

# Chapter 7

## Tools of Ethics for Management



### What Follows Why?

In the following, we will deal with the central question of business ethics: How can the behavior of employees be influenced in such a way that ethical behavior is encouraged:

1. To avert damage to economic activity for third parties (interest of society).
2. To avert damage to economic activity for the company (interest of the company).
3. To increase the productivity of interpersonal cooperation (interest of the company and society).

### Learning Goals

You are asked to explain the instruments in your own words and to use them by means of examples (Fig. 7.1).

## 7.1 Institutional Ethics on Company Level

In the following, institutions will be analyzed as the first ethics tools, the rules that ensure ethical behavior for the company and thus indirectly for society as well.

### 7.1.1 *Corporate Principles and Vision*

Guiding principles are ethically sound behavioral principles, which give the employees a general action orientation (definition). They represent the company's own standards. They have a general effect on the conduct of business or in particular against the stakeholders. These norms should help the employees to make decisions

6.1. Ethics of institutions	6.2. Ethics of organizations	6.3. Ethics of leadership
1. Corporate image 2. Operational and strategic objectives 3. Code of Conduct 4. Ethical control systems 5. Ethical stakeholder analysis	1. Organization structure 2. Ombudspersons 3. Ethics officers 4. Ethics Committee 5. Whistle blowing	1. Ethical corporate culture 2. Ethical leadership 3. Leadership evaluations 4. Ethical staff selection 5. Ethical personnel development 6. Ethics seminars 7. Corporate Volunteering 8. Training near-the-job

**Fig. 7.1** Tools of ethics for the management

in ethically critical situations by weighing ethical goods.<sup>1</sup> They are generally held as goals, that is to say they may not always be practicable and stand as part of the target hierarchy over the concrete and workable corporate objectives.

The guidelines communicate corporate values internally and externally. Corporate image supplements the corporate constitution. How can guidelines be transferred to employees, how do they become an enterprise culture? For this purpose, there are other ethics tools that directly or indirectly influence corporate culture through motivation, control and sanctions. They are presented later.

A higher-level part of the mission statement can be the corporate vision (for example, as a metaphor). It is even more abstract and is intended to serve as a supreme goal, meaningful, motivating and united. E.g. Siemens: “We want to generate lasting value for the societies we are operating in.”<sup>2</sup> or The Siemens Corporate Responsibility Report (2003) or the vision of the Faculty of Economics of the University of Applied Sciences (HTW). “We convey more than knowledge”.

The guiding principles can be controlled by the public and prompted by the stakeholders. For example, the obvious contradiction between the guiding principle of honest customer advisors and the sale of risky certificates and derivatives in recent years has led to a loss of the credibility of many banks.

### Group Work Corporate Image

Design a corporate image for your own business (Fig. 7.2).

Visions are intended to inspire and motivate the employees in the sense of ANTOINE DE SAINT-EXUPERY to take up and implement the company goals as their own:

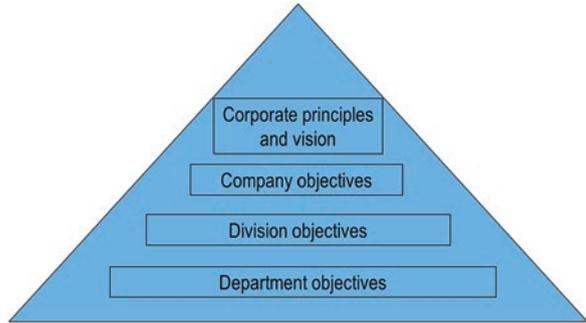
“If you want to build a ship, don’t drum up the men to gather wood, divide the work, and give orders. Instead, teach them to yearn for the vast and endless sea.”

Here are some examples of international companies:

<sup>1</sup> See Leisinger, Klaus M. (1997), pp. 119 and Göbel, Elisabeth (2010), pp. 213.

<sup>2</sup> <http://www.siemens.com/global/en/home/company/sustainability.html> (20.12.2016).

**Fig. 7.2** Targets of the company (based on Göbel (2010), p. 214)



### **Unilever**

“We conduct our operations with honesty, integrity and openness, and with respect for the human rights and interests of our employees. We shall similarly respect the legitimate interests of those with whom we have relationships.”<sup>3</sup>

### **Levis**

“We believe that business can drive profits through principles, and that our values as a company and as individuals give us a competitive advantage.”

### **Empathy – Walking in Other People’s Shoes**

Empathy begins with paying close attention to the world around us. We listen and respond to the needs of our customers, employees and other stakeholders.

### **Originality – Being Authentic and Innovative**

The pioneering spirit that started in 1873 with the very first pair of blue jeans still permeates all aspects of our business. Through innovative products and practices, we break the mold.

### **Integrity – Doing the Right Thing**

Integrity means doing right by our employees, brands, company and society as a whole. Ethical conduct and social responsibility characterize our way of doing business.

### **Courage – Standing Up for What We Believe**

It takes courage to be great. Courage is the willingness to tell the truth and to challenge hierarchy, accepted practice and conventional wisdom. It means standing by our convictions and acting on our beliefs.

We are the embodiment of the energy and events of our time, inspiring people from all walks of life with a pioneering spirit. Generations have worn Levi’s® jeans, turning them into a symbol of freedom and self-expression in the face of adversity, challenge and social change. Our customers forged a new territory called the

<sup>3</sup><http://www.unilever.com/aboutus/purposeandprinciples/ourprinciples/> (28.09.2012).

American West. They fought in wars for peace. They instigated counterculture revolutions. They tore down the Berlin Wall. Reverent, irreverent – they took a stand.”<sup>4</sup>

Company guidelines can refer to the stakeholders or the focus of the company’s activities, such as a chemical company that focuses on environmental protection and/or sustainability. Depending on the stakeholder, the following priorities can be selected:

Employees: human dignity, respect, job security, etc.

Customers: high product quality, reliability, innovation etc.

Society: environmental protection, compliance with laws and international standards, etc.

Suppliers: long-term, partnership-based cooperation, no dependency on dependencies, no corruption or gift acceptance, etc.<sup>5</sup>

In order to have an effect, it must be clearly stated in the mission statement that, in the event of a conflict, ethical principles have priority over profit maximization and that compliance with the guiding principles is monitored and violations are sanctioned.<sup>6</sup>

To ensure that the company’s corporate principles are supported by the employees and are not perceived as impaired by the company’s management, it is recommended that employees and possibly also the most important stakeholders be involved in the elaboration of guidelines. This shows an ethical discourse that enables the employees to understand the consequences of their actions and, finally, a weighing of goods. The company management guidelines must then be communicated and advertised in the company and externally. This also strengthens the corporate identity and improves the reputation of the company.<sup>7</sup> General Electric and Siemens, for example, both advertise with their wind energy efficiency fund. But there is also a great danger. The visions and principles sound ethical and convey the impression that the company is solely a good thing. The suspicion is always there that some companies present the ethical guidelines only for image and PR, but that they play no role in everyday functioning of the company.<sup>8</sup> However, if a case publicly contradicts the guidelines and is not an exception, this obvious contradiction seems hypocritical and weakens the credibility of the company. The guiding principles can be checked by the public and requested by the stakeholders. For example, the obvious contradiction between the guiding principle of honest customer advisors and the sale of risky certificates and derivatives in recent years has led to a loss of the credibility of many banks.

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<sup>4</sup><http://www.levistrauss.com/about/values-vision> (28.09.2012).

<sup>5</sup>See Göbel, Elisabeth (2010), p. 217.

<sup>6</sup>See Göbel, Elisabeth (2010), p. 218.

<sup>7</sup>See Göbel, Elisabeth (2010), pp. 220.

<sup>8</sup>See Wittmann, Stephan (1994), pp. 88.

## 7.1.2 *Operative and Strategic Targets*

### 7.1.2.1 **Company Targets and Strategies**

A company's operational objectives can be met using overarching guiding principles. In this way, they narrow down their model by including a measurable goal (growth in percent) and a time reference (years or months) in addition to an objective (for instance profit or turnover) and a material scope (total company or division).

In the mid-1980s, the Otto group defined environmental protection as a corporate objective. An environmental and social policy area was established for this purpose. As a secondary goal they adopted the enforcement of social standards in the worldwide trade with the suppliers. Internally, employee training was carried out, environmentally oriented input-output balances were prepared and incentives for environmentally conscious behavior were set. Nonetheless, the operability of objectives must be achieved through intermediate objectives.<sup>9</sup>

Other examples include reforestation projects from beer breweries such as Krombach or the agro-forestry development project of Ritter GmbH & Co. KG in Nicaragua. By paying "fair" prices, the local farmers are sustainably supported to cultivate cocoa without destroying more rainforest.<sup>10</sup>

**Strategy** is defined as:

"a fundamental pattern of present and planned resource deployments and environmental interactions that indicate how the organization will achieve its objectives."<sup>11</sup>

Or simply:

The target-medium combination to achieve long-term goals.

More specifically, this is the definition of the economic sectors in which the company intends to operate and enjoy long-term use, which includes the distribution of company resources, in order to achieve competencies and thus competitive advantages.<sup>12</sup> Corporate, business area and functional area strategies are differentiated. The company strategies include, for example, decisions on products, markets, co-operations, organizational structure, personnel strategies and the company's constitution.

<sup>9</sup> See Lohrie, Achim/Merck, Johannes (2000), pp. 44.

<sup>10</sup> See Göbel, Elisabeth (2010), p. 172.

<sup>11</sup> Hofer, Charles Warren/Schnedel, Dan (1978), p. 25..

<sup>12</sup> See Bea, Franz Xaver/Haas, Jürgen (2009), pp. 53 and Göbel, Elisabeth (2010), p. 167.

### 7.1.2.2 Division Targets and Strategies

Company targets are broken down to the division level and defined operationally, for which strategies are determined. In the case of business strategy, the competition strategies normally attributable to Porter<sup>13</sup> are listed here. For a company, there are three different options to be successful in competition: (1) Cost leadership, (2) Product differentiation, to separate from the competitors, and (3) A niche strategy in which the company focuses its product on a specific buyer group. Other competitive strategies are quality leadership and concentration, thus the repression or takeover of competitors.

It can be worthwhile to focus a business on ethical products. Examples for this are: organic eggs, free-range eggs, eggs from soil conservation and organic meat. The environmental orientation of a company or environmentally friendly products is a differentiation strategy if consumers also have an environmental orientation. If this is very pronounced, a corresponding orientation for the company can become vital. If there is an environmentally conscious buyer group, this can be developed with a niche strategy. The increase in organic products, along with specialized chains like Alnatura, are also examples of businesses focused on ethical products.

The cost leader will always outperform a company with an environmental policy orientation for production in a pure market economy, because here, as already explained, market failure exists. However, if society and the economy are well developed and have a regulatory framework that internalizes the negative external effects through prohibitions, taxes and subsidies, environmental policy becomes a positive competitive factor.

Ultimately, public opinion is most responsible for sanctioning ethical misconduct. For this reason, particular importance is attached to the media. Public opinion also determines the behavior of consumers in the selection of products and thus indirectly the success of the company. An ethical perception of the consumer forces companies to adopt ethically-oriented production. To this end, a consumer group has been developed, called Lohas (Lifestyle of Health and Sustainability), which focuses its consumption on the criteria of health and ecological and social sustainability.<sup>14</sup> It is therefore all the more important that consumer labels are monitored by independent organizations or by the state to provide consumers with the appropriate and objective information for an ethical choice of products.

### 7.1.2.3 Department Strategies

Company goals are defined operationally, which in turn is broken down into functional areas. To achieve this, more strategies are defined. The business area strategies are subordinated and the functional area strategy is subordinated. The company plans to implement both company and competition strategies. These may be

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<sup>13</sup> See Porter, Michael E. (2013).

<sup>14</sup> See Göbel, Elisabeth (2010), p. 326.

research, development, procurement, production and sales strategies. For example, the abandonment of animal experiments can be a successful sales concept, as exemplified by the cosmetics company Body Shop.<sup>15</sup> There seems to be a consumer group willing to pay for it.

Environmentally-oriented functional area strategies

- (a) Research and development of environmentally friendly products and production processes are the basis for a sustainable use of our planet.
- (b) resource and environmentally friendly production
- (c) sales: environmentally friendly products (during manufacture or use), recyclable or combustible packaging, environmental awareness advertising

Corporate ethics is the consistent implementation of ethical goals in company policy and not a pure PR action. Again, there must be no contradictions. For example, it is hypocritical when a clothing producer who uses child labor in India to keep production cheap is trying to create a morally positive image in Germany by promoting SOS Children's Villages.

### 7.1.3 Code of Conduct

Even before the financial crisis, a so-called "ethical boom" arose in the US. According to a study, as early as 1989 more than 90% of responding US companies already had ethics principles. The same study was carried out by French, British and German companies. Only 41% had an ethics code (Germany 51%, the UK 30% and France 41%), with most of the code introduced after 1984.<sup>16</sup> At the beginning of the millennium, 90% of large US corporations introduced a "Code of Conduct" or "Code of Ethics". Employees should focus on values such as trust, fairness, honesty, integrity, and the good of the general public. The background is the insight that the image of the company has a great influence on market success. Ethical sensitivity and confidence in integrity are factors for success.<sup>17</sup>

Companies can also set ethical standards for themselves. The problem of enforcement is the same as in cartels. For example, the German Flower and Import Trade Association has established a code of conduct for the environmentally and socially responsible production of flowers and is striving to achieve compliance.<sup>18</sup> Forty companies of the Bavarian construction industry committed themselves, within the framework of an ethics management system, to prevent unfair competition practices such as undeclared work, dumping wages and corruption.<sup>19</sup>

<sup>15</sup> See Göbel, Elisabeth (2010), p. 169, 179.

<sup>16</sup> See Center for Business Ethics (1992), p. 864 and Wittmann, Stephan (1994), p. 88.

<sup>17</sup> See Deiseroth, Dieter (2004), pp. 129.

<sup>18</sup> See Weißmann, Norbert (2000), p. 122.

<sup>19</sup> See Wieland, Josef/Grüniger, Stephan (2000), p. 167.

If executives do not follow the code of conduct, this not only undermines their credibility, but also calls into question the Code of Conduct. The contradiction between the conduct of the executives and the code can ultimately lead to frustration among employees and other stakeholders.

The Code of Conduct can be voluntarily or obligatorily given by the company or associations to the employees and then include sanctions within the scope of employment law in the case of infringements. These codes fulfill several functions.

- they enable companies to supplement and interpret general legislation, especially for employees.
- they enable companies to commit employees to uniform standards and to adhere to their ethical questions, thus enabling a corporate identity and a uniform outward appearance
- they enable companies to respond to ethical mistakes faster than the law.
- they enable companies to set their own standards, which in particular can be used to express a company-specific management ethic.
- they allow special sector specificities to be addressed, which are not addressed by general legislation.

Codes of professional associations with compulsory affiliation, such as physicians, can achieve a high degree of liability, since a breach of sanctions can be penalized with threats including exclusion from the association. They are thus effective instruments for implementing ethics in the company and for acceptance of the industry in society.

Ethical industry codes have been published by the chemical industry, the construction industry and the pharmaceutical industry. The chemical industry attaches importance to sustainable production, safety in production, transport, storage and consumption of chemical products. Furthermore, the production of chemical agents is outlawed.<sup>20</sup> The Code of Ethics, which is integrated into the ethics management system of the Bavarian construction industry, contains various behavioral standards, for instance in the areas of lawfulness and integrity, on the rejection of restrictive agreements, on dealing with clients, and on distributing or accepting gifts.<sup>21</sup>

There are several codes for the pharmaceutical industry in Germany. For example, the Ethics Code Association of the Diagnostica Industry (VDGH) is concerned mainly with the regulation of fair competition. The Voluntary Self-Monitoring Association for the Pharmaceutical Industry (FSA) was set up to monitor compliance with these regulations. The association for voluntary self-regulation in the pharmaceutical industry agreed to the national implementation of the European Transparency Code, which was drawn up by the European Federation of Pharmaceutical Industries and Associations EFPIA. The Code regulates all relationships between physicians and healthcare institutions and drug manufacturers. The

<sup>20</sup> See Strenger, Herrmann J. (1989) and [http://www.bavc.de/bavc/web/web.nsf/id/li\\_domo-7hwgy4.html](http://www.bavc.de/bavc/web/web.nsf/id/li_domo-7hwgy4.html).

<sup>21</sup> See Wieland, Josef/Grüninger, Stephan (2000), pp. 167 and <http://www.bauindustrie-bayern.de/themen/emb-wertemanagement/emb-wertemanagement-bau-ev.html>.

main focus of the Code is on donations and payments in the context of training events, as well as in service and advisory consultations. Information on fees payable by manufacturers to physicians for their clinical trials or application observations was published. A doctor's individual publication of the donation with the nomination of the recipient and the name of his/her business address is provided. If the physicians of the publication disagree, the publication will be in an aggregated form.<sup>22</sup> The members of the Association for Medicines and Cooperation in Health Care (AGK e.V.) have agreed on a code which aims at compliance with legal and ethical requirements for the marketing of medicinal products.<sup>23</sup>

In addition, the World Health Organization published a Code of Conduct for the marketing of breastmilk substitute products in 1981, in particular to prevent the idea of mother's milk substitute products being superior from spreading.<sup>24</sup> The UN adopted an International Code of Conduct for the distribution and use of pesticides. The goal is the international risk reduction in the handling of pesticides.<sup>25</sup>

## Conclusion

Business associations can commit themselves to complying with ethical standards without state compulsion. The question, however, is why they are doing this and why the state has apparently left a regulatory vacuum here. All rules must be implemented by ethical control systems, since they are otherwise pure PR measures.

### 7.1.4 Ethical Control Systems

#### 7.1.4.1 Compliance Programs

In 1991 the Federal Sentencing Guidelines for Organizations (FSGO) entered into force in the United States, which provide for fiscal penalties for companies when they take institutional measures to prevent employees' economic crimes. This also made it clear that the companies are responsible for the actions of their employees. As a result, companies have issued binding internal regulations, so-called compliance programs or guidelines, for the legal requirements relating to their liability. Compliance programs have the aim of implementing ("to comply") state regulations for internal business in the company. They are thus based on incentive ethics. In Germany, this would be e.g. The Securities Trading Act, in particular the

<sup>22</sup> See Laschet, Helmut (2013); <http://www.fsa-pharma.de/> and <http://www.vfa.de/de/verband-mitglieder/transparenzkodex-der-pharmaindustrie/zusammenarbeit-zwischen-pharmazeutischer-industrie-und-aerzten-unverzichtbar.html>.

<sup>23</sup> See <http://www.ak-gesundheitswesen.de/verhaltenskodex/> and <http://www.lofarma.de/unternehmen/pharma-kodex>.

<sup>24</sup> See [http://www.who.int/nutrition/publications/code\\_english.pdf](http://www.who.int/nutrition/publications/code_english.pdf) and [http://www.afs-stillen.de/front\\_content.php?idart=135](http://www.afs-stillen.de/front_content.php?idart=135) (11/3/2012).

<sup>25</sup> See [http://www.bvl.bund.de/SharedDocs/Downloads/04\\_Pflanzenschutzmittel/CodeOfConduct\\_DE.pdf?\\_\\_blob=publicationFile&v=2](http://www.bvl.bund.de/SharedDocs/Downloads/04_Pflanzenschutzmittel/CodeOfConduct_DE.pdf?__blob=publicationFile&v=2).

provisions on Insider Information, the Money Laundering Act and the German Investment Protection Act.

Contrary to German law, legal persons can also be prosecuted in the USA. US law is based on the assumption that the behavior of employees is also determined by company guidelines and corporate culture. For example, an effective ethics program, which ensures that legal violations in the company are detected and sanctioned, is mitigating in its effect. The cooperation of the enterprises in the detection of offenses is taken into account in the sentence.<sup>26</sup> The companies have an incentive with the FSGO to ensure clear responsibilities because they themselves are otherwise responsible for the ethical misconduct of employees.<sup>27</sup> The employees are still liable, but the companies cannot escape responsibility. However, this presupposes that the management cannot completely impose the costs of ethical misconduct on the company owner.

### 7.1.4.2 Integrity Programs

In an integrity program all measures are taken to implement the internally formulated ethical company specifications, which are not based on an external law.

As already explained, there can be no absolute control of employees in the company and regulations have the disadvantage that they can never cover all situations. The chairman of the board of Levi Strauss & Co., Haas, judged the compliance program of his company thus: “We became buried in paperwork, and anytime we faced a unique ethical issue, another rule or regulation was born.”<sup>28</sup> (See the comments on institutional ethics). Levi Strauss & Co. therefore opted for a value orientation in order to ensure the employees’ ethical behavior. Shared values and insight into the principles derived from them formed the basis of an ethos. The company identified its values as honesty, adherence to promises, fairness, respect for others, compassion and integrity.<sup>29</sup>

Integrity programs go far beyond compliance programs, in that they want to promote the moral self-responsibility of the employees with a broad, decentralized scope for decision making. They include ethical guidelines, objectives and control of their compliance, including the associated rewards and sanctions (Fig. 7.3).

In the case of the compliance programs, the employee is mostly avoiding punishment, without having to be convinced of the measure, while the Integrity Program wants to motivate the employees to adopt “integrity” behavior, which is based on individual ethics. For this reason it is advisable to involve the employee in the development of the Integrity Program and to inform him about the compliance program.

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<sup>26</sup> See Steinherr, Christian/Steinmann, Horst/Olbrich, Thomas (1997), pp. 1, 7, 16; Clausen, Andrea (2009), pp. 32; Zimmermann, Rudolf (2004); Paine, Lynn Sharp (1994), p. 110 and Noll, Bernd (2002), pp. 119.

<sup>27</sup> See Fetzer, Joachim (2004), pp. 34.

<sup>28</sup> Quoted after Jensen, Annette (2003), p. 2.

<sup>29</sup> See Jensen, Annette (2003), p. 2.

	<b>Compliance program</b>	<b>Integrity program</b>
Output base	Internal implementation of an external legal requirement	Internal implementation of an internal requirement
Aim	Avoidance of state penalties	Responsible, ethical behavior
Actor	Compliance officers	Management
Motivation	Avoidance of disadvantages	Ethos, values,
Design room	None	(In case of sanctions: avoidance of disadvantages)
Rewards / sanctions	Mandatory, sanctions (extrinsic)	None
Measures	Training, written guidelines, sanctions, controls, reports	Partially voluntary, appeals up to sanctions (intrinsic and extrinsic)

**Fig. 7.3** Difference Compliance and Integrity Program (See Paine, Noll und Göbel (See Paine, Lynn Sharp (1994), p. 113; Göbel, Elisabeth (2010), p. 246f and Noll, Bernd (2002), p. 121))

The compliance program must be designed and controlled very tightly in accordance with legal requirements, while the integrity program allows for a self-defined decision-making margin. Paine emphasizes the need for executives to present and embody the values of the Integrity Program. They must also be able to enforce them in the company and to be able to do so in terms of character and intellect.<sup>30</sup> As a corporate motif, we can summarize the guiding principle for the compliance programs “Keep us out of trouble” and for the Integrity Programs “Make our business better.”<sup>31</sup>

### Summary

In the case of the integrity programs, which allow the company to have its own scope, it is particularly important for the employees’ later acceptance that they be involved in the design process and that the objectives and decisions of the management are made clear. The compliance programs must be explained according to the legal requirements. Executives must be aware of the values of the Integrity Program. They should also be able to enforce them in the company, and they should also be able to do so in terms of character and intellect.

### Comprehension Questions

1. How can companies benefit from ethical corporate objectives?
2. What are the advantages of codes of conduct for companies and associations?
3. How can companies benefit from ethical corporate objectives?
4. Explain the difference between compliance and integrity programs.

<sup>30</sup> See Paine, Lynn Sharp (1994), p. 111.

<sup>31</sup> See Paine, Lynn Sharp (1994), p. 109ff; Steinmann, Horst/Kustermann, Brigitte (1999), p. 212, Clausen, Andrea (2009), pp. 32 and Göbel, Elisabeth (2010), pp. 248.

