2.8 Workplace Deaths by Industry, 2010

Figure 2.9

Requiring workers to wear protective clothing like gloves, hard hats, and goggles cuts down on accidents. It also helps the firm reduce time lost from work due to injuries.



For most people, fortunately, things are better than they were at Johns Manville. Procter & Gamble (P&G), for example, considers the safety and health of its employees paramount and promotes the attitude that “Nothing we do is worth getting hurt for.” With nearly one hundred thousand employees worldwide, P&G uses a measure of worker safety called “total incident rate per employee,” which records injuries resulting in loss of consciousness, time lost from work, medical transfer to another job, motion restriction, or medical treatment beyond first aid. The





company attributes the low rate of such incidents—less than one incident per hundred employees—to a variety of programs to promote workplace safety (Procter & Gamble, 2003).

## Freedom from Sexual Harassment

What is *sexual harassment*? The law is quite precise:

- Sexual harassment occurs when an employee makes "unwelcome sexual advances, requests for sexual favors, and other verbal or physical conduct of a sexual nature" to another employee who doesn't welcome the advances.
- It's also sexual harassment when "submission to or rejection of this conduct explicitly or implicitly affects an individual's employment, unreasonably interferes with an individual's work performance or creates an intimidating, hostile or offensive work environment." (U.S. Equal Employment Opportunity Commission, 2012)

To prevent sexual harassment—or at least minimize its likelihood—a company should adopt a formal anti harassment policy describing prohibited conduct, asserting its objections to the behavior, and detailing penalties for violating the policy (Grossman, 2012). Employers also have an obligation to investigate harassment complaints. Failure to enforce anti-harassment policies can be very costly. In 1998, for example, Mitsubishi paid $34 million to more than three hundred fifty female employees of its Normal, Illinois, plant to settle a sexual harassment case supported by the Equal Employment Opportunity Commission. The EEOC reprimanded the company for permitting an atmosphere of verbal and physical abuse against women, charging that female workers had been subjected to various forms of harassment, ranging from exposure to obscene graffiti and vulgar jokes to fondling and groping (Grossman, 2012).

## Equal Opportunity and Diversity

People must be hired, evaluated, promoted, and rewarded on the basis of merit, not personal characteristics. This, too, is the law—namely, Title VII of the 1964 Civil Rights Act. Like most companies, P&G has a formal policy on hiring and promotion that forbids discrimination based on race, color, religion, gender, age, national origin, citizenship, sexual orientation, or disability. P&G expects all employees to support its commitment to equal employment opportunity and warns that those who violate company policies will face strict disciplinary action, including termination of employment (Procter & Gamble, 2012).

## Equal Pay and the Wage Gap

The Equal Pay Act of 1963 requires equal pay for both men and women in jobs that entail equal skill, equal effort, equal responsibility, or similar working conditions. What has been the effect of the law after forty years? In 1963, women earned, on average, $0.589 for every $1 earned by men. By 2010, that difference—which we call the *wage*



*gap*—has been closed to $0.812 to $1, or approximately 81 percent (Aamodt, 2011). Figure 2.10 "Median Annual Earnings by Gender and Race" provides some interesting numbers on the differences in annual earnings based not only on gender but on race, as well. Figure 2.11 "Median Annual Earnings by Level of Education" throws further light on the wage and unemployment gap when education is taken into consideration.

Figure 2.10 Median Annual Earnings by Gender and Race

What accounts for the difference, despite the mandate of federal law? For one thing, the jobs typically held by women tend to pay less than those typically held by men. In addition, men often have better job opportunities. For example, a man newly hired at the same time as a woman will often get a higher-paying assignment at the entry level. Coupled with the fact that the same sort of discrimination applies when it comes to training and promotions, women are usually relegated to a lifetime of lower earnings.

Figure 2.11 Median Annual Earnings by Level of Education

Education pays in higher earnings and lower unemployment rates.

Note: Data are 2010 annual averages for persons age 25 and over. Earnings are for full-time wage and salary workers.





Source: Bureau of Labor Statistics, Current Population Survey.

## Building Diverse Workforces

In addition to complying with equal employment opportunity laws, many companies make special efforts to recruit employees who are underrepresented in the workforce according to sex, race, or some other characteristic. In helping to build more diverse workforces, such initiatives contribute to competitive advantage for two reasons: (1) People from diverse backgrounds bring new talents and fresh perspectives to an organization, typically enhancing creativity in the development of new products. (2) By reflecting more accurately the changing demographics of the marketplace, a diverse workforce improves a company's ability to serve an ethnically diverse population.

## Wages and Benefits

At the very least, employers must obey laws governing minimum wage and overtime pay. A minimum wage is set by the federal government, though states can set their own rates. The current federal rate, for example, is $7.25, while the rate in the state of Washington is $8.67. When there's a difference, the higher rate applies (U.S. Department of Labor, 2012). By law, employers must also provide certain benefits—social security (which provides retirement benefits), unemployment insurance (which protects against loss of income in case of job loss), and workers' compensation (which covers lost wages and medical costs in case of on-the-job injury). Most large companies pay most of their workers more than minimum wage and offer considerably broader benefits, including medical, dental, and vision care, as well as pension benefits.

## Customers

The purpose of any business is to satisfy customers, who reward businesses by buying their products. Sellers are also responsible—both ethically and legally—for treating customers fairly. The rights of consumers were first articulated by President John F. Kennedy in 1962 when he submitted to Congress a presidential message devoted to consumer issues (Waxman, 1993). Kennedy identified four consumer rights:

1. *The right to safe products*. A company should sell no product that it suspects of being unsafe for buyers. Thus, producers have an obligation to safety-test products before releasing them for public consumption. The automobile industry, for example, conducts extensive safety testing before introducing new models (though recalls remain common).
2. *The right to be informed about a product*. Sellers should furnish consumers with the product information that they need to make an informed purchase decision. That's why pillows have labels identifying the materials used to make them, for instance.
3. *The right to choose what to buy*. Consumers have a right to decide which products to purchase, and sellers should let them know what their options are. Pharmacists, for example, should tell patients