### ***7.1.5 The Ethical Aspects of the Shareholder Value Concept***

During the Enron crisis and the subprime crisis the shareholder value concept was the prevailing management concept. The shareholder value concept specifically criticizes profit as a means of controlling the performance of companies, based on the ability to control and determine it, and thus the options for control and manipulation of it. In the end, it argues, profits do not reflect the annual success of a company as a premium for the stockholders of a company, the shareholder or the investors, rather it is a fictitious evaluation unit, quite in contrast to cash flow. All too often the actual profitability of the company is not included in the profit. Management sees growth and investments often uncritically against pure sales growth, whereby unprofitable growth would destroy the value of the company and thus of the shareholders. The profit approach is neither suitable for evaluating investments, nor does it take the value of money over time into consideration.<sup>32</sup> The shareholder value concept proposes the use of a new measurement, the so-called free cash flow. This represents the amount of money that the stockholders will have leftover at the end of a period, in other words all revenues minus expenses, including the pure investments and both real and notional capital costs.

The inclusion of capital costs is a special feature of the shareholder value concept, and has far-reaching consequences. The shareholder value concept differentiates itself in particular from other cash flow approaches. The shareholder value concept takes not only external finance costs that effectively occur as regular expenses into account, but also the notional costs of equity capital. To calculate these notional costs, the average historical stock performance is increased by a risk premium for the respective branch of enterprise. The costs of equity capital are up to 10%, depending on the branch and the time frame it is based on. The shareholder value concept is thus also suitable to evaluate investments. You must earn at least the reduced cost of capital, whether you are talking about investments in capital assets or in other companies. The free cash flow is then reduced over the periods with the costs of capital and makes up the net return on the investments, or the shareholder value, thus the enterprise value. According to the shareholder value approach there is only one motto for the manager: maximize the shareholder value.

Unfortunately the shareholder value approach has four fatal flaws. First is its clarity, second its focus on the costs of capital, third the one-sidedness of its orientation towards companies and the maximization of the shareholder value, and fourth the short-term perspective of the approach.

#### **Calamitous Clarity**

How is one supposed to guess the exact cash flow of a company for all future periods? Since most future environmental factors are unknown, it is impossible to estimate cash flow with any exactitude. Despite this, there are quantitative periodic calculations of shareholder value with numbers that are always very clear. Even risk premiums or gradient scenarios relativize the results only a bit, and from a period

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<sup>32</sup> See Rappaport, Alfred (1995), pp. 15.

not usually beyond the tenth cycle. For the sake of simplicity the growth rates are continued as an infinite sequence. Numbers are facts, and yet as Churchill said, "Don't trust any statistics you haven't faked yourself." It is not even necessary to intend to fake statistics. A bit of optimism when predicting future figures, synergy effects or growth in company sales is sufficient. How else can the many overpriced takeovers be explained, such as Chrysler by Daimler or Voicestream by Deutsche Telekom? The consulting American investment banks were simply mistaken. The same must apply for the recommendation to sell, which the bank analysts at the end of the 1990s calculated at the height of the stock market boom. If the value were calculable using the shareholder value approach, all analysts in 2001 would have to have calculated huge overvaluations.

The problem of conflicting interests must also be recognized in the consultations for takeovers. The consulting investment banks were surely paid well for the takeovers of Chrysler and Voicestream, making it highly advisable to check the base calculations through a third party before the takeovers occurred. The calculations will have been correct, but there may have been many speculations in the assumptions underlying the calculations. Numbers are clear, but whenever we are dealing with estimations the numbers are usually wrong, which can lead to a false sense of security from the clear conclusions. But why did the stock analysts and rating agencies fail in extreme cases such as Enron and Worldcom, in which there was a huge level of investor fraud? Because figures are often not facts. Not even, as Rappaport says, "cash facts" are facts if we are dealing with future, and thus insecure, cash. Even if the balance sheets of a company (or an economy) have not been manipulated, pure numbers tell us little about the current state and almost nothing about the future state of things. These depend on many external factors that cannot be prognosticated or recorded from the people in the company who must deal with the future conditions; all of which are qualitative factors, not concrete, exact numbers.

The shareholder value is determined by financial figures. These numbers are the result of many past factors, including many qualitative factors, which are influenced by people. Numbers create a purely quantitative world and can thus only reflect a certain simplicity, not reality. Andreas Schüren, President of the management consulting firm Rölfs MCParnter said succinctly, "It is ridiculous to believe I have everything under control when I only have numbers under control."<sup>33</sup> A one-sided orientation to these simplified, purely quantitative enterprise images thus contains the great danger of making poor decisions. If you only look in the rearview mirror you cannot steer a company. You can only see a small segment, and that segment is in the past. Even the estimations for future development are based on numbers from the past. Then we consider that there is constant pressure from the capital markets and competition to save on costs. This pressure, in connection with a strong belief in the power of numbers, a company policy oriented towards short-term success gave controlling an enormously important role for operative and especially for strategic decisions.

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<sup>33</sup>Quoted and translated from Handelsblatt dated February 10/11/12, 2006, p. 3.

Controlling is a necessary but inadequate condition for economic success. Qualitative market leadership cannot be calculated on this basis any more than a well-tuned enterprise process with motivated employees. The best example for this is Opel. At the beginning of the 1990s, GM sent financier Louis Hughes with the notorious purchasing manager José Ignacio Lopez to Germany in order to cut costs at Opel. The short-term success they had was at the cost of quality, however. Opel cars broke down more frequently, and its market share dropped from 17% to 10.5%.<sup>34</sup> The simplest way to save on costs is still to stop investments and lay off half of the employees. The bottom falling out of business after deficient internal business procedures will only be reflected in company figures after 1 or 2 years.

The predictability of the shareholder value based on the free cash flow is the part of the shareholder value concept that impresses most. Especially investment banks and stock analysts use the concept for exactly this reason. At the end of the 1980s it became the dominant management and stock market evaluation concept. The approach is well meant and understandable, maybe even impressive, and its critique of the traditional company evaluation methods is justified. Unfortunately, exactly the well-meant, initially revolutionary improvements are often the most dangerous and the financial mathematics with their perennially clear results are the most dangerous simplifications. The supposed strengths of the shareholder value concept, calculating a seemingly secure company value including future figures is partially responsible for the stock market bubble in American and European stock markets at the end of the 1990s.

#### *Short-Term Focus of Company Policy*

Extremely short-term thinking has become the norm at the management levels of listed companies. A current study determined that most American managers will relinquish investments with a positive value proposition if it would mean missing the quarterly figures expected by the stock market.<sup>35</sup> This tendency is increased by discounting free cash flows with capital costs in the shareholder value approach, since the short-term profits are given too high of a priority (discounted cash flow). This is only consistent because the investors can reinvest the money they receive today, and thus produce additional profits. This procedure may be correct for capital market theory, but it means that temporary parts of the company that only exist for three cycles have the same value as parts that exist indefinitely but only produce a fraction of the amount. The shareholder value approach consistently sees only cash, and since cash today has more value than the profit of tomorrow, this leads to a short-term perspective and investments that will only be profitable later being undervalued. Gifted managers who instinctively make long-term strategic company decisions have little role to play in this scenario.

Long-term investments tend to reduce the cash flow and thus the shareholder value. A manager maximizes his shareholder value and thus the share price (perhaps his stock options as well) when he cuts all non-vital expenditures. This includes

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<sup>34</sup> See Handelsblatt dated 10/11/12, 2006, p. 3.

<sup>35</sup> See Graham, John R./Harvey, Campbell R./Rajgopal, Shiva (2004).

expenditures that have a positive effect on company returns over the long term, or those that may not be directly visible at all, such as investing in employees with continued education expenses and social provisions. Unethical dismissal of employees can raise the shareholder value in the short term. It is not initially important if the number of employees is sufficient for the long-term in order to fulfill all operative and strategic functions as long as the quantity is sufficient to fulfill the operative tasks necessary to keep profit at the current level. Whether the employees are overworked in this situation is not important, since the negative effects of overwork, stress and a poor work environment only show themselves in the long-term. The employees are no longer a qualitative production factor in the shareholder value approach, but rather a quantitative cost factor. Increased conflicts with stakeholders, the groups with which the company is in a mutual or even dependent relationship, will only occur over the longer term. One of the main differences between the stakeholder and shareholder approaches is thus in the time frame used. The 6-month analyst perspectives strengthen the short-term focus of enterprise decisions in stock quotation even more. However, other investments such as research and development or quality control are not important for company success in the short term. The future profit contribution from such investments is difficult for external persons such as analysts to judge. Decisions and influences are only considered important if they will reflect in profits within the next 6 months. Six months is a long time for stock prices, but nothing for the strategic development of a company. Without long-term investments there is no future growth.

A manager has to show the public activity, otherwise he cannot justify his position and salary. What if it were actually better for him to do nothing? The result is a company policy focused on short-term results and bolstered by the short duration of management contracts. The daily and weekly press with a very short-term perspective plays a role here as well. Can the manager of a public company go against the trend as a publicly owned firm and refuse to do the activities that all the other managers use to get famous in the eye of the public? It would at least be very difficult. There is a danger that short-term company policy dominates and the necessary yet difficult decisions for the long term are not taken. Even Rappaport mentioned the danger of a short-term reduction of costs to increase shareholder value with negative effects on the long-term development of a company in his second edition of "Shareholder Value." As an example he uses the dismissal of sales personnel with good customer contacts, but he does not consider this a weakness of the shareholder value approach, rather he considers it an incorrect or absent application of the shareholder value approach.<sup>36</sup>

The shareholder value concept is a contract theory. Since all activities to be performed under contract with a third party such as suppliers, employees etc. have been removed, only the owner or principal is entitled to the residual earnings. The stakeholder concept on the other hand, considers the company to be a coalition of interest groups such as suppliers, employees, customers, communes, states etc. who create the value of the company together, which means that the interests of the groups

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<sup>36</sup> See Rappaport, Alfred (1995), p. 11.

involved must be included in the company goals in addition to the profit or cash flow maximization. The shareholder value approach tends to represent more the American view of companies and the stakeholder approach more the European view.<sup>37</sup> Both approaches are correct, but they only cover part of the world of enterprises.

The shareholder value approach makes clear that the priority of a company is to produce added values. The employees of a company must understand that they cannot demand a salary from the company that exceeds their contribution to value creation. In particular in times of harder international competition through globalization, the structures must be repeatedly examined for efficiency. The relative production advantages, and thus the international distribution of labor, are constantly changing. The employees themselves are in direct competition with workers from other countries. This competition is all the harder as the transportation costs of the goods produced drop, international capital becomes more mobile and the costs more transparent. An employee in the home country who costs double of someone abroad must provide double the value creation. Considering production for a world market, unemployment is a structural problem much more than an issue of demand.

#### *One-Sided Maximization of Shareholder Value*

Maximizing shareholder value is a natural and legitimate demand of the investors as providers of capital, since it is the reason for their investment in the company stock. They waive immediate consumption and accept the enterprising risk in the expectation of receiving added value, a yield. When the shareholder value concept was formulated, many managers went their way in companies and tended to follow their interests more than that of the investors, at least according to the supporters of the shareholder value approach. The managers could not be sufficiently controlled with the criteria of sales growth and profit. In addition, these factors had no direct connection to the goal of the shareholder to maximize returns, since they did not represent cash flow. This also seemed to reflect the market economy guidelines. According to Milton Friedman there is only one company goal in the market economy, maximizing profit:

“... and nature of a free economy. In such an economy, there is one and only one social responsibility of business – to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engage in open and free competition, without deception or fraud.”<sup>38</sup>

This one-sided focus on a single goal is problematic, however.

The value of a company cannot be reduced to the cash flows available as flow figures, because it leads to incorrect interpretations. An uncompromising, one-sided pursuance of the shareholder value causes friction. If the company is driven only by the goal of maximizing shareholder value, thus the interests of the capital providers, obviously many other interest groups will be shut out and public relations will worsen. The damage done to society by the banks in the financial crisis was one unethical outcome of this narrow-minded approach. It is a dangerous illusion for a

<sup>37</sup> See Noll, Bernd (2002), pp. 88.

<sup>38</sup> Friedman, Milton (1963), p. 133.

manager to believe that he could steer his company any way he wanted. A company does not work in isolation, rather it is dependent on various interest groups such as suppliers, customers, credit suppliers (banks) and in the end its own employees as well, all of whom are people who often act irrationally and unpredictably. The stakeholder approach, formulated at the end of the 1980s, emphasizes this view.<sup>39</sup> The society itself can be seen as a stakeholder. The environment of a company considers it to be a part of the community. It lives not only in the community, but from the community, creating mutual dependency. The community is not only the income side either, since the employees are the most important input factor. The legal framework is also determined by the community. This still holds in the age of globalization, though the community must be defined more broadly, or more internationally.

An uncompromising one-way tracking of the shareholder value leads to high friction losses. If the public is only concerned with the one goal of maximizing the shareholder value, ie, the interests of the investors, it will compel many other stakeholders to get rid of public relations. It is a dangerous illusion when a manager believes that he can control his company at will. A company does not work in isolation, but on the basis of various stakeholders, such as suppliers, customers, lenders (banks), and finally the company's own employees.

### ***7.1.6 Ethical Stakeholder Approach***

The so-called **stakeholder approach**, formulated at the end of the 1980s, emphasizes this view. Among the stakeholders is Freeman, who defined the term as “any group or individual who can be affected by the achievement of the organization’s objectives” or informally “those groups which make a difference”.<sup>40</sup> “The fundamental idea is that stakeholders have a stake in the operation of the firm.”<sup>41</sup>

The ethical stakeholder approach is an ethical goal balancing, in order to identify and avoid the negative effects of corporate activities on third parties in time (**definition**).

The shareholder value concept is a contract approach. Since all contractually rendered services have already been subtracted from third parties, such as suppliers, employees, etc., the owner, the principal, is entitled to this residual income. The stakeholder approach, on the other hand, sees the company as a coalition of stakeholders, such as suppliers, employees, customers, municipalities, the state, etc., which together generate the value added to the company, which is why not only the profit or cash flow optimization, but also the interests of the groups involved should

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<sup>39</sup>R.E. Freeman, who coined the term stakeholder for a broader public in 1984, does state however, that “There is no such thing as the stakeholder theory.” Freeman, R. Edward (1994), p. 413. It is more of a strategic orientation towards the interest groups important to the company. See Waxenberger, Bernhard (2001), p. 39.

<sup>40</sup>Freeman, Edward, R. (1984), p. 46.

<sup>41</sup>Post, James, E./Preston, Lee E/Sachs, Sybille (2002), p. 19.

be taken into account in the company's objectives. The shareholder-value approach more and more represents the American view of business and the stakeholder approach more the European.<sup>42</sup> Both approaches are useful, but cover only a part of the business world.

As a rule, the business stakeholder approach only takes into account stakeholder interests that are either conducive to the company's economic success or which are so influential as to adversely affect the company's economic development.<sup>43</sup>

"To be an effective strategist you must deal with those groups that can affect you, while to be responsive (and effective in the long run) you must deal with those group you can affect."<sup>44</sup>

Stakeholder management then has the task of counteracting the negative impact of stakeholders in order to promote the economic development of the company. This is called stakeholder value maximization.<sup>45</sup> Thus, regardless of the morality of a company, it can be worthwhile to disregard stakeholders' interests and/or to avert them. However, this can lead to damage that far exceeds the company's profit. The fact that the business-based stakeholder value approach considers the stakeholder interests only from the point of view of the impact on the monetary success of the company reduces the concept to a partial area of maximizing the shareholder value. That this is not sufficient, at least by the example of the use of forced labor by some German companies during the Nazi period makes clear. Here, the economic interest was dominant and at that time the stakeholder interests of the forced laborers could be ignored without negative consequences.

### **Case Study: Shell in Nigeria**

Nigeria is Africa's largest oil exporter and has the world's tenth largest oil reserves. America, Brazil and Europe are among the main oil buyers. Two-thirds of Nigerian government revenues come from oil production. Shell has been present in Nigeria since 1937. Shell Nigeria is the operator of a joint venture between the government-owned Nigerian National Petroleum Corporation – NNPC (55% share), SPDC (30%), Total E&P Nigeria Ltd (10%) and the ENI subsidiary Agip Oil Company Limited (5%). The joint venture company is focused on onshore and shallow water oil and gas production in the Niger Delta.

Shell operates approximately 50 oil fields and 5000 kilometers of oil pipelines in the Niger Delta. According to Amnesty International, the company has reported nearly 1700 oil spills since 2007, but the actual number of accidents is likely to be higher.

The non-governmental organizations (NGOs) Amnesty, Center for Environment, Human Rights and Development stated in 2015 that these sectors were still contaminated even though Shell took measures to clean up. These contaminations are still there according to the NGOs, because Shell carried out the clean up inadequately.

<sup>42</sup> See Noll, Bernd (2002), p. 88ff.

<sup>43</sup> See Post, James, E./Preston, Lee E/Sachs, Sybille (2002), p. 19 and Hill, Wilhelm (1996), p. 414.

<sup>44</sup> Freeman, Edward, R. (1984), p. 46.

<sup>45</sup> See Schaltegger, Stefan (1999), p. 14 and Göbel, Elisabeth (2010), p. 144.

The drill hole number 11 of the Bomu field is one example. Here, after the end of the work, almost half a century of pollution and oil have been found in the waters, despite several refurbishments by Shell. Shell withdrew from some parts of the Niger Delta in the 1990s, but is still responsible for safeguarding the facilities used at that time. The NGOs accuse Shell of not complying with the legal obligation to secure the outdated infrastructure.

Three quarters of the oil escaping from the exploration sites is due to pillages or manipulation. Shell has the duty to eliminate all occurring oil leaks. For Greenpeace, however, the cause of the accidents is not relevant to the environment. In addition, the NGO criticizes the fact that a very considerable amount of gas was burned during the oil spill without purpose yet it increased climate change.

The people in Nigeria suffer greatly from environmental pollution. To this end, Shell pays compensation, such as £55 m to fishermen and farmers, but it does not restore the contaminated areas. The population is being harmed by Shell. According to the human rights organizations, the national environmental protection authority is understaffed and corrupt.

The Ogoni tribe railed against oil production, which devastated their habitat. In 1993 Shell withdrew from the Ogoni area. After the killing of a mob in clashes in 1994, the police arrested the leader of the movement Ken Saro-Wiwa. In prison he wrote the book “Flames of Hell,” in which he accused Shell of cooperating relentlessly with the military junta in promoting oil. In 1995, he was hanged by the Nigerian military junta along with eight of his colleagues. In 2015, after 13 years of legal action, Shell agreed to pay a total of approximately 15.5 million dollars to the survivors of the nine men. Shell had nothing to do with the acts of violence, but wanted to make a “humanitarian gesture” to pacify the country. Nevertheless, there are still ongoing battles between the government and the rebels, which interrupt oil production. The rebels fight for participation of the population in the oil profits, but also live from abductions. In December 2016 a suit against Shell began in London, where 40,000 residents of the affected areas of Ogoni and Bille demand compensation for oil pollution and cleaning from Shell.

### Tasks

1. How do you rate the stakeholder dialog of Shell? Has Shell behaved ethically?
2. How do you assess the importance of NGOs?
3. Has Shell’s behavior paid off?

### Sources

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### Summary

There are always social groups whose interests a company does not have to take into account, because they have no influence on the profit. Unethical behavior therefore has no negative impact on the company. In the long term, however, the company is caught up with the unethical behavior. Shell has been promoting oil in the Niger Delta for decades. The company was initially able to ignore the tribes in the Niger Delta as a stakeholder. However, the pressure of the Western public grew not least due to the actions of NGOs. Finally, injured Nigerian Shell filed a claim against a Dutch court Shell for damages and won the 2013 trial.<sup>46</sup>

**Ethical stakeholder analysis** (ethical stakeholder approach) examines who is affected by the company's decisions and tries to make the ethically correct decision by weighing all the benefits and damages to third parties and the company. This is where business ethics is concerned with the question of the extent to which corporate decision-makers as human beings can harm other people. Market failures due to external effects must also be considered. In addition to the avoidance of a third harm in the sense of ethics, the foundation is to compensate all stakeholders in the sense of a situation as described in Sect. 2.2.3 defined justice (Fig. 7.4).

### 1. Interdependent Analysis and Opening of the Stakeholder Dialogue

Who is affected by company decisions? When we speak of a moral responsibility of the company, we mean the impact of corporate activities on dependent groups. Stakeholders must be identified within the framework of ethical stakeholder analysis, within which the interests and demands of the stakeholders are addressed. In interdependent analysis, the impact of all alternatives of business behavior on stakeholders must be recorded and analyzed. Here, among other things, are the probability of occurrence and the extent of possible effects. In the interdependency analysis, the stakeholders must first be determined in a stakeholder map, for example.

Here is how we determine the probability of occurrence and the extent of effects: What interests are stakeholders pursuing? Are their interests consistent with the company's interests or are there conflicts of objectives? What/who are the stakeholders? Do they have conflicting interests? How is the long-term development of stakeholders and their interests assessed?<sup>47</sup> What are the impacts of the company's

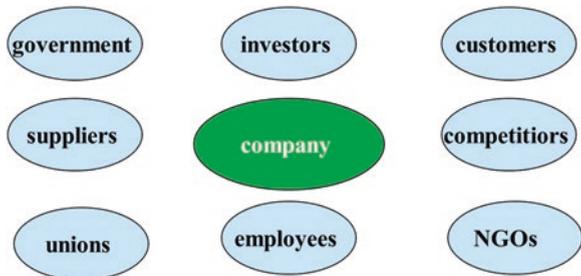
<sup>46</sup> See <http://www.sueddeutsche.de/wirtschaft/oelverschmutzung-in-nigeria-shell-zahlt-millionen-an-fischer-aus-dem-niger-delta-1.2293097> and <http://www.bund.net/shell>

<sup>47</sup> See Göbel, Elisabeth (2010), pp. 140.

**Fig. 7.4** Ethical stakeholder analysis in company decisions



**Fig. 7.5** Stakeholder Map (NGO: Non-Governmental Organizations)



decision-making alternatives on stakeholders? In order to provide information on the stakeholders beyond publicly accessible sources, the company asks the stakeholders about their interests and the effects of possible corporate decisions, thus initiating the stakeholder dialogue (opening of the stakeholder dialogue) (Fig. 7.5).

**2. Ethical assessment as consideration of the impact on stakeholders**

The next step is the ethical assessment as classification of interests according to the urgency of concerns to be considered by the company. The overall goals and value system of the company must be taken as a basis. The interests and requirements of the stakeholders need to be analyzed and evaluated. Here we clarify which interests are legitimate, i.e. are ethically justified. This is done within the framework of a discourse ethics with the stakeholders, in which all claims are initially presented by the stakeholders. In a further step, the groups of claimants are to be placed in the role of the other (ideal roletaking) in order to then work out the justification and legitimacy by balancing the benefits and damages in a discourse as a constructive discussion. Explicitly, bargaining is to be avoided here, defined as the enforcement of one’s own interests at the expense of others.<sup>48</sup> The conditions for open and fair ethically-oriented dialogue are, in particular, the willingness to put one’s own interests behind the legitimate interests of others. However, this cannot be assumed

<sup>48</sup> See Ulrich, Peter (1998), p. 13 and Göbel, Elisabeth (2010), p. 128.

**Fig. 7.6** Fundamental relation between goods



from the interest groups involved in discourse ethics. In reality, the ethical motivation of the company's management will therefore be to take on the role of the stakeholders and to carry out a weighing-up.

In balancing the interests and action alternatives (weighing goods vs evils), i.e. the consideration of the ethical advantages and disadvantages of the enterprise, a condition is sought which "combines public well-being with fairness with the greatest possible preservation of the well-being of the individual."<sup>49</sup> The aim is to maximize the value of the goods while remaining conscious of individual and community interests. This is not the utilitarian "happiness of the greatest number."

This is about balancing the impact of the company's behavior on goods or values. The basic criterion is that of fundamentalism, which means that in the event of a conflict, the good (or the goal) that serves the achievement of others is to be favored. The impact on the good of peace is, for example, higher in comparison to the good of prosperity, since there is no prosperity without peace.

According to Aristotle, another way of bringing the goods into a hierarchy is to ask for their meaning or contribution to a successful life. Thus one could place freedom over life as a value when one says that life makes no sense without freedom. However, these assessments are subjective, so that the relevant relations have to be determined (Fig. 7.6).<sup>50</sup>

### 3. Decision

After the stakeholders and their interests have been identified, their significance and development analyzed, and their ethical contribution evaluated, the next step is to make a decision and prepare a list of priorities with concrete measures according to the ethical considerations. The company or the management must decide on a behavioral alternative. In doing so, the company's own interests, in particular profit maximization, must be weighed against those of the stakeholders. The management of the company must opt for the best, and thus also the most ethical alternative.

### 4. Final stakeholder dialogue

Finally, the decision has to be explained to the stakeholders along with the planned measures (second and final stakeholder dialogue). It is precisely the non-fulfillment of concerns that may require an intensive explanation. Continuous communication with the most important stakeholders is generally required. In this case, the involvement of external consultants can be advantageous because the external impact of a company is difficult to see from the inside.

<sup>49</sup> See Korff, Wilhelm (1999), pp. 310 and Göbel, Elisabeth (2010), p. 156.

<sup>50</sup> See Böckle, Franz (1978), p. 286.

## 5. Implementation of the decision

Finally, the decisions according to the list of priorities are to be implemented through concrete measures (implementation of the decision).

### Examples of An Ethical Stakeholder Analysis Environment

With the help of a product lifecycle analysis, a company can determine the effects of production on humans or nature at every production stage. For example, Shell has identified 350 stakeholder groups from business, politics and environment in the project of exploration of gas deposits in the Amazon basin in Peru (“Camisea Project”), contacted 200 groups directly and classified 40 groups as primary stakeholders.<sup>51</sup> Following an intensive ethical stakeholder analysis, Shell concluded that the environmental impacts and the negative impact on the natives were predominant and dispensed with the exploitation of gas deposits in the Amazon basin.<sup>52</sup>

If the company comes to the conclusion that the production or sale of a product is unacceptable, the market is left with an ethical valuation. For instance, Henkel discontinued the sale of solvent-containing adhesives because children were intoxicated by the inhalation of the solvents. Because solvent-free adhesive has poorer product properties, Henkel lost market shares. Novartis and Agrevo took high-pesticides from the market in Colombia, which were used in the field of flower production.<sup>53</sup> The Otto group discontinued distribution of CFC-containing spray cans, real fur clothing and tropical wood products. As of 2003, the Home Depot retail chain no longer sells any building accessories with tropical wood parts.<sup>54</sup>

#### Human rights

Due to the violations of human rights in South Africa, numerous companies of anti-apartheidism joined and withdrew from South Africa, which ultimately led to the overthrow of the regime.<sup>55</sup> Levi Strauss & Co. (jeans) breaks business relationships with countries where systematic human rights violations take place (China for example).<sup>56</sup> In view of the human rights violations of the military dictatorship in Burma, the linen manufacturer Triumph closed its factory there.<sup>57</sup>

An action is ultimately only ethically justifiable if the interests of the shareholder are weighed with those of the stakeholders. One cannot principally be subordinated to the other, but the priority must be examined ethically in each case. Criteria for an ethical test will be the greatest concern.

All social and ethical interests that may be justified are of interest. Legally enforceable interests are only part of all legitimate interests. There is much that is legal but immoral. Case law covers only part of immoral trafficking. Laws can only arise from ethical discussions in society. Reason, conscience, and public discourse

<sup>51</sup> See Post, James, E./Preston, Lee E./Sachs, Sybille (2002), pp. 157.

<sup>52</sup> See Post, James/Preston, Lee E./Sachs, Sybille (2002), p. 161.

<sup>53</sup> See Weißmann, Norbert (2000), p. 122. G185

<sup>54</sup> See Post, James/Preston, Lee E./Sachs, Sybille (2002), p. 92, 161.

<sup>55</sup> See Noll, Bernd (2002), p. 148.

<sup>56</sup> See Haas, Robert D. (1994), p. 2.

<sup>57</sup> See Jensen, Annette (2003), p. 20.

are how we recognize legitimate interests.<sup>58</sup> Legitimacy does not necessarily align with legality. Laws can also be immoral, such as the laws on racial segregation in the US and South Africa. Economic activities can be legal but unethical, such as child labor in some countries. Finally, a court action is often not worthwhile or the injured party is not able to gather the necessary financial resources.

An ethical stakeholder analysis enables the company to recognize potential conflicts in time and thus also to avert them. The stakeholder dialogue strengthens the company's reputation. This can be seen in the example of the cigarette industry: more and more studies have proven the health damage caused by smoking, so that the non-smoker lobby got bigger and gained political influence.<sup>59</sup> In this case, the opposing stakeholders' interests are contrasted with the economic interests of the tobacco industry. Despite the fact that they used very high budgets for PR work to stop this development, the health issue of the stakeholders finally succeeded.

### Summary

Companies are dependent on society. This is also true in the age of globalization, whereby society is defined more broadly, that is to say more internationally. According to the principle "Do ut des", a minimum of social responsibility can and must be demanded, which also explains the critical attitude of large sections of the population to entrepreneurial violations. However, society's sense of responsibility cannot be assumed by companies, but must be demanded by society in the public and in the form of laws. If this does not happen, the company does not have a monetary incentive to behave in a socially desirable way, but rather can maximize its profit at the expense of society (such as the non-environmental disposal of production waste, competition offences or even balance sheet manipulation).

### Group Work Ethical Evaluation

In group work, consider the effects listed below, using the examples listed below: Which goods are affected by which groups? What are the effects? How would they weigh in against each other and what would they propose as a solution?

1. Animal experiments in the cosmetics industry and drug research
2. Environmental protection
3. Alcohol and tobacco

### Solution

1. Animal experiments in the cosmetics industry and drug research.

Animal experiments harm the good life and well-being of creatures. In contrast to this, the cosmetics industry is confronted with first a new, then tested product with its benefits for companies and society. In the pharmaceutical industry, this can mean saving human lives or at least the improvement of their health. Here one can justify the death and suffering of animals for drug research, but not for the cosmetics

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<sup>58</sup> See Göbel, Elisabeth (2010), p. 145.

<sup>59</sup> See Göbel, Elisabeth (2010), pp. 140.

industry. In this consideration, the probabilities and extent of the benefits and damages must, of course, be taken into account.

2. The same applies to environmental protection. Here the short-term interests of company profits and jobs are up against the long-term effects on the goods environment and thus indirectly on the life, well-being and health of the people. Weighing the impact on the goods is made more difficult by the time lag and by measuring problems in the event of environmental degradation.
3. Alcohol and tobacco harm health, which can cost life. Both are very important goods. Tobacco also harms others who are forced to inhale smoke (passive smoking). On the other hand, the goods stand for company profits, taxes and jobs. On top of that, however, there is still the good of freedom for one's own way of life or for a personal balancing of goods. In moderation, tobacco and alcohol can be consumed at a limited risk. This balancing assumes, however, that the consumers have the rationality and information to make a decision to their advantage. As adolescents have only limited rationality, the purchase of these products is forbidden to them.<sup>60</sup>

Discourse ethics and the consequences of ethics are applied in ethical stakeholder analysis. Responsible action is only possible by including the effects of one's own behavior on third parties. However, this can only be achieved by analyzing public sources, studies or expert surveys, and ultimately through dialogue with the stakeholders.

### Comprehension Questions

1. What are the differences between the business shareholder approach and the stakeholder approach?
2. How does this limit the ethical stakeholder approach? Why is it necessary for the long-term success of a company?
3. Describe the ethical stakeholder analysis in your own words.

## 7.2 Organizational Ethics

### What Follows Why?

The following question is concerned with the extent to which the organizational structure of companies can hinder or promote the ethical behavior of employees and management staff. The Waters study can be used for this purpose.<sup>61</sup> In 1978 he examined the background for the price conventions of the US electrical industry (including General Electric), which are being criticized here, on the basis of the testimony before the US Congress. It identified seven barriers in companies that hamper moral or legal behavior. Four of these barriers refer to corporate culture and

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<sup>60</sup> See Göbel, Elisabeth (2010), pp. 169.

<sup>61</sup> See Waters, James A. (1991) and Oppenrieder, Bernd (1986), pp. 25.

are presented later. The remaining three refer to the organizational structure of the company:

1. Division of work; specialization (division of work)
2. Separation of decisions and execution (separation of decisions)
3. Principle of command and obedience (strict line of command)

The business management organization now sees an important prerequisite for the learning ability of companies (“organizational learning” or “double-loop learning”) in the company’s organization, ie the structure and the rules.

- A steep hierarchy,
- a strong centralization of decisions,
- a clear division of labor,
- punishment of anyone who reveals errors and
- a climate of fear and competition,
- prevent or hinder the use of individual learning by organizing and implementing as collective learning.<sup>62</sup>

## ***7.2.1 Organizational Structure***

### **7.2.1.1 Division of Labor and Specialization**

Work division, specialization in particular, represents one of the most important productivity factors of the organization form. The different strengths of people are coordinated and aggregated within the company. Specialization enables learning advantages and the work division allows quick processing of complex tasks. They also have disadvantages. If a task is distributed to many, the specialists have no overall view. If every employee sees only his small section, there can be mistakes and misunderstandings if there is a lack of coordination. Furthermore, it is easy to create blinders, which leads to the dominance of special interests and lack of a global view (selectivity of the viewing angle). This impairs synergy. If everyone thinks someone else is responsible, something significant can be missed, such as security control or the environmental impact of products. If a process is subdivided into many small parts, the employees are only responsible for those parts, and not for the process as a whole, which allows responsibility to be avoided. Often, no areas of responsibility are defined within the job descriptions, so responsibility cannot be attributed to anyone. Some employees consider this positive.

It is precisely departmental thinking that has a negative impact in this context. No one is responsible for any maladministration. The organizational structure acts as an ethical barrier. On the contrary, the organizational structure can even be

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<sup>62</sup> See Argyris, Christ (1994), pp. 8 and pp. 27.

influenced by the evil-doers in an attempt to circumvent ethical concerns.<sup>63</sup> This applies in particular to the division of staff between staff and line organization units. The expert only advises and does not decide, so is not responsible, and the decision-maker depends on the information from the expert. Since decisions are often logical from the information, the expert has great power.<sup>64</sup> Since he does not decide, he does not feel ethically responsible. He also lacks an overview as he contributes only a part of the information to the decision, with the rest of the information coming from other experts.

### Examples

- In the case of banks' credit decisions, there are many hierarchy levels and often even several managers at the same hierarchy level signing. This means that the decision is checked by many, but no one can be personally blamed if the credit fails.
- The cause of death of an employee of the Amoco Fina refinery from leukemia was determined to be production-induced benzene poisoning. Eight years after the death of the employee there was a liability trial. The defendants were a safety engineer, who claimed the dangers were minimal, the manager, who did not take the dangers of the health service seriously, and his superiors in the US, who refused to change production protocol for reasons of cost, and finally the head of the research department, who did not sufficiently investigate benzene. Ultimately none of these persons could be found guilty in 1989, because no one could prove that he was responsible for the decision to continue the production of benzene.<sup>65</sup>

#### 7.2.1.2 Separation of Decisions and Execution in Vertical Organization (Hierarchy)

The less decision-making power the individual has the less responsibility he has. In a strict hierarchy the responsibility is always with the higher level, so that all responsibility lies with the management, the executive committee or the supervisory board. However, they have neither the information nor the reference to carry out a follow-up on the decisions of the lower level. As a rule they are not involved at all, so no one is responsible. The employees at the lower levels are only given quantitative targets. As in the case of the company Sears, Roebuck & Company this can lead to a deliberately excessive quantitative goal, coupled with corresponding pressure on the employees to mislead the buyer to purchase, thus to unethical behavior.<sup>66</sup> Result-oriented quantitative management systems support unethical behavior, since they put employees under pressure to reach the given figures. If management only

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<sup>63</sup> See Waters, James A. (1991), pp. 290.

<sup>64</sup> See Oppenrieder, Bernd (1986), pp. 27 and Waters, James A. (1991), pp. 32.

<sup>65</sup> See Fetzer, Joachim (2004), p. 34.

<sup>66</sup> See Oppenrieder, Bernd (1986), pp. 27 and Paine, Lynn Sharp (1994).

controls the performance results, this corresponds to a goal that the end justifies the means.<sup>67</sup>

Added to this is the information filtering effect of hierarchies.<sup>68</sup> As in the case of Enron, the employees are often careful not to give negative information upwards, so as not to have any repercussions. This is countered by a supervisor because he does not have to act or be responsible, which can lead to immoral behavior not being reported in the company.

There are two problem-solving approaches. On the one hand, the so-called re-integration, in which the division of labor is again brought together into holistic work processes, so that there is a person responsible for the final result and the reduction of hierarchies on the other hand. Deciding and executing should be re-integrated.<sup>69</sup> This coincides with the ethical approach of seeing man as a self-determined moral creature. Responsibility for the consequences of one's own behavior is the basis for ethical behavior.<sup>70</sup>

### 7.2.1.3 Command and Obedience (Strict Line of Command)

Waters quotes a witness who was asked why he did not report the illegal behavior: "I had no power to go higher. I do not report to anyone else than my superior." and "I had to assume that whatever he told me came from his superior, just as my subordinate would have to assume that what I told him came from my superior."<sup>71</sup>

The principle of command and obedience (strict line of command) leads to a lack of responsibility for the lower levels, which are the only ones that have the information for an ethical impact assessment (see command need).

Added to this is the fourth organizational problem of information transfer.

### 7.2.1.4 The Information Problem

As early as the beginning of the nineties, German executives complained of a loss of values, especially a lack of sincerity, honesty and openness, which had a negative effect on the horizontal and vertical transfer of information within the company. Negative information was withheld. Information was manipulated. Departments were trying to play off each other using false information.<sup>72</sup>

If a company determines that the reporting path must be complied with when the information is disseminated, this means that the lower hierarchy level decides what the higher level knows. For example, the division decides what information the

<sup>67</sup> See Waters, James A. (1991), pp. 288.

<sup>68</sup> See Waters, James A. (1991), pp. 285.

<sup>69</sup> See Steinmann, Horst/Löhr, Albert (1991), p. 120.

<sup>70</sup> See Göbel, Elisabeth (2010), pp. 269.

<sup>71</sup> Quoted from Waters, James A. (1991), p. 285.

<sup>72</sup> See Dahm, Karl-Wilhelm (1993), pp. 4.

Fig. 7.7 The information problem



board receives. Information (knowledge) also means power. No one can act on mistakes without information. False information leads to wrong decisions. Information does not have to be deliberately falsified, it is also possible to distort it by passing it to many levels. This effect is easily seen in the “telephone” game children play. The “telephone” problem is amplified by the number of intermediary stages in information transfer and by unethical behavior (Fig. 7.7).

What solutions are available for the information problem?

### 1. Open communication

Firstly, it is a good idea not to prescribe a hierarchical reporting path, but rather to give the lower levels the possibility to skip hierarchical levels. This may result in conflicts of objectives. The task of a hierarchy with management levels consists in the information aggregation and selection and on the other hand in the delegation of leadership. The employee of a lower level will generally not be able to decide who needs what information. Rather, it can be assumed that much redundant information will be passed on to the wrong executives, resulting in inefficiencies. Upper control levels are overloaded with the additional processing of information. In addition, a manager who works two levels above the employee can assess the concrete work situation only with difficulty. The framework information is missing in order to process the transmitted information. In addition, the superordinate level will not want to be involved in leadership questions in order not to frustrate the leadership of the lower levels or undermine authority. This also makes it clear that a good working climate is a prerequisite for open communication. Without mutual trust, there will be no communication between the levels, as we will elaborate in more detail later. The dimension of these target conflicts will also depend on the nature of the company or the company area. In particular, the qualification of the employees at the lower levels will determine whether they can decide which information is relevant for the higher levels. From this point of view, open communication can be applied

to areas of high qualification, such as research departments, business consultancy or financial services providers.

## 2. **Face-to-face talks of company management with randomly selected employees, independent of hierarchical levels**

Implementation problems of open communication apply only to bottom-up communication and not to top-down communication, which is why the top management levels occasionally update their information through a direct call to lower levels to check the inter-level information flow.

## 3. **More self-responsibility(decentralized management)**

From analyzing the organisation of ants in Sect. 5.6, we concluded that decentralized management of complex tasks, i.e. decision-making at lower levels, taking into account corporate objectives without the feedback of a higher authority, is possible. This presupposes that the employees, like the ants, have a corresponding imprint. These are the knowledge of the company's goals and the morality or attitude to ethically pursue corporate goals without control. Here, too, ethics play a decisive role.

According to a study of 150 management executives conducted by Roland Berger, a decentralized form of organization has the highest growth potential.<sup>73</sup> Decentralized management presupposes ethics among the employees, insofar as they have to assume responsibility. They must make decisions with an impact on the success of the company and the welfare of third parties, i.e. a balancing in the sense of an ethical stakeholder approach. This in turn requires an ethical personality and professional competence, which means that this approach cannot be applied in all areas of the company, though it has many advantages. The information problem presented above is eliminated because it is clear where the information for ethical weighing of options is available and responsibility is assigned to the place where decisions and information coincide.

## 4. **Fewer hierarchical levels**

The fewer hierarchical levels there are, the fewer conscious and unconscious information distortions exist. The goal of an organization should be a minimum of leadership, as the Lean Management approach has already expressed. Every leader has his own interests and strengthens the principal-agent problem in the company. Excessive managers weaken the employee's motivation by improper interventions, worsen the operating climate and reduce the acceptance of the company's income distribution.

## 5. **An ethical management**

An ethically-oriented corporate management tends to get more and more honest information from the employees because there is a trust base. An ethically-oriented

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<sup>73</sup> See Bötzel, Stefan u.a. (2004), p. 8.

corporate management also includes an ethical employee selection and value mediation in the company.

### **Conclusion**

First, it should be noted that an irresponsible corporate structure is not just a problem of ethics. If the responsibility is not clearly assigned, this means that the employees cannot be held accountable for wrong decisions. This is a negative incentive. Non- or faulty services will not be punished, resulting in a lack of management and thus a lower productivity. Furthermore, a lack of responsibility does not mean that you do not feel responsible. With a trained ethical awareness, the employee will ask himself what he can change positively and what consequences his actions and his non-action have. What is crucial is that the supervisors support him, so the company is ethically oriented.

Since such a self-critical employee can not be taken for granted, responsibilities must be clearly defined in the job descriptions. Responsibility trees help, as they assign product responsibility of the company to all employees involved in the production position. It is important that there are no gaps in responsibility or overlapping areas either, which could lead to misunderstandings among the employees regarding the division of action and responsibility. In order to clearly divide the tasks of the employees and thus also the responsibility, they have to be presented together with the company processes within the framework of quality management.

A basic problem is that the supervisor cannot know when there is important information at the lower level. The responsibility for the information transfer must therefore lie decentralized with the employee, who is the first to receive it. Information transfer must be a duty. Forced information transfer should be sanctioned.

Ultimately, hierarchical levels decrease efficiency because decisions are delayed and information is lost. Freedom rights and labor costs are high in the modern industrial areas, which means that with fewer hierarchies and more responsibility for the employees, not only could costs be saved, but also higher pay and greater scope for personal development would be possible.

It is an illusion that executives can control employees. The more complex the tasks become, the less is possible, since the employee always has an informational advantage on the executive. It is also difficult to make general statements about the set of hierarchical levels and the structure of the hierarchies, since the processes and tasks, and ultimately the qualifications of the employees in each industry are different. Companies should not only set up cost centers for executives and try to cut down the revenues of the subordinate employees, but also run trials without the hierarchy to show the added value and the tasks of leadership. In the banking sector, for example, decentralized activities, such as distribution, could be assigned to a personnel and information coordinator. The responsibility would then be clear for the employees who have direct customer contact and thus immediate information access. However, a holistic approach to decentralized management is required, as is the management approach of qualitative leadership which is presented later.

### Summary

Good management practice is about developing a culture of trust. For this, supportive behavior is demanded, instead of a hierarchical dependency, as is the opening of information paths across the organization. Decision-making competencies should be delegated rather than centralized, combined with more self-control rather than external control.<sup>74</sup> The approach of the decentralized company organization means an optimization of decision units as modules, so that the disadvantages of a complex hierarchy are circumvented, but the individual at his level is not overwhelmed with decisions. The employee can directly intervene in the company process. In this way, elaborate decision-making processes become superfluous and the motivation of the employee in the company is increased.<sup>75</sup>

### Comprehension Questions

1. How can hierarchies negatively affect productivity in a company?
2. How can hierarchies negatively affect ethics in a company?
3. What are some possibilities to avoid the negative effects of hierarchies?

### 7.2.2 Ombudspersons

The name Ombudsman comes from Sweden. The ombudsman serves as a contact, mediator and conciliator for the citizens and is intended to strengthen its position against the state offices. For example, he examines complaints about misuse of power or arbitrary decisions. In the company, he can perform a similar function. It serves as a neutral, institutionalized dialogue and access body. If he enjoys trust, he can settle conflicts and make external whistle blowing superfluous.<sup>76</sup> In order to maintain objectivity, it is a good idea to engage an external lawyer for this task. In this case, the term “trustworthy attorney” is recommended as a more suitable name. As an external lawyer, he is supposed to mediate between lawmakers and the company in the event of legal violations such as fraud, infidelity, bribery and other economic offenses. Compared to anonymous online systems, the ombudsman offers the advantage of personal contact, which – as practice shows – almost eliminates false information. Online systems are also less familiar with how to deal with the information. The Ombudsman has the role of a trusted person. On the one hand, it protects the identity of the complainant. On the other hand, the employees want to not only communicate their problems, but also advise them about the progress of the complaints process.<sup>77</sup>

<sup>74</sup> See Steinmann, Horst/Löhr, Albert (1991), p. 120.

<sup>75</sup> See Reichwald, R./Möslein K. (1997), pp. 16.

<sup>76</sup> See Staffelbach, Bruno (1994), p. 328, Joussem, E. (2008), pp. 50 and Göbel, Elisabeth (2010), pp. 270.

<sup>77</sup> See Joussem, E. (2008), pp. 50 and <http://ombudsmann.lexpert.de/products/products.htm> and <http://www.ombudsmann-strafrecht.de/fragen-antworten.html> (Abfrage vom 22.08.2014).

The Ombuds Office makes it possible for employees on lower levels to bypass the hierarchy. It is best to demonstrate neutrality if the position is occupied externally. It is only when it is neutral and objective that it will be recognized by the employees and the company offices. However, it also needs the support of management, otherwise the recommendations will not be implemented and will be meaningless.

For stakeholders, for example, free hotlines can be created for complaints, which also include ethical issues (e.g. customer complaints).

### 7.2.3 *Ethics Officers*

Ethics officers perform the functions of a complaint office and an ombudsman. However, their scope also encompasses anticipation of ethical problems and conflicts, and proposals for solutions. The dialog function is thus expanded by an innovation, impulse and development function. An Ethics Officer in the USA is also responsible for implementing the ethical standards adopted in the company and for establishing or maintaining an ethical corporate culture.<sup>78</sup> The ethics officer can be supported by their own department, which is particularly appropriate for large corporations, where there is a network of ethics officers who are internationally distributed and need to be coordinated. For example, Siemens has set up the “Compliance Helpdesk and Monitoring” department in Germany, which provides information on immoral practices and maintains a hotline (“Tell us”) and advises employees on ethical issues (“Ask us”).<sup>79</sup>

### 7.2.4 *Ethics Commission*

In contrast to the aforementioned institutions, an ethics committee is not a permanent body and is made up of several people, which makes an even greater acceptance in the company possible. The people should be selected in such a way that all stakeholder groups of the company and possibly also other stakeholders (for example customers) are represented. A dialogue forum increases both acceptance and legitimacy and allows the company to use the commission as a forum for discussion.<sup>80</sup>

Classical tasks of the ethics committee are e.g.

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<sup>78</sup> See, <http://www.corporate-ethics.us/EO.htm> and <http://www.wisegeek.com/what-is-an-ethics-officer.htm> (9.10.2012).

<sup>79</sup> See Göbel, Elisabeth (2010), p. 275.

<sup>80</sup> See Steinmann, Horst/Löhr, Albert (1991), p. 115 and Pech J.C. (2007), pp. 267.

- the preparation and development of the corporate image and setting penalties for non-compliance,
- ethical advice to management,
- develop solutions to ethical issues,
- external and internal ethics complaints as well as
- propose measures to promote an ethics culture within the company.<sup>81</sup>

Except for external and internal ethics complaint processing, these are all advisory functions that can be met by a body composed of employees and external stakeholders. In this way, an ethical stakeholder dialogue can be held within the Commission and thus an ethical consideration taking into account the external perception of stakeholders. In dealing with complaints, however, an ethics committee has the disadvantage that it is not a permanent organ in the company. The many different members of the commission can also lead to voting problems. This is why they should be supported by the internal ethics officers in handling complaints. In general, the ethics committee should be given the opportunity to inform itself directly about the business processes. For this, it is necessary for them to interview employees directly.

In general, the ethics committee has only an advisory and opinion-forming function. The executive powers lie with the management. But there is also another design option here. The ethics committee can assist the supervisory board or the owner in monitoring the management through a separate information function, thus reducing the principal agent problem. The ethics committee then no longer only advises the management, but also the supervisory board. The Supervisory Board represents the owners of the company in the control of the management and therefore the entire company. In the end, they ultimately contribute to ethical corporate responsibility as the highest organ of the organization.

### **7.2.5 Whistleblowing**

How should an employee behave when supervisors order him to carry out an immoral act because it is supposed to be in the company's interest? Employees and executives are in a dilemma or loyalty conflict here.<sup>82</sup>

For the employee, it is easiest in this case to pursue the interests of the company, because he does not have to deal with sanctions and may even be rewarded. This behavior, however, is not ethically desirable because third parties are harmed. The employee cannot usually quit because he is dependent on his workplace and this is disproportionate power. Quitting would be a frightening behavior for other employees and would not change anything in the company policy. He could argue the case with the superiors and colleagues and appeal to moral values. However, this requires

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<sup>81</sup> See Staffelbach, Bruno (1994), pp. 331 and Wittmann, Stephan (1994), p. 89.

<sup>82</sup> See Steinmann, Horst/Löhr, Albert (1991), pp. 152.

a lot of civil courage and is not necessarily successful, but is sometimes understood as an affront. As a rule, employees will avoid confrontation with the company and behave unethically as a result<sup>83</sup> In the long term, the company generally suffers from unethical behavior, as will be shown in the following examples:

- Customers should not be lied to about product characteristics and terms of contract: In the short term, a profitable sale is achieved, but in the long term the company loses a customer and its reputation.
- Balance sheets must not be falsified or bad corporate messages kept secret from the lenders and shareholders: In the short term, the company can ward off negative consequences, but usually no turnaround is achieved on this basis and the misconduct will accelerate the decline.
- Dependencies (for example from suppliers) should not be exploited: it is quite easy to depress the supplier's prices. However, if the supplier no longer has a profit margin, he will fail in the medium term or will lower the quality of his products and thereby deteriorate (for example, the GM/Opel strategy for the buyer Lopez<sup>84</sup>). In the long term this strategy leads to quality problems and a concentration of the suppliers, which makes a one-sided dependence into a mutual one.

If ethical violations are not in the interests of the company, it is important that an open corporate culture exist in which alleged violations and conflicts are addressed. The employees will not otherwise dare to reveal their ethical dilemmas and erroneously try to act in the interest of the company.

Since the company management cannot monitor the processes in the company, it often does not know about unethical behavior. In most cases an employee can turn to his or her superior and the latter will support him or her in the case of ethical action. However, if superiors are involved in the violations, they will try to keep the unethical incidents secret.

In addition, the public, i.e. the stakeholders and the economic system as a whole, are interested in ethical company behavior. Whistleblowing can also be extended to them.<sup>85</sup> Unethical behavior damages people and the system as a whole, as it leads to cost/benefit distortions. If the internal complaint channels of the company do not work or the company management covers up the unethical behavior, the employee can only turn to the public in order to achieve a change through public pressure. In order to tackle this problem, there is an organizational approach, so-called whistleblowing, which is the disclosure of unethical business practices to the corporate management or the public.<sup>86</sup>

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<sup>83</sup> See Göbel, Elisabeth (2010), p. 203.

<sup>84</sup> See Süddeutsche.de, 17.12.2010. <http://www.sueddeutsche.de/wirtschaft/opel-lopez-und-die-boesen-folgen-1.810821>

<sup>85</sup> See Annuschein, Rainer (2009).

<sup>86</sup> A minority opinion also includes the internal display of unethical behavior by colleagues or other employees of the company in opposition to whistle blowing. See Leisinger, Klaus M. (1997), pp. 133.

In the following cases, employees turned to the public to stop an unethical behavior:

1. The vice president of the research department of the US tobacco company Brown & Williamson, who made public the fact that his company was secretly adding addictive ingredients to tobacco.<sup>87</sup>
2. In the run-up to the Challenger disaster, employees pointed to security shortcomings.<sup>88</sup>
3. Employees at Ford Pinto pointed out safety deficiencies.
4. The American Dan Gellert informed the public that the aircraft L-1011 of his employer Lockheed did not meet safety requirements.<sup>89</sup>

There are various criteria for whistleblowing. The criteria for awarding the Whistleblower Prize are cited by the Association of German Scientists. For whistleblowing, the following prerequisites must be fulfilled (definition):

- First, it must be a revealing wrongdoing.
- Secondly, the whistleblower must be able to sound an alarm by first trying to draw attention to the disgrace in the company. If nothing happens there, he goes public (going outside).
- Third, the whistleblower must show unselfish motives (serving the public interest).
- And fourth, he has to accept important disadvantages, such as threats to his position, his career or even his existence due to the revelation (risking retaliation).<sup>90</sup>

Whether or not a personal advantage is associated with whistleblowing is important for the ethical assessment. For example, the sale of Swiss tax CDs with the secret bank data of potential tax evaders is not motivated mainly by ethical reasons if 2.5 million euros is paid by German tax offices.<sup>91</sup> Rather, the whistleblower is expected to accept personal disadvantages in order to benefit the community or to calm its conscience, which is an extreme ethical requirement that recalls Kant, who expects a good attitude as well as self-sacrifice for a pure, optimal ethical action.

Whistleblowing is the conscious circumvention of the company hierarchy or corporate management. Whistleblowers are often perceived as informers, disloyal employees or tattletales, and are exposed to bullying or reprisals. The company is not responsible for the whistleblower, the company itself, or other stakeholders (such as vendor-dependent vendors). The consequences are drastic when the employee turns to the public, because this is always associated with company image. It is also not impossible that innocent employees will be harmed by whistleblowing

<sup>87</sup> See Maijca, Marin (2003).

<sup>88</sup> See Martin, Douglas (2012).

<sup>89</sup> See Leisinger, Klaus M. (1997), p. 134.

<sup>90</sup> See the criteria for awarding the Whistleblower Prize by the Vereinigung Deutscher Wissenschaftler (Association of German Scientists). [http://www.vdw-ev.de/index.php/de-DE/?option=com\\_content&view=article&id=17](http://www.vdw-ev.de/index.php/de-DE/?option=com_content&view=article&id=17) (retrieval 22.08.2014).

<sup>91</sup> See Pittroff, E. (2011), p. 9ff and Göbel, Elisabeth (2010), p. 206.

if, for example, an environmentally damaging product can no longer be manufactured and the employees have to be dismissed.

The whistleblower must therefore always weigh the possible outcomes. What are the consequences of his action, and who will be affected? Furthermore, it should only be an option on the basis of facts and after having exhausted all internal business opportunities. Open arguments and complaints are always preferable to whistleblowing. The facts should be assessed objectively, as emotional revenge feelings are counterproductive.

Because of the interest of the public in the discovery of unethical business behavior the whistleblower has been legally protected against bullying or dismissal in GB since 1999.<sup>92</sup> In Germany an employee is obliged to be loyal to his employer, and must first report criminal offenses, with the exception of serious crimes such as robbery and predatory blackmail. Only when this is unsuccessful is it allowed to go outside. If he infringes this regulation, a dismissal is justified under employment law.<sup>93</sup> Being ordered to do something is not an excuse. A superior who orders a crime is punishable, as is the employee who performs it. At best, there is a reduction in penalty if there was a strong dependency.<sup>94</sup>

Whistleblowing can also act as a **principal witness regulation** if the whistleblower is involved in the criminal offenses. In the case of UBS, the US Internal Revenue Service (IRS) decided to reward the informant Bradley Birkenfeld with \$104 million for information on American tax evaders.<sup>95</sup> However, this has little to do with ethics.

Whistleblowing always shows that the official complaints and company controls or hierarchies have not worked. At the very least, trust in the whistleblowers is missing in their own company culture. Corporate culture is mainly characterized by management. A culture of “silence” and “looking away” is usually produced by the management. The creation of taboos that management wants to suppress, such as poor working conditions and safety standards, or poor product characteristics, is sanctioned by discriminating employees in the company processes. There is no risk communication. Such a culture promotes “betrayal,” since it can be broken only by whistleblowing.<sup>96</sup>

The company can use the function of the whistleblower by appointing an independent contact person, creating a position directly under the management of the company. Messages should be official or anonymous and must always be excluded from reprisals. The whistleblowing office requires unlimited access authorization in the company in order to check the correctness of the messages or to collect evidence.

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<sup>92</sup> See Thurn, Valentin/Ott, Ursula (2001), p. 104.

<sup>93</sup> See <http://www.spiegel.de/karriere/berufsleben/geachtete-whistleblower-die-denunzianten-vom-dienst-a-765414.html>

<sup>94</sup> <http://www.fiskalbetrug.de> (30.09.2013).

<sup>95</sup> See [http://www.washingtonpost.com/business/economy/ubs-whistleblower-awarded-104m-by-irs-for-helping-in-swiss-bank-probe/2012/09/11/1a7232a2-fc28-11e1-b153-218509a954e1\\_story.html](http://www.washingtonpost.com/business/economy/ubs-whistleblower-awarded-104m-by-irs-for-helping-in-swiss-bank-probe/2012/09/11/1a7232a2-fc28-11e1-b153-218509a954e1_story.html)

<sup>96</sup> See Rhode-Liebenau, Björn (2005), pp. 37.

The company management may be exempted from this. The internal company whistle-blowing cases are not public, which is a major advantage for the company. The reputation of the company will not be damaged and punitive payments may be avoided.

### Summary

Prevention can be achieved through ethics seminars, guidelines, ethical promotion and remuneration guidelines, direct contact between hierarchy levels, thus also the company management with the basis and ultimately through the correct selection of the managers and employees. The decisive factor is corporate culture, which should promote ethical behavior instead of suppressing it. Ultimately, it must be possible to place information and in particular complaints past the hierarchy. There should be ombudsmen for complaints about supervisors.

The presented organizational measures support ethics within the company. However, the decisive factor is an all-embracing ethical concept, which is supported by the entire company and is internalized by the employees, especially by the management. Of course, the establishment of ethics and ethics instruments is an effective PR instrument. If it remains, however, it acts counterproductively.

### Comprehension Questions

1. Do you consider **complaints offices** in companies important? Give reasons for your opinion.
2. What types of **complaint offices** are there? Describe their advantages and disadvantages.
3. Name the four criteria for whistleblowing.
4. How can whistleblowing come about?

### What Follows Why?

It has been shown that ethical behavior increases productivity in the company. The following is about ethics in human resources management. The management and selection of personnel directly influences the corporate culture and is therefore the most important instrument for the ethical conduct of the company.

## 7.3 Leadership Ethics

Leadership in a company is defined as a goal-oriented design, steering and development of the company (definition). This includes corporate governance as the company's organizational structure and management, in particular the personnel management. Guidance is also understood as "the goal-oriented behavioral influencing of persons by means of communication processes" and related to the operation, "the behavioral influencing of the employees by the superiors."<sup>97</sup>

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<sup>97</sup>Hey, Dieter/Schröter, Armin (1985), p. 31. Or "Leadership is the accomplishment of a goal through the direction of human assistants." Prentice, W.C.H. (2004), p. 102.

In the following, we will use the Case Study of Enron to elaborate the requirements for optimal corporate management.

### ***7.3.1 Case Study of Enron***

#### **Group Work Enron**

Read the case Enron described in [Sect. 4.1](#) and discuss the reasons for the bankruptcy of Enron in your group. How could Enron rise to the top ten US companies and then collapse?

### ***7.3.2 Weaknesses of Corporate Governance***

#### **7.3.2.1 From Entrepreneur to Manager**

If we continue to look for causes behind the business crises described, mistakes made by managers seem to be a central factor. What is the function of managers in a company? What are their special attributes? Let us start historically and ask how we arrived at companies run by managers. Excepting agricultural operations, companies only came into being within the framework of industrialization. First the productive combination of human and machine as a result of progress in methods of production made the distribution of labor in larger groups lucrative. The first industrial companies of any importance were porcelain and fabric manufacturers in England, France and Germany in the seventeenth and eighteenth centuries. The company as an organizational form was created, which would come to dominate national economic value creation over the following decades and centuries as technical progress advanced. The industrial revolution permanently changed the requirements of human cohabitation. The world was no longer the same and each new step of technical progress again changed the general framework for the economy, and thus for society. The globalization currently discussed is itself a consequence of the progress made in transportation and communication technologies. Globalization has existed at least since the invention of the sea-faring vessel. The importance of capital grew with technological progress. For the increasingly complex machines, increasingly large shares of the domestic product had to be funneled to investment. The organizational form and social construction of a company also became larger and more complex. Whereas a farmer could cultivate a field himself with a plow, now many people became dependent on mutual cooperation in order to realize value creation together.

How were companies created? How were humans and machines brought together into a productive whole? The famous economist Schumpeter offers a qualitative

explanation for this phenomenon.<sup>98</sup> According to Schumpeter, there must first always be an entrepreneur. An entrepreneur is no ordinary person, but is a gambler and a daredevil. The founder of a company, the so-called pioneer entrepreneur, plays his luck for the possible riches and dares to make the first step in realizing his idea, which is generally an innovation. These are often engineers, such as Edison with his light bulb, who founded General Electric, but it can also be an innovative process such as assembly-line production from Henry Ford, new organizational forms, the development of a market or something similar. All of these ideas carry the promise of large profits in the process of value creation, in other words added value for the pioneer entrepreneur. They are dispersed across the entire national economy later on, when the innovations and ideas have been established and copied by others who try to get pioneer profits in competition by forcing prices down. The advantages to be gained from the products are then distributed almost exclusively among the consumers. The pioneer entrepreneurs carry the risk of failure on themselves, including the capital that they invested to see their idea realized. The attractive profits and a certain thrill in the risk are just one aspect to explain why risks are taken for an enterprise. Otherwise entrepreneurs would be no different from gamblers. They are designers, changers, who must cut new paths with their idea. There is a great deal that goes into the implementation of an idea in an enterprise.

The entrepreneur must be convinced of his idea and have an iron will to implement it. This conviction often borders on mania; it gives him the energy to get things moving again and again, and to overcome obstacles until his idea has been realized. Schumpeter talks of a dynamic entrepreneur. This usually goes so far that the entrepreneur makes the idea into his life's purpose. He is so convinced of its importance, that the idea and the person become one, which can border on an obsession. He finds the implementation of the idea in the enterprise creative and meaningful self-realization, a creative process for something entirely new. He is prepared to risk his existence and security for it. This classical entrepreneur has access to neither venture capitalists nor stock markets. He is usually forced to borrow the capital and be personally responsible for the debt. Schumpeter thus identifies an additional requirement for the implementation of the enterprise. The entrepreneur must find a dynamic and risk-friendly banker who sees the potential of his idea and makes the necessary capital available to him.

So, to sum up, an entrepreneur is historically something special and something positive. He is not only something of a genius, he is a mover and a shaker and someone willing to dare to actively implement an idea. He helps the national economy by implementing an innovation and creates value through the productive combination of humans and machines. He wants to see his idea become a reality and risks his own existence for it. Of course he wants to be rewarded for his efforts. To get rich is often not the main motivation, but comes after the self-realization. This idealized image of an entrepreneur is basically altruistic. He apparently sacrifices himself in order to create jobs and welfare for everyone. He should therefore be honored and admired by society. This image does not correspond to today's reality, in which

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<sup>98</sup> See Schumpeter, Joseph Alois (1911).

society no longer has a picture of the self-sacrificing entrepreneur, but that of the greedy manager.

A manager is not an entrepreneur. The job description of an entrepreneur has changed over the years. Pioneer and founding entrepreneurs are the exception today. There are still innovations made now and then, but they are usually made within existing companies. The picture painted above of the company liable for itself is rarely the case anymore. The introduction of joint stock companies has fundamentally changed the distribution of risk. In order to finance innovation potential, and thus to be able to use it, the stock companies were created in addition to private companies to be a collection point for capital and limit the risk liability. Only the capital used is the liability. The entrepreneur no longer has to wager his person and existence for his idea. Even start-ups finance their growth and innovation with venture capital from the corresponding stock markets. A new breed of manager was created. He became an employee of the investors, an agent of the principals, which brought new problems.

The role of the manager includes other interests and motivations just as the capital-providing market has other legalities. These legalities can make moral or ethical behavior, and thus efficient management, more difficult. We will examine this in detail in the following chapter.

### 7.3.2.2 The Principal-Agent Problem

There are many theories on managers. The old Stuart Theory considers managers idealistically as “honorable wealth builders.” Neoclassical theory presupposes maximization of benefit, but does not differentiate between company owner and manager. If entrepreneurs as founder and owner no longer head enterprises, but instead the owners entrust third parties with the tasks of company management and thus separate these roles, the interests behind each role are also separated. Anyone who has ever delegated an important task to a third person can understand this, as they became dependent on the other person’s performance and reliability. This has advantages and disadvantages. If the agent, that is the employed third person, is better qualified for the task than the principal, that is the owner or capital provider, then the task delegation is advantageous for both parties. The principal is always faced with the problem however, that he has to rely on the agent. The principal-agent issue can be expressed in the saying “never trust anybody but yourself.” Economic science addressed this problem as early as Adam Smith, and has taken it up in the Principal Agent Theory in the last few decades as joint-stock companies have increased in importance.<sup>99</sup>

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<sup>99</sup>Ross is considered to be the founder of the Agency Theory. See Ross, Stephen A. (1973a, b), p. 134 and Novak, Eric (1997a, b), p. 22. Jensen, Michael C./Meckling, William H. (1976a, b), p. 348. The foundations can already be found in Adam Smith’s “Wealth of Nations ...”, See Madrian, Jens Peter (1998), p. 69.

The Principal-Agent Theory first dealt with this divergence, although it continued to assume consistent rational benefit maximization. According to this, if taken *ad absurdum*, it would be the goal of the manager, within the legal framework and using the least amount of labor and personal sacrifice, to get the most out of the company he has been entrusted with for himself, thus damaging the company. The conflict of interests between principal and agent are emphasized in the Principal-Agent Theory. In reality, managers are generally between these two extremes, being neither selfless, self-sacrificing pawns of the capital provider, nor a purely benefit-maximizing parasite. The capital provider must be aware of the possible conflict of interest however, and calculate for the extremes.

With diverging interests, the principal-agent theory differentiates between the so-called moral hazard and risk-shifting problems. Moral hazard describes the incentives of the agent that would be damaging to the principal, such as hiding profits from the principal in order to show them in hard times as successes. The agent engages in risk-shifting when he secures the enterprise risk at the cost of the principal, for example by holding back dividend payments for the principal as profit retention. The agent could also increase his benefits at the cost of the principal through indirect benefits, which we might imagine as expensive business trips, office spaces and company cars. Of course the intrinsic human interests and needs are a part of everything we do and should not be underestimated. The manager wants power, influence and recognition. He can reach this goal by increasing sales e.g. at the cost of profitability and enterprise security. This would also be possible through take-overs, in which he could strengthen his image as a conqueror. On the whole, the principal-agent theory determines various agency costs that arise from the separation of enterprise owner and manager. First there are the bonding costs, which the principal must pay in order to assure that the agents act in conformance with their interests. Then he must remain informed and intervene in the case of deviant behavior, to force the agents to adjust their behavior. The remaining residual costs come from the fact that he will never succeed in getting the agents one hundred percent in line with his interests.

When implementing his interests, the principal is at a disadvantage from an asymmetry of information. The principal-agent theory differentiates between hidden characteristics, hidden information and hidden action. Hidden characteristics are understood to be the personal characteristics of the agent that are not known by the principal upon entering a contractual relationship despite certificates, such as the actual level of qualification, integrity, work habits and loyalty. Bringing in external managers carries a large risk of false estimations (hidden characteristics). Managers may be able to prove their success in other companies, but it may be very difficult for the principal (employer) to judge the truth behind such assertions. The market for managers is not transparent for the seeking employer, nor is the actual good itself, the personnel. Hiring an external employee is thus quite risky and can only be recommended if there is no one comparable from inside the enterprise available, or if knowledge from outside the company, to which there would otherwise be no access, can be acquired.

Headhunters also help little to overcome asymmetric information, as they are interested in placing their candidate well in order to earn the higher salary through the placement commission. In turn, a manager can exploit the asymmetric information to his advantage through frequent job changes. If he succeeds in presenting himself better than he really is, he can improve on every change. If his lack of suitability in the company increases after he has established his position, he can leave. Often, the new employer tolerates the weaknesses of the manager. In principle, however, the manager who has hired him is not interested in revealing his decision to make a mistake as long as the weaknesses of the employee do not pose a personal disadvantage for him.

Hidden information is the informational deficit that the principal has when controlling the actions of the agent. He simply does not know what information is behind the actions of the agent. Hidden action is then the inability of the principal to evaluate the effectiveness of an agent's actions after the fact. The principal may know the results of the action, but not the framework in which the action took place, in other words all environmental conditions at the time of the action. He thus does not know if the success or failure is due to external factors for which the manager is not responsible, or due to the performance of management.<sup>100</sup> It is easy for the manager to blame his failure on external factors such as a recession, reductions in demand, bad weather, preliminary product shortage etc.

The control costs for the principal are directly related to the expected returns from his share of the capital, as information and implementation costs increase with the size of the company. If the agency costs are less than the residual costs, the principal will not interfere. Herein lies a fundamental problem of the mutual stock corporations. Control is only possible, if at all, via the supervisory board, since the small investors or capital providers abroad are not present at the shareholder's meeting due to time and travel expenses disproportional to their stock share. In such cases control through the supervisory board is impossible. On the other hand, minority shareholders have a disproportionately high level of power at shareholder's meetings due to the small number of those entitled to vote who are actually present. From this background it is apparent why the investors in Enron and the investment banks within the framework of the subprime crisis, were unable to control the managers.

The control of the managers by the owners is made more difficult by the close linkage of supervisory boards, board members and politics, especially in Germany and Switzerland. In the literature one speaks of a consensus society, which arises from these personal relationships and which can be blocked against changes.<sup>101</sup>

The disproportionate development of salaries can thus also be attributed to the lack of control of the company's management. Why should an immorally-minded board of directors omit self-enrichment if they have nothing to fear?

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<sup>100</sup> See Madrian, Jens Peter (1998), p. 70.

<sup>101</sup> See Schieffer, Alexander (1998), p. 296.

### 7.3.3 *Incentives, Risk and Compensation Schemes*

#### 7.3.3.1 **Experimental Evidence on the Importance of Risk Adequate Compensation**

Since the Enron, Worldcom and the financial crisis, compensation for bank managers and managers in other public companies have come under intense scrutiny. Compensation has been held responsible for encouraging excess risk-taking, particularly within the financial system. It has been asserted that bonus compensation schemes have caused asymmetries in the treatment of gains and losses, which can lead to excessively risky behavior. The purpose of this chapter is to test this hypothesis.<sup>102</sup> Do unilaterally constructed incentive schemes encourage undue risk-taking? This question is examined with a behavioral experiment using the game roulette. It is used to analyze how unilateral compensation affects risk behavior.

#### **Related Literature**

According to principal agent theory (Ross 1973a, b; Jensen and Meckling 1976; Nowak 1997a, b) correlating a manager's compensation with either their performance or that of the firm promotes better incentive alignment and leads to higher motivation and thus stronger company values. However, there is an asymmetric imbalance between the term, magnitude and probability of gains and losses in common compensation schemes. Short-term results are rewarded even when these results are later reversed. This encourages risk taking by the employees – agents – at the cost of the company – the principal. The agents undertake actions that generate a high probability of gains in the short-term, while the risk of a larger loss in the longer-term is not taken into consideration, causing the principle to bear all of the long-term risk. A substantial body of literature has emerged to test the relationship between manager compensation and manager behavior and performance.

Figures of the Office of the New York State Comptroller show that bonuses in Wall Street financial institutions continued to register large positive numbers in 2007 and 2008, even while the banks suffered large losses (Sharma 2012). Surveys by the Financial Stability Forum (2009) showed that over 80% of financial market participants and experts believe that compensation practices played a role in promoting the accumulation of risks that led to the financial crisis. Cuomo (2009) shows that bonuses and overall compensation did not vary significantly even though profits diminished during the financial crisis. Cai et al. (2010) studied the pay structures of banking executives before the financial crisis. They found some problematic practices (such as too much bonus and stock-related compensation). These practices might have encouraged “short-termism” and excessive risk-taking.

Agarwal and Ben-David (2011) results show that the explosion in mortgage volume during the crisis and the deterioration of underwriting standards can be partly

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<sup>102</sup> See Conrad, Christian A. (2015): Incentives, Risk and Compensation Schemes: Experimental Evidence on the Importance of Risk Adequate Compensation, in: Applied Economics and Finance, Vol. 2, No. 2; November 2015, p. 50–55.

attributed to the incentives of loan officers. They studied a controlled experiment conducted by a large bank. The compensation scheme of loan officers was changed from fixed salary to commission-based compensation. Loan officers were 19% more likely to accept loan applications, approved loan amounts larger by 23%, and the loans were 28% more likely to default. The increase in default occurred primarily within the population of loans that would not have been accepted in the absence of commission-based compensation.

However, Gregg et al. (2012) found that the cash-plus-bonus pay-performance sensitivity of financial firms is not significantly higher than in other sectors and concluded that it is unlikely that incentive structures could be held responsible for inducing bank executives to focus on short-term profits. This would mean that we are facing a general compensation problem.

Cooper et al. (2014) found evidence that industry and size-adjusted CEO pay is negatively related to future shareholder wealth changes for periods up to 5 years after payment. Sun reviewed the early executive compensation studies, bonus plan maximization hypotheses and equity-based compensation. Use of opportunistic management incentives encourage earnings management based on executive compensation for contracts is promoted when earnings management is driven by opportunistic management incentives. He shows that firms pay a price and its negative impact on shareholders is economically significant (Sun 2012).

Schotter and Weigelt (1992) use four different compensation schemes to demonstrate that a compensation scheme that induces behavior consistent with lower discount rates is a necessary condition for reconciling divergent time preferences between principals and agents, and that subjects become more myopic in their investment decisions if compensation contracts are incorrectly structured.

Colesa et al. (2006) found that higher sensitivity of CEO wealth to stock volatility encourages riskier policy choices, including relatively more investment in R&D, less investment in PPE, more focus, and higher leverage. They also provide empirical evidence of a strong causal relation between managerial compensation and investment policy, debt policy, and firm risk. Cheating is also influenced by compensation schemes. Gilla et al. (2013) show that exposing workers to a compensation scheme based on random bonuses makes them cheat more but has no effect on their productivity.

Andersson et al. (2013) studied risk-taking on behalf of others in an experiment. The decision makers were facing high-powered incentives to increase the risk on behalf of others through hedged compensation contracts or with tournament incentives. The decision-makers responded strongly to incentives that result in an increased risk-exposure for others. There have also been experimental studies concerning the binary choice task and the study concerning the binary double gamble to explore the predictive validity of dispositional traits and affective states in decision making under risk and uncertainty (Papaeconomou 2012).

This chapter provides a simple incentive-based experiment regarding unilateral bonus compensation schemes based on the game roulette which can be easily repeated with the students. There have been several experiments with roulette but with the objective to scrutinize the gambling behavior (Rubio; Hernández and

Santacreu (n.d)) and guessing tendencies (Rubio et al. 2010). The following experiment simulates most common short-term bonus compensation schemes without accountability. They were also the dominating compensation schemes before and during the financial crisis.

### **Experimental Design Roulette**

The purpose of this chapter is to test the hypothesis that unilaterally constructed incentive schemes encourage excess risk-taking. The methodology is to simulate decision-making under asymmetric incentive structures. Therefore an experimental environment similar to the compensation schemes had to be constructed. Roulette has the advantage of clearly demonstrating the probabilities for gains and losses. In the game Roulette the probability of losses is compensated with higher payouts (apart from zero). A higher risk has an equivalent higher payout. In order to simulate behavior with different incentive and risk structures, decision-makers have to be exposed to different remuneration schemes, which is why there were game rounds with different considerations of gains and losses.

### **Game 5: Roulette**

The experiment is started with symmetrical incentive structures. Round A and B have identical incentive structures. Round A serves as a control round for B. Finally in round C a unilateral consideration of the profits takes place and the changes in the betting behavior are recorded. An indicator for higher risk-taking would be a higher capital set even though the winning probability stayed the same.

In round A, the students are able to play Roulette with an initial play capital of €1000. Losses and gains are credited with 100%. The students are asked to check each other's calculations after each game.

In the round B the gambling losses and gains are counted each with 50% and are added to the initial capital of €1000. Thus there were still no conflicting interests and no asymmetries in the treatment of gains and losses. Round B therefore has identical incentive structures as round A. So A is able to serve as a control group for B.

In round C a unilateral consideration of the profits takes place. The set capital is not deducted, if the roulette bet is wrong. Conversely, the payout is credited with 50%, and added to the €1000 of initial capital. The results of the rounds B and C are added, starting from an initial capital of €1000 each and the player with the highest result is rewarded with €10 real money. For this game we chose real money to have a stronger link to compensation in real life. The rules are explained to the students before starting the experiment.

Round C thus corresponds to the unilateral performance-based remuneration of the common bonus-based compensation schemes. Loss and profit incentives are not equally distributed. Losses are borne by the companies and profits are rewarded with bonuses. This simple experiment shows clear results.

## Results

The experiment was conducted with 69 students from different Business Bachelor and Master courses at the University of Applied Science HTW at Saarbrücken.<sup>103</sup> The students played 3 rounds Roulette (A, B and C), each with three games. They could bet on red or black, on one of the three thirds of the 36 numbers or on one number. The winning number and color was determined by the roulette wheel. If it was zero, the game was repeated and not registered. The payouts were distributed according to the probability of winning ( $\times 2$ ,  $\times 3$ ,  $\times 36$ ) and accumulated in each round.

In round C, the sum of the average capital set rose from €1361.88 in round B to €3899.28, by 186%. The highest possible profit (calculated as the product of the set capital and the possible payout) in all three games rose to €30,000.72 (see Figs. 1 and 2).

If you set the maximal possible gain in relation to set capital as a risk measurement indicator, the willingness to take risks increased from 5.05 to 7.69 (see Table 1). The significantly higher standard deviation in round C shows that some players were more willing to take risks than the average (see Figs. 7.8, 7.9, 7.10, 7.11 and 7.12).

## Conclusion

The experiment showed that unilaterally constructed incentive schemes encourage excess risk-taking. This would indicate that common bonus-based compensation schemes are not a good idea and in fact enhance risk because of the asymmetries in the treatment of gains and losses. In most cases compensation can only decrease down to the base salary while gains from bonuses can be limitless. Short-term results are rewarded even when these results are subsequently reversed. This encourages risk-taking by the employees (agents) at the cost of the company (the principal). They undertake actions that generate a high probability of gains in the short-term while the risk of a larger loss in the longer-term is not taken into consideration, thus becoming a liability to the principal. This does not align with the basic

	Round A	Round B	Round C
Average set capital	€1,252.63	€1,361.88	€3,899.28
Average maximal possible gain	€5,946.83	€6,874.49	€30,000.72
Risk as max. possible gain/set capital	4.75	5.05	7.69
Standard deviation average set capital	€779.65	€650.32	€2,408.89
Standard deviation maximal possible gain	€634.21	€9,687.06	€31,585.46

**Fig. 7.8** Statistical data

<sup>103</sup> See Conrad, Christian A. (2015).

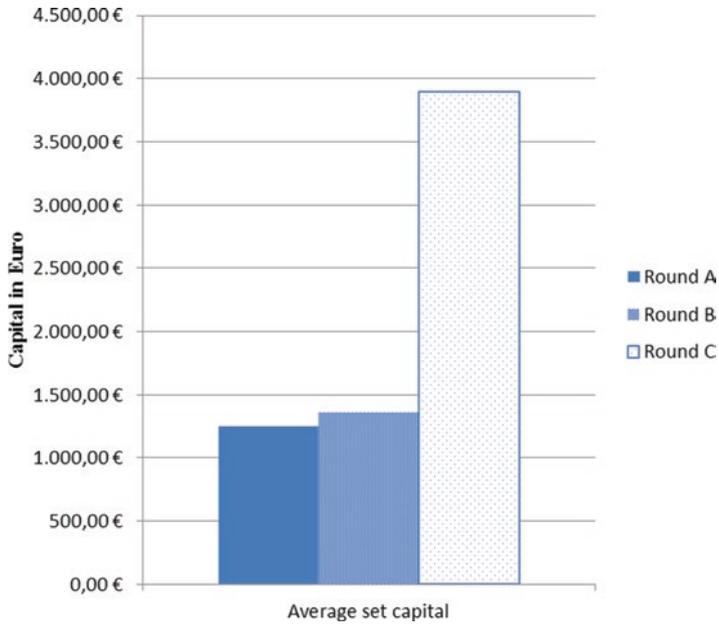


Fig. 7.9 Set capital

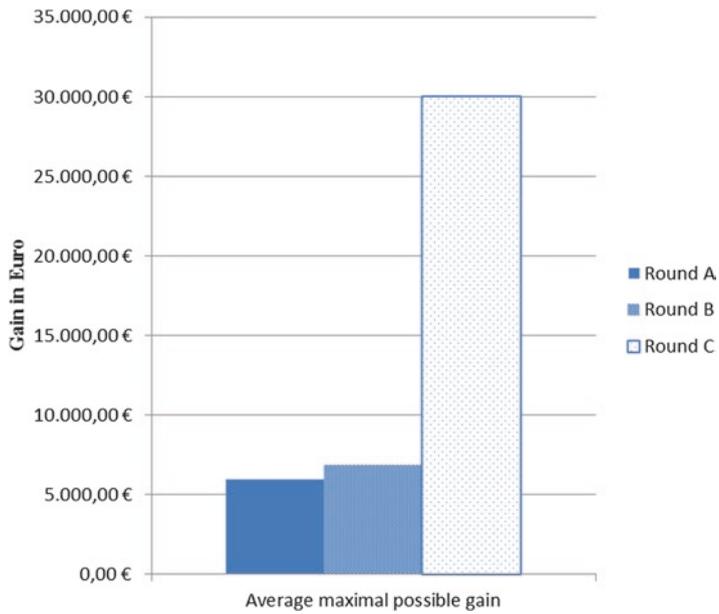


Fig. 7.10 Maximum possible gain

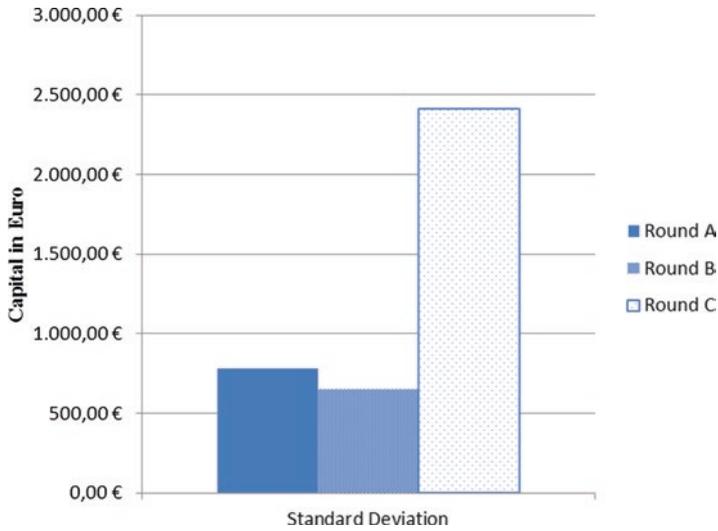


Fig. 7.11 Standard deviation set capital

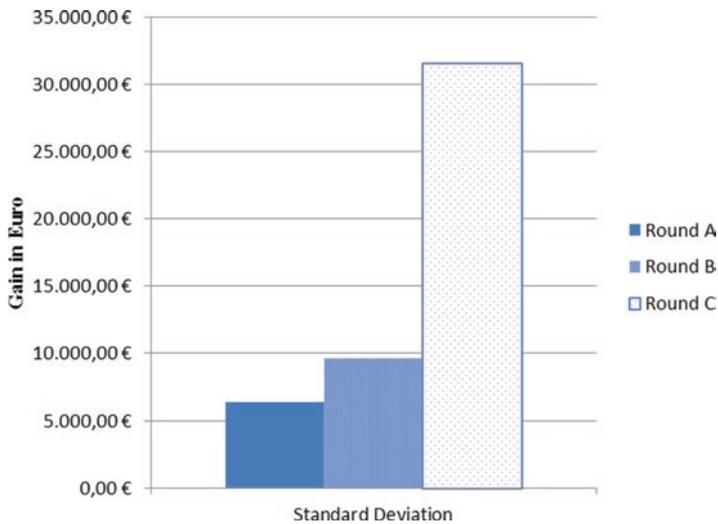


Fig. 7.12 Standard deviation maximum possible gain

idea of principal-agent theory. Of course a connection between a manager’s compensation and a firm or manager’s performance will promote better incentive alignment and lead to higher motivation, which increases firm value, but only if losses and profits are remunerated symmetrically.

The existing asymmetries of bonus compensation schemes have led to a divergence of interests between employees on the one hand and the health of financial

institutions and other companies at large on the other hand. Compensation packages for CEO's and other managers have gotten out of control. Remuneration and bonuses depend on short-term profitability, which increases share prices in the short-term, but not the long-term health of the company. In the financial system, investment managers increased the risks for their employer by buying highly profitable but risky assets and were rewarded with high bonuses which led to the financial crisis in the long term. In addition, the review of research literature showed that cheating is promoted by high and unilateral variable compensations. CEOs have incentives to manipulate earnings if executive compensation is strongly linked to performance. Opportunistic earnings management behavior has been detected.

Risk adequate compensation is therefore an important prerequisite for good performance in all risk-handling professions. Without accountability variable compensation schemes become unilateral bonus maximation schemes with negative effects for the company and the principal. It means risking other people's money which will generally be abused (moral hazards) (Andersson et al. 2013).

### **7.3.3.2 Stock Options and Bonuses as Unethical Incentives for Company Management**

What solutions are offered to overcome the principal-agent issue? The most obvious answer is to involve the agent in a share of the principal's success of the principal. Success-based bonuses or stock options are also called into question here. Stock options make it possible to share in a company at a set price for a predetermined length of time. Stock options are thus offered as a solution and such an approach provides a suitable incentive with which to get the managers (agents) to act in the interest of the shareholders (principals). When managers maximize their stock options they are also maximizing the shareholder value. With the increasing attention on shareholder orientation and the principle-agent issue in public, more and more companies are introducing stock options. Enron also used stock options. Interests seemed to be harmonized with the stock option. In practice however, stock options are a reflection of the unbalanced power distribution between stockholders and management, which has made them somewhat ridiculous. The options are usually given based on the current level of stock prices, which means managers do not have to do more than keep the status quo in order to take just the additional value created by the stocks to adjust for inflation. General movements in investments propitious for stocks increase the value of the options, which explains the exorbitant profit increases of the 100 largest US companies (excluding banks) by around 200%, in particular with more advantageous accounting regulations. In this time period there was a recession, while profits only increased by 3% in the growth phase from 1995 to 2000.<sup>104</sup> The value of the stock options held by ex-Daimler Head

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<sup>104</sup> See *Wirtschaftswoche* dated April 23, 2007, no. 17, p. 113.

Schrempp in 2007 actually increased by about €50 million, even though the rate for Daimler stocks in his time in office fell from around €100 to around €50. At times the value of Daimler stocks was just €25.<sup>105</sup>

If there is to be a motivation for exceptional performance, it would have been better to select a basic price below the current price level, or at least distribute the options in relation to the value development of the average stock index and the respective company branch, thus setting a benchmark comparison. The manager would then be paid only for the above-average development of the branch. As it is, he gets rewarded for many things that he does not influence, and never has to pay, which makes the options in the end just additional wages.

The negative incentive is intensified by the generally very short look-up period. If the manager maximizes his benefits assuming this constellation, he will do everything possible to cause a short-term increase in stock prices. If he is successful, and achieves several million in the short-term through the sale of his stock options, the long-term development of the company is no longer important to him, especially if he can leave the company with his millions in profit from the short-term increase.<sup>106</sup> This is why world famous investment manager Warren Buffet considers the stock option plans to be the cause of incredibly overpaid CEOs.<sup>107</sup> For Sean Harrigan, head of the world's largest pension fund Calpers, the enormous increase in wages for top managers is also due to the professional salary consultants who can expect contracts from the top management at the same time (especially auditors).<sup>108</sup>

Be that as it may, the introduction of stock options to overcome the principal-agent issue has not only created a completely new incentive structure, but has completely distorted the internal distribution of enterprise incomes. If the difference between the salary of a worker and a top manager in 1980 was 40 times more, it was about 530 times more in 2001.<sup>109</sup> In the time period of 1990–2004 the annual salary of an average US worker was \$27,000, which the average salary of US CEOs went from \$2.82 million to \$11.8 million.<sup>110</sup> The extreme increase in management salaries took place in the USA first. In the meanwhile, however, managers all over the world point to the USA when demanding higher salaries, and insist that this is the international standard. Even in the US the unequal salaries have become heavily criticized.<sup>111</sup>

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<sup>105</sup> See Berliner Zeitung dated June 05, 2007, p. 11.

<sup>106</sup> See Utzig, Siegfried (2002), pp. 595.

<sup>107</sup> See Utzig, Siegfried (2002), pp. 595.

<sup>108</sup> See Handelsblatt dated November 08, 2004, p. 2.

<sup>109</sup> See Schwarz, Gunter Christian/Holland, Björn (2002), p. 1665. Schwarz and Holland identify a ratio of 80:1 between top management and worker salaries in the 1980s as the reference point for salary increases. Sean Harrigan, Head of the world's largest pension fund Calpers uses 40:1. See Handelsblatt dated November 08, 2004, p. 2.

<sup>110</sup> See Die Welt, dated January 16, 2006, p. 16.

<sup>111</sup> See Handelsblatt dated November 08, 2004, p. 2 and Die Welt, vom 19.01.06, p. 16.

Stock options are an important incentive instrument in harmonizing the interests of managers and stockholders. They must be designed in such a way however, that only effective, thus successful, efforts are rewarded and the look-up period extends beyond the time that the manager is at the company. Otherwise stock options can have a negative effect on the long-term shareholder value due to the informational advantage of the manager. As the example of Enron illustrates, there are many possibilities to increase short-term shareholder value at the cost of the long-term value. Focusing on the short-term shareholder value, and thus the company success, was also a cause behind the stock market bubble of the 1990s and the subsequent crash from to the willingness to take high risks. This dangerous effect is increased even more by focusing on the shareholder value approach, as we will show.

Too large of a share for the manager in the stock capital of a company can cause a manager to undervalue being employed long term in the company. The manager is more likely to maximize his benefits by increasing the stock price in the short term in order to make his stock profits. He is then “rich” and can kick back and relax. The manager finds support in his planning of this kind of “business” from the insider issue, which is often underestimated, as we can clearly see in the case of Enron. The CEO and other managers in the company are the first to know if the orders received are unable to meet the published growth prognoses either in volume or in yields, if liquidity is short or claims are no longer valuable – not to mention the creative book-keeping they do themselves. The manager can thus always sell their overvalued stock to the stockholders with less information who will be gullible, which is in fact fraud.

Many countries consider the burden of proof in such a case to be on the principals, which makes no sense based on the informational asymmetry. It would make much more sense to assume the managers are informed about the internal figures. The burden of proof of innocence if a manager permanently enriches himself at the cost of stockholders should be on the manager. In the USA at least, according to the rules of the 10b-5 Security Exchange Act, fraudulent statements with an effect on the price of stocks can be prosecuted in criminal and civil court.<sup>112</sup> In other countries the lawmakers and courts are apparently simply overwhelmed. For example, investors in the German enterprise EM TV had to prove that they bought their stocks due to the false ad hoc announcement and thus suffered damages. The company had falsely entered sales with children’s shows and Formula1. As a result the company suffered loses in 2000 instead of the profit they had announced.<sup>113</sup> It is incomprehensible that top-paid managers and owners are not prosecuted by the justice system when they make false reports, from which they have profited. If the managers erred the reports should have at least been corrected by the managers in due course. Meanwhile, the managers can bank on the 3-year statue of limitations. Three years have never yet been sufficient for lawmakers and courts to reach and implement an effective judgment. In light of all this, it is no wonder that stocks still have a shad-

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<sup>112</sup> See Handelsblatt dated October 19, 2004, p. 29.

<sup>113</sup> See Handelsblatt dated May 26/27/28, 2006, p. 26.

owy existence in Germany. The broad public is still put off by the rules of the capital market.

How can the effects of the principle-agent issue be reduced? Stock options are only somewhat suitable as a solution, and if they are to be applied, they must be organized differently. Stock options should motivate the managers to act the interest of the company. If they are incorrectly administered they only increase the opportunities of the manager at the costs of the opportunities for the principal while increasing the principal's risks. Correctly conceived, they would create the same opportunity/risk distribution for both parties. In contrast to the manager, the shareholder not only enjoys the increased value of the company, but also carries a loss of value. He is liable via his capital.

If the interests of shareholders and managers (principal and agents) are to be in harmony with one another, the manager may not only profit from a positive company development, but must be held responsible for a negative development. Otherwise the moral hazard problem comes into play. The manager is rewarded when he behaves immorally, touching up balance sheets and generally trying to achieve short-term success without considering the long-term company development.

There are many ways for the manager to manipulate success. For example, a CEO can devalue the stock assets or create exaggerated reserves when he takes on the position, and blame this on his predecessor in order to then revalue the positions and claim it as a success. A one-sided and short-term inclusion in the opportunities for the manager generally encourages their willingness to take risks and give the long-term needs and risks of the company a lower priority. In addition, when one considers that the shareholder (principal) takes on a large risk when employing the company managers (agents), since he does know the manager's personality structure and qualifications (hidden characteristics), the responsibility of the manager is particularly important for the shareholder. In the end, the shareholder is always dependent trusting his managers because he can control their actions only to a limited extent, as we have shown. The more he can trust him, the less he has to try and control him, which reduces the costs for the shareholder and thus increases the returns on this capital investment. There is also a reduced risk of failure, which increases the expected value of the capital returns. Both will increase readiness to invest in the company. The shareholder can only trust the manager when the latter behaves morally. Morality is therefore particularly important for economic development.

Properly designed, the managers' incentives would have to create the same chances of risk distribution as the principal. In contrast to the manager, the shareholder not only participates in the value growth of the company, but also in the decline in value. He is liable with his capital. In order to establish a harmony of interests between the shareholder and the manager (the agent and his principal), the manager must not only profit from the positive course of the company, but must also be held liable for a negative development. Otherwise, disincentives (moral hazard problems) arise. The manager is rewarded if he behaves immorally, ie hears balance

sheets and generally tries to show short-term success without consideration for long-term company development.

In order to align the long-term interests of companies and managers, stock options should only be given to the managers over the long term, as long as the company success is also increased by the manager over the long term. An appropriate index to use for cash flow would be modified long-term total capital profitability, in relation to the branch average.

Modified total Capital Profitability in percent (MCP) = (cash flow/balance sheet total)  $\times$  100

This index has many weaknesses as well, however. For example, it takes neither the financing structure into consideration, nor the necessary investments due to the focus on cash flow. This provides an incentive not to invest, since it would reduce the MCP. These disadvantages would be compensated by the long-term perspective. Exceeding the long-term above-average modified total capital profitability, of the branch, is the basis for a performance-oriented remuneration. This means that compensation is paid retrospectively at the MCP average of the previous 5 years and only if the company developed better than the sector as a whole. In addition, its greater advantage is its simplicity, which qualifies it very well as an external control measurement.

We have thus determined that stock options can cause lasting disincentives in managers (moral hazard issue) if the opportunity and risk distribution between principal and agent is not balanced and if the manager does not behave morally on principle. The same applies for success-based compensation, if for the short-term the manager is not put in the position to retire after only a few years and evade accountability. We will remember. By repackaging US mortgages as investment products, bankers were able to realize approximately \$23.9 billion dollars in bonus payments in 2006. In 2007, Swiss bank UBS paid out \$10 billion Swiss Francs in bonus payments alone. Wrong compensation programs are also a reason behind the disasters at Enron, Worldcom and other companies and the subprime crisis. If all market participants behave at the costs of the system because of the false incentives through compensation programs this is alone sufficient to create a systemic crisis. The short term oriented bonus payments are therefore one main reason for the subprime crisis.

The meaning of corporate identity and especially the internal and emotional moral commitment of employees to the company has faded into the background over the past few decades, which has only increased the effects of the principal-agent issue. It used to be expected of managers that they work their way up the chain in their company, or at least are acquainted with the most important value creation levels and have assumed the corporate identity. This not only had the advantage that the manager could better judge the effects of their decisions on the company by knowing it well and identifying more strongly with the company. A poor personnel selection was also less likely to occur through the hidden characteristics issue, since the manager had already proven himself over the course of several years in the company. The principal-agent issue can really only be overcome by increasing the common interest of agent and principal, or to formulate it more generally, by encouraging

the identification of the agent (manager) with the company, so that he becomes a bit more like the classical entrepreneur described above. The issue of the hidden characteristics, hidden information and hidden actions is found at every level of management down to the subordinate, decision-implementing units. A total management approach is thus needed, as we will describe in the second-to-last chapter of this book.

### **Conclusion**

We note that stock options can all lead the manager to create long-term disincentives (moral hazards) if the risks and chances are not balanced between the principal and the agent, and the manager does not behave morally. The same applies to the performance-related remuneration if it is granted in the short term and enables the manager to retire after a few years. A risky, short-term oriented behavior of the manager at the expense of the company is provoked by such incentives. A one-sided participation of the managers in the positive development of the company, ie profit participation without a loss participation, leads to a strong risk-taking of the manager at the expense of the principal. A risk-adequate, ie balanced remuneration according to the opportunity and risk profile of the respective position is important in order to avoid distortions in the managers' decision-making.<sup>114</sup> If all market participants behave to the detriment of the system as a result of wrong behavioral incentives, this alone is sufficient to create a crisis. The wrong incentives in the form of short-term overpriced bonuses are therefore a major cause of the subprime crisis. The consequence was an immoral behavior of managers at the expense of companies, customers and society. Even morally oriented people find it hard to resist millions of dollars because of the constraints of survival. Not to be forgotten is that in the US education and health have to be financed privately. In 2006, bonuses received from US house credits alone amounted to US \$ 23.9 billion. In 2007 alone, UBS poured 10 billion Swiss franc bonuses.

#### **7.3.3.3 Fair Compensation**

It is surely indisputable that a top manager receives a higher salary than a worker, and that this can be a cause for jealousy. The worker and the broader public may see such wage differences as unfair. But not all people are the same, and thus not everyone is equally qualified to hold a top management position. What distinguishes the position of a top manager compared to an employee or worker? In the end it is the importance to, and effect on, the company. Both top managers and workers are employees of the company and should work hard for the good of the company. A day has only 24 h for both of them, which is why overtime for the manager is also limited. However, the decisions made by a top manager have operative and strategically fundamental influence on the company, which is not the case for a normal worker or employee. The success or failure of a company is attributable to the

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<sup>114</sup>See Conrad, Christian A. (2015).

management in the end, since they determine how an enterprise deals with changing environmental influences. The position of a top manager has one particularly important characteristic, namely the responsibility for the success of the company, and thus for all others dependent upon a company's success, such as investors, outside creditors, employees, customers, suppliers and others (applies to politicians as well.) It is therefore of existential importance for all companies that they have managers giving their best. Top managers are therefore remunerated like princes and companies try to outbid each other with salary offers in order to attract the very best. Besides power from their responsibility, they are attracted by social prestige and recognition, and recently by stock options as well. To get these privileges the managers work themselves into the ground, sacrifice themselves to live up to the task and responsibility and thus to achieve more benefits for everyone.

This would be the ideal, but the subprime crisis and Enron and the others have shown that reality is often very different. Companies go bankrupt, banks and shareholders lose everything, yet the top managers responsible retire with millions in profits from the sale of their shares to enjoy. Even if the company survives, but its situation is permanently damaged, the top managers may be replaced, but get millions in compensation. Many companies do poorly despite offering the highest manager salaries.

It is difficult to understand why a manager who does not improve the company, or who even makes it perform worse, should receive a high salary. Enterprises are often restructured, leading to extensive layoffs. The employees to lose their jobs are still responsible for their families and have a hard time understanding why they were let go when they had always fulfilled their duty to the company, receiving a set salary for working hard and performing well for the good of the company, and doing so for years or decades. The employees are liable with their jobs as a consequence of poor decisions from management, even though they are not compensated for the entrepreneurial risk with their salary despite small settlements from social funds. Managers on the other hand, receive not only sometimes huge compensations, but can sell their stock options in time before a fall in prices due to their insider knowledge. In the end the top managers are the first to see that the enterprise they are managing will not reach the given targets. In the case of bankruptcy, the shareholders and stakeholders such as employees, suppliers and credit institutes foot the bill, which perverts the principle of enterprise liability. The same applies for liability insurance without a deductible. If you want a manager that works hard for the enterprise he is entrusted with, the top managers will have to become more like the liable entrepreneurs. Currently they are just overpaid employees.

Measured on salary, in 1999 the best top manager in the USA, and probably in the world, was doubtlessly Enron's Kenneth Lay. He had the largest salary package with \$44.2 million.<sup>115</sup> Outsiders often logically assume that the best man or woman is at the top of a company. They assume that the people who have proven their performance, know-how and personality and worked their way up in that company or another, is trusted with the power and responsibility to direct the fate of the com-

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<sup>115</sup> See [http://en.wikipedia.org/wiki/Kenneth\\_Lay](http://en.wikipedia.org/wiki/Kenneth_Lay) dated October 08, 2006.

pany, and thus that of the stakeholders and shareholders. Since there is also a market for managers, we might imagine that the company prepared to pay the most for its managers also gets the best managers. This argument is often used by the top managers when they are defending their salaries. Taken to its extreme, this would mean that the companies should go to their credit limit to purchase the best management board, as everything is dependent upon good leadership. The best managers would then be found in the largest companies since they can afford the highest salaries relative to their sales. As a logical consequence, the poor managers would be in the small companies. Since the best managers make the right decisions and the poor managers make the wrong ones, the large companies would continue growing and the small ones would shrivel away. The large companies ABB, Enron, Worldcom, General Motors, Chrysler and Daimler or Citigroup and AIG would have had the best managers, while small companies such as SAP, which has doubled its size repeatedly, would have the poor managers. Of course everything depends on the management. A poor company can be managed successfully even in a difficult branch, where demand is decreasing. According to a survey of German liquidators, the main reason for insolvency is mistakes in management.<sup>116</sup> Especially in the day and age of global markets, there is a demand for management that can adjust to changing conditions every day, such as a new competitor. In fact, a top manager must be able to predict the changes. He must be a visionary, like Jules Verne. Predicting all of the developments in a global economy would have been too much for even Jules Verne, however.

If top managers want top salaries, they also have to provide top performance and be a model for their employees. In the end they also represent the company to the world outside, determine strategy and corporate identity. They shouldn't wonder that they are the object of people's anger when they perform poorly and then get rich unjustly from the company, such as in the case of ABB. The charismatic company managers Percy Barnevik and Göran Lindhal took 148 million sfr and 48 million sfr before they left ABB with an annual loss of 700 million sfr. That is not all, however. ABB was involved in several bribery cases, and according to insiders this was mostly because of the immoral example the top management set for the rest of the company. When the ex-Aventis head Dormann took over ABB he considered corruption one of the main problems of the company. He took drastic measures and instituted a code of ethics that every employee had to sign. Forty to fifty employees were fired from ABB over cases of corruption in 2004 alone. Employees were able to report suspected corruption via a whistle-blowing program.<sup>117</sup>

Top managers must provide top performance, which includes taking responsibility for decisions. The tendency to prepare decisions via management consultants is understandable with the background of how much pressure is on managers to justify themselves to their boards, but it is not understandable when we remember that a top manager is actually always supposed to have the information and competence to manage his company and his employees independently. Following this thinking, the

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<sup>116</sup>See Handelsblatt dated June 25, 2006.

<sup>117</sup>See Handelsblatt dated August 10, 2005, p. 10.

head of DaimlerChrysler Dieter Zetsche, in contrast to his predecessor Schrempp who resigned, believes that the development of the company is a task belonging to the top management, and excludes the option of falling back on management consultants.<sup>118</sup> External management consultants are only justifiable in certain situations in which the company management is unavoidably overwhelmed, such as in company crises where important decisions must be made under enormous pressure to act in very little time. In these crisis situations management is already overwhelmed with the task of finding and evaluating the necessary information to make short-term decisions. Management consultants are often hired however, to lend support for the decisions of the top management with their name. Seen thus, they are usually purely public relations consultants, and always a sign of weak management. The quality of the consultation is not the most important, but rather the big, impressive international name of the consulting firm.

The compensations of bank managers increased also before the financial crisis of 1929 in exorbitant highs. Like today they resulted from extremely risky speculations. The high manager salaries and the business crises are also a symbol for weak shareholder control. Why should a manager get what an entrepreneur deserves. He is only an employee and is not liable with his capital. The only thing he can lose is his job.

The fact is that the board of directors has a huge amount of power and controls from the non executive directors are limited. The non executive directors might be also executive directors of other companies. If there is no direct conflict of interests at least they will all have the same interest in increasing the salaries of managers.

The fate of the company is therefore bound up with the ability and integrity of the board of directors for good or for evil. In other words, the board also has a large responsibility. A high salary is thus not only reasonable, it is also necessary. The board of directors must share in the consequences, including personal liability through private assets, whether as a repayment requirement from bonuses received or a part of the salary. It should in fact be counterintuitive to the ethos of a manager to receive a large compensation if the company is doing worse after his management than before. The motto for management should be "First the company, then me. He should want to be the last to leave the ship, not the first. A lack of professional ethics is also the expression of a lack in morality. In the contribution made by a manager for the value creation of a company, we must differentiate between his individual contribution and that of his position. The importance of an executive position for the company is alone a source of value creation, if the job is fulfilled without any large mistakes.

It is conceivable to place a manager from a level lower in the company in the position of CEO and continue to pay him his lower salary. The personal limit product of the manager must be decisive for an above-average salary, i.e. what he contributes in above-average value creation to the company. This is why many managers in the top positions stress their irreplaceable above-average performance and their uniqueness. The time they spend in the top management position is too long for this

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<sup>118</sup>See *Wirtschaftswoche* dated January 12, 2006, p. 11.

to be true however, since if they were so incredibly unique, we must assume that there would be no higher priority for other companies than to lure them away. Unfortunately in practice it is not always the best managers that make it to the top. Apparently the reverse is true when filling top management positions, that there is too little competition and transparency, otherwise there would not be so many company crises as a result of poor personnel decisions. The incentive schemes in salaries make it possible, even encourage and strengthen the chances, to get rich in the short term at the cost of the company. But even poor personnel decisions could be controlled and we must ask ourselves why a single person can cause so much damage in a company.

#### **7.3.3.4 Lack of Controls on Company Management**

Another reason for the crisis at Enron, Worldcom & Co. is apparently company managers with too much power. Jeff Skilling at Enron, Bernie Ebbers at Worldcom, Percy Barnevik at ABB, John Chambers at Cisco, Jean-Marie Messier at Vivendi, Cees van der Hoeven at Ahold, and last but not least Dennis Kozlowski from Tyco managed their respective companies like autocrats with their charismatic and exaggerated self-confident personalities. Blinded by initial success, companies and investors followed them right into the downfall. This is a human phenomenon of groups, which can often be observed wherever there is a large concentration of power. At some point the powerful people themselves begin to believe in their infallibility, get careless, uncritical, and only tolerate yes-men around them. In companies this is often reflected in an attempt to garner more and more power through expanding mergers, which at some point can no longer be controlled and end up overwhelming the company. The record in this phenomenon is held by Tyco, with up to 200 company takeovers in its heyday.<sup>119</sup> Kozlowski later served a 25-year sentence for fraud and other offences, and the investors, stockholders and creditors of Tyco were granted the right to sue the ex-Tyco auditor PriceWaterhouseCoopers. They had over-reported \$5 billion in profits, which is why the new management reached an out-of-court agreement to pay \$3 billion in damages.<sup>120</sup>

Many top managers show weaknesses both in their personality and in their skills, which have almost ruined some companies (such as ABB and DaimlerChrysler) and have completely ruined others (Enron and Worldcom). Where does it come from? How are management positions awarded, if performance, ability and integrity are not the deciding criteria? Hiring decisions always carry with them the risk of the hidden characteristics, as previously discussed. People who are capable of presenting themselves well, and don't take truth all too literally, always have the advantage. For an employer, or a BoD, can only be accused of poor personnel decisions to a certain extent, but later they can certainly be held accountable for not acting once the weaknesses of the manager hired become clear. There is another aspect that is

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<sup>119</sup> See Probst, Gilbert/Raisch, Sebastian (2004), pp. 38.

<sup>120</sup> See Handelsblatt dated May 16, 2007, p. 11.

much more important. A company is above all a functional cooperation of many people, an organization. It is about people, power, influence, welfare and the distribution of all of these. In this environment politics becomes important, increasingly so as the companies get bigger.

Let us assume that people are evolved from apes. As has been observed in groups of apes, a hierarchy, that is power and recognition, is not determined by the strengths of individuals, but by political influence in the group. The key is the relative strength of all the group members an individual can get to support them. If one group member wants more power than others, it must build alliances. The supporters are generally strong, otherwise they could not assert themselves among the alliances, but the qualifications, the strengths necessary for this, are not identical to those of a specialized qualification or ability to run a company. What is needed here are political abilities, such as communicating to others that their interests (also power, influence and remuneration) are best represented in the company. It is in fact possible that two rival and equally strong alliances will not manage to impose their desired candidate and thus agree on a compromise candidate. This candidate is often professionally and politically weak, so that he cannot damage the alliances in the key position he will have. There are also paradoxes in internal promotions. Performance is not always transparent. Appearance is often more important than the truth. Appearances can deceive however, and there are people with an exceptional talent to do so. Another example: as a manager with a strength in implementation works his way up the ladder, those who have supported his rise in power usually come as well. These are the people who are unconditionally loyal, as well as employees who are not qualified managers, but the ones who never criticize the manager and never have – or at least do not voice – a conflicting opinion and give only positive feedback, in other words the yes-men. They do not really have their own personality, and at most have perhaps half of the potential needed to be a good manager. The manager chooses these people himself. He usually prefers those who do unconditional dirty work and yes-men to creative thinkers and personalities not only because they are more comfortable to have around, but because they will protect him from supporting an equally qualified, or even a better qualified manager in his sphere of influence. Such a person could steal the show, and then even the position. Better to have just one light shining in the darkness. The head of Citigroup, Prince, followed his charismatic foster father Weill to the top position. The lawyer by profession is rumored to have had absolutely no experience in operative banking business when he took up the position.<sup>121</sup> The deputy of Richard Fuld, the head of Lehmann (Joseph Gregory) is said that his greatest strength was that he could not become dangerous.<sup>122</sup>

Of course, one must be able to afford such a politically motivated “mistake” in personnel. At best only large companies can afford such a move, since there are enough other employees to compensate the reduction in value creation through this poor selection. The more important the position for the company, the higher are the

<sup>121</sup> See Handelsblatt dated November 11, 2007.

<sup>122</sup> See Der Spiegel 11/2009, pp. 43.

costs of a poor decision. Generally, we can say that such personnel choices can only be supported if the manager has no one holding him accountable or the effects of their poor performance are not obvious due to a lack of a clear chain of responsibility or appropriate controlling.

Effective controls from the Board are all the more important via representatives of the stockholder interests, and separating the CEO from the controlling board chair is the absolute minimum requirement. In larger companies the Chairman of the Board should be a well-paid full-time job. He should also be personally interested in the company's success and thus involved in long-term oriented option programs. It must be assured that control over the Board is objective, and thus impartial. This applies for both auditors and supervisory boards. Previous management of the same firm are just as poorly qualified for this job as the management of firms in which the management to be checked, or their friends and family, sits on the supervisory board. Due to the professionalism and identification of interests, mutual stock funds for this task would be the best form of payment, followed by funded insurance systems. A positive example for the successful representation of stockholder interests is Calpers, the world's largest US pension fund. It not only refuses to lay off managers who have not represented the interests of the stockholders in its view, but is also involved in politics whenever stockholder interests are affected. The fund refused, for example, to agree to dismiss managers who paid their auditors for tasks other than checking accounts. Many companies reacted and now separate audits and consultations.<sup>123</sup>

The disproportionate development in salaries can thus be attributed to a lack of controls on company management. Why should a board that does not think morally deny itself enrichment, if there are no consequences to be feared?

### Conclusion

All in all, the Management Board is governed by the company and the Supervisory Board's control facilities are limited. Often, the supervisory board members are also board members of other companies. Even if this does not lead to a conflict of interests, they have at least the same interest in increasing the level of managerial remuneration. For this reason, the company's fortunes are linked to the ability and integrity of the Executive Board. Or in other words, it carries a great responsibility. A high salary is therefore not only appropriate, but also necessary. But the responsibility must also be borne by the board, which should also include personal liability with private assets as with the entrepreneur, whether as a repayment obligation of bonuses or salary components received. Actually, it should contradict a manager's professional ethos that he gets a high compensation if the company functions worse than before. And actually, the motto for management is "first the company and then me." And like the captain of a sinking ship, he should be the last to leave the ship and not the first. Lack of professional ethos is always an expression of a lack of morality.

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<sup>123</sup> See Handelsblatt dated November 08, 2004, p. 2.

### Summary

Unfortunately, it is not the case that only the best managers rise to the top, otherwise there would be no corporate crises as a result of manager failures. Obviously there is too little competition and transparency in the process of filling top management positions. The incentive mechanisms for salaries, which make a short-term enrichment possible and even at the expense of the company, reinforce this. The wrong incentives in the form of short-term overpriced bonuses are a major cause of the subprime crisis. A risky, short-term oriented behavior of the manager at the expense of enterprise, thus an immoral behavior, is provoked by such incentives. At least partial liability is necessary to remedy incentive distortions and to ensure a risk-adequate remuneration.

### Comprehension Questions

1. Can the company recognize when someone is a moral and good manager? Justify their assessment.
2. How can you explain the increasing wage differential between top executives of stock exchanges and employees of lower salary levels?
3. How would you reward your top manager as a corporate owner? Explain your position.

## 7.3.4 Ethical Corporate Culture

### 7.3.4.1 Case Study: VW Diesel Scandal

#### The Scandal

November 20, 2006, the technicians of VW Chief Engineer Rudolf Krebs discovered that they could not technically meet the stringent emission guidelines of the US market. The technicians found a solution. They manipulated the results in the exhaust gas tests by installing software that regulates the exhaust gases only in the test cycle. According to participants of a meeting, Rudolf Krebs said: “We’ll do it, but we must not get caught.”<sup>124</sup>

On September 18, 2015, the US Environmental Protection Agency (EPA) published that VW intentionally bypassed emissions regulations for more than half a million diesel vehicles. In an e-mail from the United States Environmental Protection Agency (EPA) to VW of 18 September 2015 states:

“the EPA has determined that VW manufactured and installed defeat devices in certain model year 2009 through 2015 diesel light-duty vehicles equipped with 2.0 liter engines. These defeat devices bypass, defeat or render inoperative elements of the vehicles’ emission control system that exist to comply with CAA emission standards.”<sup>125</sup>

<sup>124</sup> <http://www.ndr.de/nachrichten/niedersachsen/VW-Anatomie-eines-Wirtschaftsverbrechens,vw2936.html>.

<sup>125</sup> <https://www.epa.gov/sites/production/files/2015-10/documents/vw-nov-cao-09-18-15.pdf>

With low exhaust emissions, the company won several environmental awards and started the “clean diesel” marketing campaign. This marketing campaign was extremely successful and helped the VW Group sell 11 million manipulated vehicles until the fraud was discovered in September 2015.

### Consequences

The exhaust gas manipulation led to compensation claims against VW, possible tax payments, reimbursement of production money, as well as the uncertain future of current and future diesel models. VW and Audi, Seat and Škoda had to call back millions of cars and also reprogram the engines of new cars. Last but not least there is huge image damage.

VW has agreed on a settlement of 15 billion US dollars with the American authorities. This sum is provided by VW for the repurchase and conversion of affected vehicles, as well as for the establishment of environmental funds. In Canada, the VW Group has negotiated a settlement of 2.1 billion Canadian dollars (1.5 billion euros) for redemptions and compensation payments. According to expert estimates, the entire cost of the exhaust gas scandal will amount to 30 billion euros. The number of VW car registrations has declined since the scandal. For these reasons, VW has set up a plan called “the future package.” With this plan, VW will save €3.7 billion annually in the German plants alone. Much of these savings are to be achieved by means of job cuts. In the German plants, around 20,000 jobs are to be cut by 2020. Worldwide, another 10,000 jobs will be lost. Furthermore, the model diversity will become significantly narrower.

Worldwide 11 million vehicles have to be retrofitted. VW does not, however, guarantee any consequential damage after the conversion and keeps the technical details of the software update secret, so that an independent expert can never check for error.

The CEO Winterkorn accepted partial responsibility and stepped down in September 2015. At the time when Winterkorn was told of the manipulation, he was the highest earning manager in Germany. In summary, Martin Winterkorn received 35.3 million euros in the years 2012–2014 with a fixed share of 5.7 million euros. This shows that over 83% of Winterkorn’s earnings were dependent on the company’s success.

It is currently known that Winterkorn had known about the exhaust gas manipulation since May 2014. The public prosecutor’s office in the German town of Braunschweig opened an investigation against Winterkorn for fraud suspicion in January 2017. The investigations were based on witness testimonials and evaluations of confiscated files which showed that Winterkorn “could have had previous knowledge of the manipulating software and its effect.”<sup>126</sup>

Winterkorn and co-owner and supervisory board Ferdinand Piëch had set themselves the goal of overtaking Toyota in 2018 as the world’s largest automobile group. It succeeded in 2015. The Swiss psychotherapist Theodor Itten discusses

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<sup>126</sup> <http://www.spiegel.de/wirtschaft/unternehmen/martin-winterkorn-staatsanwaltschaft-ermittelt-wegen-betrugsverdacht-a-1132013.html>

another aspect as an explanation for the rapid rise and the surprisingly rapid descent of such managers. His book “Größenwahn” (english: megalomania) deals with many heads of top managers, who failed in a similar way. “Many managers have a morbid exaltation of themselves – which ultimately causes them to crash,”<sup>127</sup> says Itten, diagnosing a narcissistic personality disorder. This is responsible for many managers who have made their career even to the top level.<sup>128</sup> “The same character traits that help managers to rise, let them often also fall down. This is the problem.”<sup>129</sup>

### Solution

1. Conviction ethics: VW deliberately manipulated the exhaust gas values, which is why an honest attitude can not be presumed. Winterkorn did not do anything about it. The customers were deliberately deceived by the advertising of “clean diesel.”
2. Kant’s rules of ethical reasoning: a) Categorical imperative: general law? If every automotive producer manipulates, the environmental impact would be enormous: No! Do you want to be affected by such a behavior yourself as a car purchaser or environmentally conscious person? No! B) Publicity rule: The rights of the public and VW buyers have been violated: No! C) Practical Imperative: No, the environment and customers were deliberately deceived by advertising “clean diesel” to maximize profit.
3. Duty ethics (deontological ethics): No, the environmental requirements were clear.
4. Implications (teleological ethics): Environmental requirements served the purpose of protecting nature and people. There were customers who were willing to pay a higher price.
5. Moral economics: There was apparently no adequate government control that would detect and punish the manipulation of exhaust gas values, so every automobile producer was forced to cheat.

<http://www.ndr.de/nachrichten/niedersachsen/VW-Anatomie-eines-Wirtschaftsverbrechens,vw2936.html>; <http://www.manager-magazin.de/fotostrecke/volkswagen-die-chronik-des-abgasskandals-fotostrecke-131601-42.html>; <https://www.epa.gov/sites/production/files/2015-10/documents/vw-nov-caa-09-18-15.pdf>; <http://www.spiegel.de/wirtschaft/unternehmen/martin-winterkorn-wird-70-die-arroganz-der-macht-a-1149070.html>; <http://www.tagesschau.de/wirtschaft/vw-vergleich-103.html>; <https://www.tagesschau.de/wirtschaft/vw-kanada-101.html>; *Handelsblatt* 71 (224), S. 6–7; [http://www.focus.de/auto/news/autoabsatz/neuzulassungen-im-juli-passat-zulassungen-brechen-um-25-prozent-ein\\_id\\_5702913.html](http://www.focus.de/auto/news/autoabsatz/neuzulassungen-im-juli-passat-zulassungen-brechen-um-25-prozent-ein_id_5702913.html); Volkswagen Aktiengesellschaft: Konzernabschluss 2013,

<sup>127</sup> <http://www.spiegel.de/wirtschaft/unternehmen/martin-winterkorn-wird-70-die-arroganz-der-macht-a-1149070.html>. Translation by the author.

<sup>128</sup> See <http://www.spiegel.de/wirtschaft/unternehmen/martin-winterkorn-wird-70-die-arroganz-der-macht-a-1149070.html>

<sup>129</sup> <http://www.spiegel.de/wirtschaft/unternehmen/martin-winterkorn-wird-70-die-arroganz-der-macht-a-1149070.html>. Translation by the author.

2014 und 2015; *Die Kitzinger* 7, S. 21; <https://www.welt.de/wirtschaft/article152865049/Winterkorn-wusste-schon-2014-ueber-Abgasskandal-Bescheid.html>; <http://www.spiegel.de/wirtschaft/unternehmen/martin-winterkorn-staatsanwaltschaft-ermittelt-wegen-betrugsverdacht-a-1132013.html>; <http://www.n-tv.de/wirtschaft/Zetsche-kritisiert-Volkswagen-article16770101.html>

### 7.3.4.2 What Is a Company Culture?

**Group Work** How would you behave as an employee? Discuss the effect of the following examples:

1. In the company, there is competition among the employees as in “up or out,” while the company management demands fair team play among the employees.
2. Openness, honesty and fairness are required, but only those who do not make mistakes are promoted. Mistakes can mean dismissal.
3. Honesty and modesty of the performance of the team are demanded, but the person is promoted who is bragging about a third person’s performance and hiding his own mistakes.
4. Personal effort is required, though rewards are equal regardless of results.
5. The demand for personal performance and constructive criticism is demanded, but the one who eats lunch with the supervisor and agrees with everything is promoted.

As a result of the group work, the seminar participants showed a great discomfort and a rejection of the above examples. A clash of the individual culture of the employee and the company culture necessarily leads to the termination or at least to the internal termination of the employee.

Trust is quickly lost and building new trust takes time if it is possible at all. The rules a society makes determine its long-term success. Rules that are implemented determine human behavior within the society through rewards or punishments, which are signals that make those rewarded into role models and those punished into deterrents. The unjustified enrichment of a top manager also acts as a “role model.” If a high level boss does not have to make an effort and show above-average performance through hard, honest work, what can be expected from a lower level employee who is paid much less? What kind of company culture with what kind of performance would there be if all employees behaved that way? Immorality then pays off. Loyalty, morality and honest work are devalued with such salaries, which must reduce the motivation to behave in accordance with the system and to work hard and productively. If this kind of behavior is allowed to pay off, it would not only crush the system economically, it would also be a step backwards for civilization. A democracy is based on certain values and principles, which are understood as a “social contract.” *Égalité*, *fraternité* and *liberté* contain something like a minimum of performance fairness and equal chances. An openly tolerated, unjust enrich-

ment not only goes against these principles, it provokes jealousy and thus strips away social consensus (peace).

Moral behavior must be worth the effort. Poor examples undermine morality, which applies both within a company and a national economy. Others will see that it pays to get rich at the expense of the company, or other economic participants and will try to emulate those who do. The top manager who has gotten rich by selling his stock options even though he has hurt the company he was entrusted with, will find copycats as well as corrupt buyers. If this damaging behavior is not sanctioned, then rationally, honesty would be a poor choice because it does not pay out. Mores fall apart, or better the morals of the actors, who damage not only the company or individual person but the system as a whole.

Corporate principles have to be lived out. If employees and executives behave differently than the corporate image, it becomes a waste of paperwork. Argyris differentiates official behavioral requirements (espoused norms) and actually lived norms or norms-in-use.<sup>130</sup> Decisive for the ethical behavior of all people in a company, are the actual norms-in-use in the form of so-called corporate culture. These are all norms, values and behaviors that define the behavior of people in the company as a group (**definition**).

The same people can have several cultures, depending on which group or community they are a part of. A culture deviating from the corporate culture would be e.g. the behaviors, norms and values in the family. Corporate cultures can be differentiated in a group as subcultures of many individual working groups. Depending on the location, international corporations have divergent cultures.

The company cultures contribute decisively to the success of the company. They are a competitive factor because they directly influence the co-operation of the employees and thus the added value of the organization, mainly from the division of labor and the synergy. Already in the 1970s, Americans developed the concept of corporate culture as a management approach. Here, they explained, among other things, the differences in productivity between American and Japanese companies. The Japanese employees were characterized by a higher discipline and willingness to cooperate.<sup>131</sup>

In the early 1980s, Hofstede described the connection between the general culture of a country and the behavior of the people in the company by interviewing IBM employees in 71 countries with a questionnaire on their behavior for 10 years. He showed that the behavior of managers is strongly influenced by their culture, which is particularly reflected in their leadership and the organization of the company process.<sup>132</sup>

From the answers Hofstede developed four cultural dimensions for describing cultures:

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<sup>130</sup> See Argyris, Christ (1994), pp. 216 f.

<sup>131</sup> See Schreyögg, Georg (1991). Steinmann, Horst/Schreyögg, Georg (1991), pp. 12; Steinmann, Horst/Schreyögg, Georg (2005) and Geißler, Cornelia (2010).

<sup>132</sup> See Hofstede, Geert/Hofstede, Gert Jan/Minkov, Michael (2010).

1. an individualistic versus a collectivist culture, in which the American corporate cultures are given an individualistic character and the Japanese a collectivist.
2. a different acceptance of status differences (power-distance)
3. a different risk assessment or uncertainty avoidance (uncertainty avoidance)
4. More male or female dominated cultures (masculinity / femininity)

According to the Waters study, four out of seven criteria that prevent ethical behavior in the company are attributable to corporate culture:

1. an unethical role model function of the superiors, as a general toleration of unethical behavior or as unethical socialization, thus modelling of such behavior by the superiors. In particular, initial start-ups can be influenced.
2. an overgrown group loyalty that prevents misbehavior from being reported to the outside and encourages competition among the groups.
3. a strong orientation of the success indicators on quantities in the case of a simultaneous internal undervaluation of ethical, qualitative factors, especially in order not to endanger the quantifiable goal fulfillment. This results inter alia in an inhibition to openly address moral aspects in the company.
4. A tendency of the company, thus indirectly all employees in the company, to hide ethical violations, in order to prevent a poor image and possible punishment from the outside.

Corporate cultures represent the established orientation patterns for behavior in the company. These orientation patterns are deeply anchored on an unconscious level. They reduce complexity and give the employees behavioral security. An entrepreneurial function is attributed to the corporate culture. As a rule, a change in the habitual culture is rejected by the employees, and the especially if this behavior was successful for the employees.<sup>133</sup> Culture is an identity-building and preserving factor. This aspect is reflected in Schein's definition of organizational culture. It defines it as "a pattern of common ground prizes that the group has learned to deal with their problems of external adaptation and internal integration, which has proven itself and is therefore binding; And is therefore passed on to new members as a rational and emotionally correct approach to dealing with problems."<sup>134</sup>

According to the popular cultural model of Schein, there are three cultural activities:

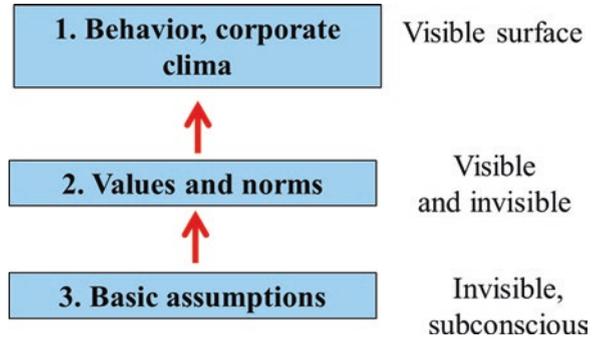
1. The cultured surface is determined by the behaviors and process results. They are the first to be recognized in the company, but they must be interpreted. Visible behaviors are expressed, in the language, manners, rituals and clothing (as well as myths and artefacts, such as the company building and office facilities and equipment). This also includes the corporate identity as well as the company's

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<sup>133</sup> See Schreyögg, Georg (1991), pp. 208.

<sup>134</sup> "...a pattern of shared basic assumptions that was learned by a group as it solved its problems of external adaptation and internal integration, that has worked well enough to be considered valid and, therefore, to be taught to new members as the correct way to perceive, think, and feel in relation to those problems." Schein, Edgar H. (2004), p. 17.

**Fig. 7.13** Organizational culture by Schein



operating environment, how people deal with each other and the way they interact with other stakeholders, such as suppliers and customers.

2. On the next level are the norms and values which control the behavior of the employees. Standards are the guiding principles, the behavioral guidelines, if they are also lived. They are only partially visible through the behavior. Man can partially recognize the values of the organization and deliberately question and influence them, but they are also partly hidden in the subconscious. Collective values are, for example, honesty and reliability, ie attitudes that determine the behavior of employees.
3. At the deepest level, in the subconscious, there are basic assumptions. They are so deeply anchored that they are not consciously perceived by members of the organization. They are thus not directly recognizable. These are the dispositions of behavior which, without thinking, are assumed to be self-evident. It is a spontaneous way of reacting to the environment. These basic assumptions about reality, the environment, are not questioned or discussed. These include ideas about the meaning of life or religion (Fig. 7.13).

### 7.3.4.3 How Does the Corporate Culture Influence the Employees?

Empirical studies show the influence of corporate culture on company activities. Cullen, Parboteeah and Victor showed that a company culture perceived as ethical by the employees had a positive effect on the commitment of employees in the company organization.<sup>135</sup> In an ethical corporate culture, managers are increasingly ethical.<sup>136</sup> Finally, the employees lie less in an ethical corporate culture.<sup>137</sup>

Corporate culture is therefore the most important criterion for company success, but unfortunately it is also the criterion that is most difficult to influence. In fact, the corporate guidelines, the officially desired behavioral rules, often differ from the

<sup>135</sup> See Cullen, J. B./Parboteeah, K. P./Victor, B. (2003).

<sup>136</sup> See Flannery, B. L./May, D. R. (2000).

<sup>137</sup> See Ross Jr., W. T./Robertson, D. C. (2000).

actual, “secret rules of the game.”<sup>138</sup> All other instruments for the purpose of winning will fail if the corporate culture does not communicate them. Can it be a good strategy if it can be seen as a contradiction to the behavior of employees and therefore cannot be implemented? Ethical behavior in the company therefore requires an ethical corporate culture. Otherwise, ethical behavior as a violation of norms would be sanctioned by the other employees (and vice versa).

In groups, people take on roles that influence their behavior. Groups have a group-adjusted morality behavior with their own norms. Groups can increase productivity, through control or cognitive stimulation. Conversely, the wrong norms of a group can also lead to opportunism, conformity, and adaptation of the group members. This would lead to a herd behavior in an ethically wrong direction, as was the case with the group norms of the bankers within the framework of the financial crisis (group-think effect). Deindividuation promotes social loafing if the performance of the individual cannot be controlled. An individually identifiable performance enhances performance through social competition. The attitude of the group and the individuals influence each other. The individuals adapt themselves to the group in order to be socially accepted (social comparative processes or the pursuit of conformity). Norms can lead to moral behavior, as demonstrated in experiments.<sup>139</sup>

Muzafer Sherif had already conducted an experiment on group adaptation processes as early as 1935. Subjects would estimate the removal of a light from their eyes. On the basis of the so-called autokinetic effect, all subjects estimated differently. In a second pass, the subjects were able to communicate their assessments to each other. The result was that they matched their minds over time.<sup>140</sup> Jacobs and Campbell showed in 1961 that group norms that arise in an autokinetic situation as group adaptation processes are passed on by generations of groups but lose influence.<sup>141</sup> Weick and Gil-fillian found again in 1971 that such group standards lasted longer when viewed as efficient and fair.<sup>142</sup>

### **Game 6: Asch Conformity Experiment**

1. The following picture is shown to the students with a beamer. The students are asked to estimate the number of telephones and to write the number on a paper (Fig. 7.14).
2. The following picture is shown to the students with a beamer.

80% get the wrong information on a folded paper says that 280 telephones are pictured. They are asked not to show the paper to the others. Then there is group

<sup>138</sup> See Scott-Morgan, Peter (1994), pp. 29.

<sup>139</sup> See Aronson E./Wilson T. D./Akert, R. M. (2008), pp. 241, pp. 285; Jonas K./Stroebe, W./Hewstone M. (Hrsg.) (2007), pp. 374 and Bierhoff, H. W. (2006), pp. 413.

<sup>140</sup> See Sherif, M. (1935); Aronson E./Wilson T. D./Akert, R. M. (2008), pp. 234 and Bierhoff, H. W. (2006), pp. 414.

<sup>141</sup> See Jacobs, K. C./Campbell, D. T. (1961) and Bierhoff, H. W. (2006), p. 415.

<sup>142</sup> See Aronson E./Wilson T. D./Akert, R. M. (2008), pp. 241.; Jonas K./Stroebe, W./Hewstone M. (2007), p. 374; Bierhoff, H. W. (2006), pp. 413 and Dobelli, R. (2011), pp. 17.



Fig. 7.14 telephones 1 (Solution:  $12 \times 20 + 40 = 280$  telephones)

discussion about the number of telephones. It can be seen that the students who have to estimate will adjust their estimation to the wrong information of the group majority (Fig. 7.15).

3. The following picture is shown to the students with a beamer. The students are asked to discuss the number in the group. After 5 min the students should write their result on a paper. Then the results are compared to the number on paper of the first experiment. The difference in the individual estimation is the group influence (Fig. 7.16).

Solomon E. Asch conducted an experiment in 1955 in which individuals in a group should say which of three strokes is longer. Approx. 37% went for the wrong group opinion, if it was presented with sufficient confidence. With the Asch Conformity experiment Solomon E. Asch demonstrated that individuals can also adapt to wrong group opinions when the group represents them self-confidently.<sup>143</sup>

It has been demonstrated with fMRI brain scanners that people feel negative emotions when they behave differently from the group. In the experiment by Gregory Berns et al. the subjects should say whether two figures are identical. Aids were given as subjects and 2/3 of the subjects reported false results. The remaining 1/3 subjects, who did not know the wrong results, struggled in the brain areas responsible for seeing and perceiving. The same held for the subjects who knew the answer was wrong, but asserted this opinion. Only in the subjects who expressed their opinion against the group opinion was the brain area that is relevant for nega-

<sup>143</sup> See Asch, Solomon E. (1951) and Jonas K./Stroebe, W./Hewstone M. (2007), pp. 9, pp. 379.



Fig. 7.15 telephones 2 (Solution:  $12 \times 20 + 31 = 277$  telephones)

tive emotions and for social behavior active.<sup>144</sup> In this way, people are seen as social creatures who are already living on a group-formality and who already feel social non-acceptance as punishment (normative social influence).<sup>145</sup>

In an experiment by Robert Cialdini, Raymond Reno and Carl Kallgren, two different areas were created in front of a library: a clean area and a dirty one. Afterwards flyers were stuck to the windshield and people’s behavior was observed. In the clean area only slightly more than 10% of the subjects threw the flyers to the ground and the dirty area was about 30%. Sociology here speaks of descriptive norms (or perceived norms), since they are perceived only by the behavior of others in concrete situations, regardless of whether the behavior is socially desirable. The environment had been polluted by others, although this was contrary to the norm so most people acted accordingly. In the second experiment, the researchers once left the visual area clear from all dirt and paper and once they demonstratively threw papers on the ground. In the face of the good example only around 8% threw the leaflet on the ground and in the dirty area even less than 5%. Apparently the dirty environment had a moral reinforcing effect. In this so-called injunctive (challenging) norm, peo-

<sup>144</sup> See Aronson E./Wilson T. D./Akert, R. M. (2008), p. 244.

<sup>145</sup> See Aronson E./Wilson T. D./Akert, R. M. (2008), pp. 241 and Jonas K./Stroebe, W./Hewstone M. (2007), pp. 379.



**Fig. 7.16** telephones 3 (Solution:  $12 \times 20 + 40 = 280$  telephones)

ple orient themselves to what behavior of others is actually desired in a situation. The importance of the model and culture for the behavior of the employees in the company also depends on this. Injunctive norms are more powerful than descriptive norms.<sup>146</sup>

The influence of authorities as negative role models can also be proved with the well-known experiment of Stanley Milgram of 1961. Subjects should teach other subjects and punish the students with electric shock if the performance is poor. They were asked to do so by the game leader in a white coat as an authority. They forgot the social norm not to harm others. 62.5% went up to the maximum of 450 volts.<sup>147</sup> In 2012 an experiment was carried out by and on Facebook, where the users' posts were manipulated. It was found that negative mail caused the users to more negative posts and vice versa. In this way, man is influenced morally by other people, which can be attributed to the influence of corporate culture as the behavior of many people on the individual employee.<sup>148</sup>

<sup>146</sup> See Aronson E./Wilson T. D./Akert, R. M. (2008), pp. 259; Jonas K./Stroebe, W./Hewstone M. (2007), pp. 414 and <http://www.cobocards.com/pool/de/card/4emnb0513/online-karteikarten-injunktive-und-deskriptive-norm/>

<sup>147</sup> See Aronson E./Wilson T. D./Akert, R. M. (2008), pp. 261 and Jonas K./Stroebe, W./Hewstone M. (2007), pp. 400.

<sup>148</sup> See [http://www.chip.de/news/Manipulation-Facebook-Experiment-im-Eigenbau\\_70849545.html](http://www.chip.de/news/Manipulation-Facebook-Experiment-im-Eigenbau_70849545.html); <http://www.spiegel.de/netzwelt/web/facebook-experiment-aerger-um-manipulierte-news-feeds-a-978147.html#js-article-comments-box-pager> and <http://www.faz.net/aktuell/wirtschaft/netzwirtschaft/der-facebook-boersengang/facebook-managerin-sheryl-sandberg-entschuldigt-sich-fuer-psycho-experiment-13024578.html> (retrieval 24.07.2014).

Immoral behavior intensifies immoral attitudes in a culture. Judson Mills checked the attitude of the students toward cheating at a primary school and then they had to take an exam that was so difficult it could only be passed by cheating. He explained to the students that they cannot be caught while cheating, but this was not correct. Some students did not cheat, while others did. Then the students were questioned again about their attitude to cheating. The students who had cheated had now a more lenient attitude to cheating, and those who had not cheated rejected cheating even more.<sup>149</sup>

#### 7.3.4.4 Measurement of Company Culture

The first step would be to capture the company's culture in order to match it with the corporate guidelines. If there is a clear discrepancy, the culture must be changed. Surveys, and behavioral criteria, such as the ability to meet the needs of the customer, can be assessed through response times and customer queries.

Political science has a theoretical approach named Political Culture, which is here understood as the "distribution of political knowledge, value convictions, attitudes and behavior within the population at a specific point in time."<sup>150</sup> The initiation of this approach came from the question as to why democracy was sustainable in some countries and not in others despite the required system institutions and order, particularly where a democratic system had been newly installed. The concrete occasion for this question was the failed democracy of the German Weimar Republic, which led to Hitler's dictatorship. Political scientists determined that it is not sufficient to simply install a democratic order in the respective country. The system of order must be understood by the populace and carried by them as well. Political attitudes, thus the political culture, must fit with democracy. The methods to measure political culture are opinion surveys with direct and indirect questions, meaning hidden and control questions, which is generally known as opinion research.<sup>151</sup>

The political culture approach can be applied easily to the economically relevant attitudes, to all of the attitudes within the population of a country important to the economy. We can call this the "economic culture approach." The attitudes relevant to the functioning of society can be called the "social culture approach." What are the socially relevant attitudes? The most important have already been addressed; moral values that benefit living together in a community, and the functioning of social processes, such as reliability, honesty, helpfulness, a willingness to make sacrifices, as well as the readiness to observe societal rules by subordinating and restricting oneself. All of these characteristics are social capital because they are necessary in order for the society to create added value. Many of them are economically relevant because they reduce the costs of economic transactions or even enable

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<sup>149</sup> See Aronson, E./Wilson, T.D./Akert, R.M. (2008), pp. 171.

<sup>150</sup> See Reichel, Peter (1981), p. 26.

<sup>151</sup> See Reichel, Peter (1981), p. 26.

them to take place. These characteristics are also what create trust. As we have already mentioned, even a simple exchange of goods would not take place if both parties fundamentally distrusted each other. It is possible to work around this problem through contracts and a functional legal system, at least to a limited extent, but it comes with high transaction costs. Business with less added value for the participants than the transaction costs is not sustainable.

For our purposes we differentiate between attitudes relevant to society, economics and business and we develop corresponding questions, although there are of course overlaps. The attitude of being “thankful” is a characteristic, but humans are capable of choosing their attitudes and continuing to be thankful, while a characteristic such as aggressiveness or violent-temperedness is not as easy to reconsider and change. Changing attitudes can also be very difficult, depending on how deeply anchored they are. Many attitudes have been part of our upbringing since childhood through our parents or society, without our even being aware of it. For our purposes we are particularly interested in the attitudes that can be influenced or changed. We assume that the characteristics of each personality depend on the character of the person and are thus innate. Characteristics shouldn’t be expected to change between nations, nor change within the same society over time. The questions should make the Social Culture and Economic Culture Approaches understandable for the reader. The final questions serve to determine the attitudes of the people affected in a society or in a company. They must therefore use subtler, hidden questions and control questions, so that the interviewees cannot guess what the questions are getting at. The following questions are thus neither very open nor understandable, which would otherwise make negative associations in the questions clear.

We can find six basic characteristics relevant to a society, national economy or business.

1. Reliability 2. Loyalty 3. Team competence 4. Willingness to perform, 5. Integrity and 6. Acceptance of the system.

### **Reliability**

A person is considered reliable if they keep their promises and agreements. Moral values such as honesty and responsibility belong to the category “reliability.” Reliability is especially important for a company when the tasks delegated to employees must be correctly implemented and added value created through cooperation within the company. Reliability is also an important attitude for a national economy. The sum of productivity from all of the companies determines the productivity of the national economy, and reliability is very important for all transactions between companies and other market participants. A society considers it important that people can rely on one another, as they might in a marriage.

Possible questions would be (to be answered with yes or no):

- The saying “honesty is the best policy” just offers consolation for dumb people who aren’t able to get what they want. (Answer expected from those who are reliable: no)
- My good reputation is important to me. (Answer expected from those who are reliable: yes)

- For me promises are declarations of intent. You can't keep every promise. I don't expect from others to always keep their promises. (Answer expected from those who are reliable: no)
- I try to spend time with my children every day and concentrate on their problems. (Answer expected from those who are reliable: yes)

### **Loyalty**

Loyalty is generally considered lasting gratitude. In an ideal marriage for example, both husband and wife are thankful for mutual sacrifices. The employee is thankful to the company for enabling him to feed himself and his family, and for being treated well. The employee is therefore prepared to go above and beyond for his employer in the interests of the company as a way of giving back. Surely a certain degree of humility is necessary, since the opposite of humility would be make shameless demands, which cannot make loyalty any more likely. Employee loyalty is very important for companies. On the other hand, the employee is dependent on the company not dropping him whenever it might be advantageous.

Possible questions would be (to be answered with yes or no):

- I am thankful to have my job. (Answer expected from those who are loyal: yes)
- My employer needs me and I need my employer. (Answer expected from those who are loyal: yes)
- I am in the debt of whoever helps me. (Answer expected from those who are loyal: yes)
- I don't expect anything, but I am thankful for any help. (Answer expected from those who are loyal: yes)
- Everyone has to watch out for themselves. (Answer expected from those who are loyal: no)

### **Teamwork Capability**

We understand individuals to be capable of teamwork when they are willing to subordinate or integrate themselves in a group in order to reach higher goals. Besides seeing the necessity to integrate oneself, positive feelings such as sympathy for others as the basis for helpfulness is part of teamwork capability. It is also required to reach a common performance within networks, and thus important for all companies. Society is also dependent on productive teamwork. Examples here might be self-administration, public social aid, church organizations and clubs with social functions. The national economy profits indirectly from teamwork through companies that are more productive.

Possible questions would be (to answer with yes or no):

- In a community everyone helps everyone else out. (Answer expected from those who are team capable: yes)
- Together we are strong. (Answer expected from those who are team capable: yes)
- The individual must sacrifice sometimes for the good of the whole. (Answer expected from those who are team capable: yes)

- Do not ask what your country can do for you, ask what you can do for your country. (Answer expected from those who are team capable: yes)
- I am a part of the whole. (Answer expected from those who are team capable: yes)
- To give is greater than to receive. (Answer expected from those who are team capable: yes)
- Life is often unfair, which is why the strong must help the weak. (Answer expected from those who are team capable: yes)
- I am pleased when I can help someone. (Answer expected from those who are team capable: yes)
- Everyone has strengths and weaknesses. (Answer expected from those who are team capable: yes)

### **Willingness to Perform (or Commitment)**

People are willing to make an effort if they are either industrious by nature and consider work to be a part of life or they wish to achieve other goals by working, such as affluence or social recognition. Ambition and purpose encourage the willingness to perform well. A degree of seriousness is also necessary, however. Being focused on having fun does not bring achievements except perhaps at the beginning of a task. Over the long term, and in the degree of perfection a project may need in its details or difficulties during implementation, fun drops away and stress increases. The fun gets serious. For this reason the question personnel consultants often ask in interviews as to whether they enjoy the work is not helpful. Asking whether the applicant identifies with the work, considers it positive and engages with it would be better. Willingness to put in an effort is mostly important for the production process, for the economy.

Possible questions would be (to be answered with yes or no):

- I want to make a positive difference. Dolce Vita is not enough. I want to do something with my life. (Answer expected from those who are willing to make an effort: yes)
- Where there is a will, there is way. God helps those who help themselves. (Answer expected from those who are willing to make an effort: yes)
- No effort, no rewards. Moss grows on a rolling stone. (Answer expected from those who are willing to make an effort: yes)
- To make sure my job is secure I must make more money for my employer than I cost. (Answer expected from those who are willing to make an effort: yes)
- There should always be enjoyment. (Answer expected from those who are willing to make an effort: no)
- I don't allow myself to be taken advantage of. I have to think of myself first. Everyone does. (Answer expected from those who are willing to make an effort: no)

### **Integrity**

When confronted with a choice between paths to take, a person has integrity if they always try to take the correct, legal path where no one is treated unjustly or harmed. We could call this fairness.

Possible questions would be (to be answered with yes or no):

- To reach sales goals your boss demands that you describe false product features to your customers. (Answer expected from those who have integrity: no)
- To reach sales goals your boss demands that you manipulate the sales figures for your department. (Answer expected from those who have integrity: no)
- Your boss wants to get rid of your colleague and demands that you make a false accusation against them. (Answer expected from those who have integrity: no)
- You are married when an attractive woman or man offers a little adventure. You would be silly to let a chance like that slip by. (Answer expected from those who have integrity: no)
- Your spouse has an auto accident and becomes crippled. Do you get a divorce, since these are new conditions under which you did not get married? (Answer expected from those who have integrity: no)

### **System Acceptance**

Democracy and market economy conflict if there is not enough cultural acceptance for the way a market economy functions. In a democracy politics are neither capable of choosing optimal framework conditions for a market economy, nor creating policies that increase welfare through a market economy if the population does not accept it. Examples of this are a certain inequality in distribution and the basic understanding that one cannot demand more from the market than they contribute. Education about the market economy begins in schools and thus every state must be active in forming this education if it wants to make the system work. There is a lack of acceptance and understanding for market economy correlations, which explains why politics tend to disregard market economy rules and thus takes on losses in welfare.

Is system acceptance, also an attitude of employees, relevant for companies? Of course! This idea is perhaps new and thus unusual, but upon closer inspection the importance of this attitude becomes clear. We have already mentioned that many people have a highly developed sense of justice. This feeling becomes even stronger when the unequal treatment felt to be unjust is related to the respective person. The negative emotions to come from such feelings can be counter-productive for a company. If an employee finds it unfair that his boss earns double what he does, it can lead to anger and uncooperative behavior, even a refusal to perform or disobedience. The same applies for the national economic system as a whole. If a citizen rejects the system he can also refuse performance and cooperation, integration in the system; in other words he can simply refuse to participate constructively and vote for an extremist party. It is sufficient if the citizen does not understand the need to be productive and participate actively in the market economy system for this behavior to come about. If he has a passive, demanding form of thought, for example, he will demand that the state (like his parents) feed him, even if he does nothing. The same

demanding attitude can of course develop in relation to a company. System acceptance requires an understanding of the system, which is where the state and companies must jump in. With the respective control questions, we can test for system understanding and acceptance in order to counter this deficit through information.

Possible questions would be:

Knowledge questions: What do you associate with market economy? What do you connect with Socialism? What are the advantages and disadvantages of a market economy?

Attitude questions (to be answered with yes or no):

Is it time for a just Socialism? (Answer expected for system acceptance: no)

Is it fair for everyone to receive what they need in life? (Answer expected for system acceptance: no)

Does earned wealth exist? Do you think the rich are entitled to their wealth? (Answer expected for system acceptance: yes)

Is your performance in the company rewarded? Is your effort worth it? (Answer expected for system acceptance: yes)

We have seen that the figures from controlling do not provide a comprehensive picture of companies. Companies should at least conduct internal surveys and publish the most important results, since soft facts are so important. This includes information on the human capital of the most important managers in the form of excerpts from their resumes. Otherwise the capital investors cannot conclusively evaluate what the consequences of poor capital allocation might be.

Technical progress forms the economy and thus the framework conditions of social existence. Thus theoretically there is not one single optimal social, political and economic order for each economic and technical stage of development with which it is possible to maximize economic productivity of the system for the good of the society. The most interesting thing we see here is that morality and economic efficiency are not contradictory. Economy can only function with people if they are at the center. Economic laws and human characteristics must both be respected, although an economy as the sum of economically relevant institutions and organizations created by people is there to serve the people. Only in this way can it be useful and justify its existence.

However, societies vary in their preferences just as individual people do. Many characteristics are part of a society's identity, with certain strengths and weaknesses that must be accepted. It would therefore not maximize benefits or satisfy needs to demand the same political and economic systems with their respective political and economic cultures from all societies. Every society must find the best path for itself. It is only important that it is conscious of the importance of qualitative factors for social welfare and that it actively implements and maintains values that support productivity balanced against other social goals.

### 7.3.4.5 Cultural Management, or How I Change Corporate Culture

Cultures are not clearly structured. They are ambiguous symbolic constructs, which cannot be traced to a simple cause-effect relationship, and a large part of them cannot be quantified because many behavioral dispositions are created in the subconscious. Cultures are not genetically inherited and not rationally learned as patterns of action, they are learned unconsciously by acting in the group. Culture is experienced through an indirect process in the group through socialization (or deculturation). To make such a process artificially repeat or to plan linearly according to a pattern appears impossible against this background. Moreover, the cultures have developed more or less spontaneously over many years. Nevertheless, they essentially consist of orientation patterns of action and values, which is why they can also be influenced. People are able to be aware of their values and norms, to reflect on them and to change them intentionally. According to Schreyögg, it is mainly about convincing organizational members that a cultural change is necessary and motivating them to try something new.<sup>152</sup> It has to be added that the management is responsible for implementing the company's own standards.

How is a corporate culture created? The employees contribute norms and values from outside and through cooperative work in the company. Culture acts as an institution of action.<sup>153</sup> The group, or more precisely the culture of the group, creates a certain pressure to adapt by sanctioning deviant behavior with exclusion and by encouraging the individual to seek the recognition of the group by adaptation. Sociology speaks of enculturation as a conscious and unconscious imitation, practice, internalization, interpretation and empathy of the individual, and of a second socialization after childhood as conscious learning and prescribing on the part of the deculturing culture. People learn and internalize corporate culture through certain roles they occupy within the group, adapting to the patterns of thinking and feeling through internalization (internalization) of the company's norms.<sup>154</sup>

Internalization of norms can be an adjustment in the direction of the company goals, but it does not have to. It is also conceivable that the dominant majority of the group agrees to make a harmonious environment in the company without much trouble, that is, consumption on the job. If one wants to influence the corporate culture, one has to start with the group, the dominating individuals. These are the leaders because they have the power to reward or sanction behavior. The executives are a role model because of their position. They show the employees how they must behave in order to be rewarded in the enterprise hierarchy. They are imitated to gain advantages in the company or to be generally successful, i.e. to make a career. If it is not possible to win the managers over to the cause of the company management, there is no alternative but to replace them.

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<sup>152</sup> See Schreyögg, Georg (1991), pp. 210.

<sup>153</sup> See Neuberger, Oswald/Kompa, Ain (1987), p. 62.

<sup>154</sup> See Berger, Peter L./Luckmann, Thomas (1972), pp. 148 and Geissler, Harald/Heidsiek, Charlotte/Petersen, Jendrik (2010), pp. 7.

Is it allowed to influence people in the company? There are authors who reject this as a kind of manipulation.<sup>155</sup> Other authors see the necessity of influencing corporate culture precisely when it contradicts social morality. It is about a culture-conscious management.<sup>156</sup>

Here we encounter the fear that we will be brainwashing employees into automations. The point, however, is the creation of an ethical environment in the form of corporate culture. This is more humane and leaves the individual even more freedom. A strictly hierarchical corporate organization that knows only command and obedience, is both unethical and unfree.

If one wants to change the behavior of people, one needs their willingness to do so. That means employees have to be convinced that their behavior has disadvantages for them and/or the company. Corporate culture brings many benefits as practiced behavior. The employees know how to behave and feel safe. Replacing them therefore also means taking away their sense of orientation. Furthermore, there are always advantages that an enterprise culture offers to individuals who do not want to give it up. The future cannot be assessed, which means uncertainty. A change in culture can also be associated with a loss of power for the leaders, for example, changing from authoritarian to participatory leadership<sup>157</sup> or preserving hierarchical levels.

According to Probst, approaches to the change of corporate cultures can be symbolized by the language, artifacts and actions. They send out signals for employees. The culture expresses itself in language, through which meanings and values are transmitted. It can be seen in the use of first names or surnames and go on to companies that give themselves their own language, more precisely words, titles or function names. In his methodology, Kant recommends using convincing examples of dutiful action to encourage virtuous behavior. Similar stories can be found in employee magazines. In a broader sense, gestures and forms of expression can be included in specific language.<sup>158</sup>

Guidance consists of language and actions. Language is also used to gain attention. Terms such as corporate citizenship, reputation management, corporate social responsibility (CSR) or corporate responsibility (CR) express something new, international and give the impression of an informational advantage in comparison to the old expression of corporate ethics. Corporate citizenship is now largely used in the same way as philanthropy and patronage.<sup>159</sup> In a survey of 443 executives in the German economy, 79.5% thought that not all CSR projects of their company were actually based on true conviction, but rather on the positive external representation.<sup>160</sup>

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<sup>155</sup> So wird Ulrich Sloterdijk zitiert. See Ulrich, Peter (1984), p. 318 and Osterloh, Margit (1989), p. 153.

<sup>156</sup> See Schreyögg, Georg (1991), p. 207.

<sup>157</sup> See Schreyögg, Georg (1991), pp. 210.

<sup>158</sup> See Probst, Gilbert J. B. (1987), p. 100.

<sup>159</sup> See Lin-Hi, Nick (2014), p. 16.

<sup>160</sup> See Die Akademie für Führungskräfte der Wirtschaft (2012), p. 18.

Instruments for influencing corporate culture are all ethics tools, such as corporate principles and ethics seminars. However, actions express the power of the factual. No order is taken seriously if it is not implemented by acts. The actions concern all business processes and produce the results relevant to the employees, which are rewards as well as recognition (rites and ceremonies), which including the official honoring of employees (for example the employee of the month), though promotions also send signals to employees on how they should behave in order to be successful in the company.

Further instruments for influencing corporate culture are artifacts. Artifacts are bodies created by people, in the case of companies, the buildings and equipment with which the employees work. Corporate culture can support ethical behavior through the establishment of groups and meeting rooms, but also by light and friendly colors. In addition, attributes and status symbols determine the distribution of power, and thus also the distance between the employees. When a superior has the privilege of a large, valuable office, it also symbolizes distance to the subordinates and strengthens the hierarchy. If the ethics officer has a small office as an organizational tool for whistleblowing, it shows the employees that the ethical orientation is classified by the management as not so important or subordinate.<sup>161</sup> All measures, such as the organization of the company, the establishment of control and information systems, the allocation of employees to the offices and the distribution of business or tasks, etc., all form the broad framework of corporate culture.

#### 7.3.4.6 Ethical Corporate Identity

The ethical corporate identity is derived from the ethical corporate culture and is intended to ensure a high level of identification of the employees with the company and with the company's goals. This is intended to increase the willingness to perform, a better working atmosphere, higher satisfaction and fewer conflicts through a higher willingness to cooperate. Externally, the corporate identity should create the image of a strong, self-confident company. An ethical corporate image thus serves the formation of an ethical corporate culture within, the ethical reputation of the company without, and creates trust among the stakeholders.<sup>162</sup>

Ultimately, the importance of corporate identity has decreased in the past decades, which means the internal, emotional and moral attachment of the employees to the company in particular. This has made the principal-agent problem more acute. In the past, a company's management would have been expected to work hard in the company or at least have learned about the most important value-added stages and corporate identity before being promoted. This not only had the advantage that managers could better assess the impact of their decisions on the company because they knew it, but also had a stronger identification with the company. Furthermore,

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<sup>161</sup> See Göbel, Elisabeth (2010), pp. 226.

<sup>162</sup> See Balmer, John M. T./Fukukawa, Kyoko/Gray, Edmund R. (2007); Esch, Rudolf (2015) and Grabner-Kräuter, Sonja (2000).

the risk of failure due to hidden characteristics was less because the management had to prove itself in the company for many years. The principal-agent problem can ultimately only be overcome by increasing the interest alignment of agent and principle, or more generally, by promoting the identification of the agent (manager) with the company so that he becomes more of the traditional entrepreneur outlined above. However, the problems of hidden characteristics, hidden information, and hidden actions exist at every level of leadership to the subordinate decision-making units. We are therefore looking for a holistic ethical approach to management.

Corporate culture is formed mainly by the management. Leadership consists mainly of actions. At present, managers' compensation is being discussed. Both the ratio of the manager's remuneration to the remuneration of the employees at lower hierarchical levels as well as a highly variable remuneration for performance despite obvious mistakes result in negative signals for the employees.

### **Summary**

In groups, people take on roles that influence their behavior. Groups have a group-adjusted moral behavior with their own norms. Anonymity in the group reinforces immoral behavior. It has been demonstrated with fMRI scanners that people feel negative emotions when they behave differently from the group. Corporate culture plays a key role in the success of the company. An ethical corporate culture is a competitive factor because it directly influences the cooperation of employees and therefore the added value of the organization, mainly from the division of labor, which strongly influences synergy. The leaders are first and foremost responsible for an ethical corporate culture. The values and attitudes of the employees should be recorded regularly.

As we have seen, technical progress shapes the economy and thus also the framework conditions of social existence. Thus there is not only an optimal social order suitable for every economic and technical development, but also a corresponding social and economic culture, with which one can maximize the economic productivity of the respective system for the benefit of society. Whether this optimal social culture suits the respective nation, makes it possible to achieve or is even desired, are different questions altogether. Our goal is not only the maximum economic production with the corresponding material prosperity, but the maximum human need satisfaction, thus the happiness of the people in a society. The economy here is only a means to an end. It serves man and not vice versa. We can sum up the result of our considerations as follows: Morality is of great importance where people interact with each other to pursue a common goal, especially in the economy.

### **Comprehension Questions**

1. Define company culture.
2. Why is company culture important for the success of a company?
3. Which values and characteristics do you consider particularly important for employees to create a productive and ethical corporate culture?
4. How can you influence company culture?

### 7.3.5 *Ethical Leadership*

Managerial powers are delegated to executives in order to implement the company's objectives. Personnel management is then the influencing of assigned employees to the achievement of the enterprise goal (**definition**).

In the field of personnel management, a "basic complementarity" between economic and social efficiency is frequently assumed as the fulfillment of employee social expectations. Krell also points to the partial conflict between the two goals. Social efficiency can often only be achieved by reducing economic efficiency.<sup>163</sup> Hey and Schröter demand that management ethics be designed in such a way that the employees are motivated to make their maximum contribution to the achievement of the company goal.<sup>164</sup>

There are two aspects of human resource management that are relevant to ethics. On the one hand, it is about the human relationship between leadership and employees, who both have as human dignity and deserve ethical protection. On the other hand, the question arises as to how far the economic efficiency is influenced by ethical behavior.

#### 7.3.5.1 **The Relationship between Management and Employees**

The company hierarchy is the starting point for the management of the employees by the superiors. The superior has the right to direct his employees. This is the basis for the organizational form of companies and thus allows for efficiencies. The legitimation for this power structure is the employment contract. In this respect, the employee voluntarily agreed to comply with the instructions of the supervisor. However, there is often a dependency of the employee on the employer, since the employee is usually dependent on income from the employment contract.<sup>165</sup> Adam Smith was one of the first to point out this balance of power and the possible immoral consequences.<sup>166</sup>

Management is also dependent on the performance of the employee. Information asymmetries favor the employee, since they can deceive their superiors about their intentions and abilities and deny information within the company. In turn, the executive has exclusive knowledge not known to the employee (asymmetrical information).<sup>167</sup>

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<sup>163</sup> See Krell, Gertraude (1999), p. 342.

<sup>164</sup> See Hey, Dieter/Schröter, Armin (1985), p. 31.

<sup>165</sup> See Wittmann, Stephan (1998), p. 196.

<sup>166</sup> See Smith, Adam (1993), pp. 58.

<sup>167</sup> See Göbel, Elisabeth (2010), p. 194.

The employer depends on the loyalty of its employees because it cannot force employees to use their full productivity or to fully monitor and sanction their behavior.<sup>168</sup>

Employees are also ethically committed to their employer. They are obliged to use him and not to harm him. This is called loyalty. Both parties have entered into an unofficial loyalty agreement. Firstly, they have to provide their labor to the employer, which means, for example, that no “consumption on the job”<sup>169</sup> is carried out through excessive private telephone calls. Important information must be handed over to the employer and an honest co-operation applies to both the employer and the employee. The employer’s property must be respected. The interests of the employer are to be represented objectively, which excludes advantage, from bribery, and by lying such as faking illness (integrity).

Ethical obligations arise towards the colleagues, both from the employment contract and the fact that they are humans. Here, too, colleagues are to be treated with respect in particular, not to be ganged up on. The team approach requires open, honest communication, a good working environment and mutual support.

The inconsistency of employers can generate dilemmas for their employees. For example, they promote competition among the employees in order to increase productivity, but also demand full cooperation within the framework of teamwork. If employees report mistakes, they often face reprisals. Constructive criticism is not desired. If employees reveal errors to executives, it is often to their disadvantage.<sup>170</sup>

Apart from the obligation to work, the legislature usually prescribes other duties of the employees. They must preserve secrecy about business secrets; they must not make any reputation-damaging or credit-damaging statements. For example in Germany, they may not harm the employer through competition and are obliged to obedience (§ 241 II BGB). They are, for example, obliged to warn the employer of imminent damage.<sup>171</sup>

### **Rolling Game: The Ethical Responsibility of the Employer**

You are a personnel manager, you will learn about emotions present in a critical staff discussion: Inform the employee about his dismissal.

1. Situation of the employer: The product line of tableware goes to Romania. The employee is to incorporate the Romanians before he is released.
2. Situation Employee, of age 40, has been with the company for 16 years. He has a mortgage and 3 children (1, 3 and 6 years). His wife does not work.

<sup>168</sup> See Richter, Manfred (1994), pp. 15.

<sup>169</sup> See Göbel, Elisabeth (2010), p. 201.

<sup>170</sup> See Göbel, Elisabeth (2010), p. 202.

<sup>171</sup> See also “Treu und Glauben” (good faith) § 242 BGB, <http://wirtschaftslexikon.gabler.de/Definition/fuersorgepflicht.html?referenceKeywordName=Schutzpflichten+im+Arbeitsverh%C3%A4ltnis> and <http://wirtschaftslexikon.gabler.de/Definition/treuepflicht-des-arbeitnehmers.html> (19.09.2012).

### Moral Justification Strategies

In the above situation, you were forced to harm someone else, to behave non-ethically. How did you cope with the situation? How did you justify your behavior?

This was an ethical dilemma situation. You had the choice to do your job and harm the others or refuse the order. Refusal would have been a reason for dismissal or demotion and you would have damaged yourself. Often we tend to justify our behavior to ourselves in such a situation. In this case, the employer could say:

1. "If I don't do it, someone else will." (Relativity of responsibility)
2. "I need to think about my family." (Change of balance by increasing one's own damage). This is moral self-protection, which can also be abused. One wishes to preserve one's self-esteem, but the consequences of ethics can ultimately determine the result of the moral evaluation. These are called neutralization strategies.

Other common neutralization strategies are:

3. "It was an accident!"
4. "Others are guilty" (stating their own responsibility),
5. "This is not so bad!" Or "I've only borrowed it." (Relativization of the damage),
6. "He deserved it." (Reduction of the sacrifice),
7. "Anyone would have behaved this way." Or "They would have done it." (Depreciation of the other or of the condemned).<sup>172</sup>

The last form of the neutralization strategy is particularly applicable to an unethical corporate culture. Here, however, the danger presented by ethical ethics as an appraisal is also shown by the fact that it is responsible for the immoral behavior not the individual, but the state of affairs, which is sufficiently ethically regulated and can therefore be used by the individual as a neutralization strategy.

### Behavioral Standards for Leadership

The employees are a production factor of the enterprise and the economy. Are they just a means of achieving the goal of maximizing profit? In his categorical imperative Kant asks not only to treat man as a means, but also as an end, that is, as a man with his own dignity.<sup>173</sup>

The following norms for dealing with supervisors and employees can be found in the literature of ethics<sup>174</sup>:

1. Respectful relationship with each other, without harassment, insult, degradation or sexual harassment

<sup>172</sup> See Sykes, Gresham M./Matza, David (1957), pp. 667.

<sup>173</sup> See Kant, Immanuel (1797a), (C), p. 429.

<sup>174</sup> See Ulrich, Peter (1999), pp. 238 and Lay, Rupert (1989), pp. 140 zu den Grundsätzen der Führungsethik.

2. No discrimination, in particular, no unequal treatment in terms of promotion and payment and recruitment
3. Protection of privacy, acceptance of conscience, respect for dignity and freedom of employees, protection of personal data
4. Protection of health, particularly human work relationships

The following “meritorial duties” for the superior are derived from Kant<sup>175</sup>:

1. Communication among equals, rather than command and obedience
2. Explanation and honest information
3. Praise and blame (as constructive criticism)
4. Empathy and support

Working conditions should be “encouraging”:

1. Purposeful tasks with a variety of requirements
2. Scope of action, thus also self-responsibility and freedom for personal development
3. Possibilities for social interaction
4. Development options for the employee

The fact that the situation is different in reality is due, on the one hand, to the lack of knowledge about rights and obligations and, on the other hand, to the dependence of many employees on their employer. There is still unpaid overtime, the exploitation of unorganized workers, through temporary work and work contracts, surveillance and control through cameras, bullying and the prevention of the formation of [employee organization](#).

Executives can demand immoral actions from their employees to increase profits. Such instructions are not legitimized by the employment contract, but there are always such immoral instructions that the employees follow, because they feel they cannot refuse their superior.

Balancing consequences must take place precisely at the management level. The profit does not justify any means with damaging consequences for others. The supervisors bear a special responsibility for their actions, as the employees need them in many areas and their behavior directly affects the employees and third parties. Power is therefore the ability to produce other consequences.<sup>176</sup>

Such unethical behavior can, however, be in the interest of the company at least in the immediate term. Managers often seem to fall into the argument that they are forced to act in the interests of shareholders and immoral employees to maximize profits.<sup>177</sup> They then have no guilty conscience and feel protected by the company in the event that their misconduct is disclosed.

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<sup>175</sup> See Kant, Immanuel (1797a), pp. 13 and Göbel, Elisabeth (2010), p. 195.

<sup>176</sup> See Ulrich, Werner (1980) and Göbel, Elisabeth (2010), p. 200.

<sup>177</sup> See Gellerman, Saul W. (1986), pp. 88.

**Summary**

The executive has a special responsibility to his employees. There is a mutual loyalty obligation and an unofficial loyalty contract based on mutual trust. An ethical weighing-up of the action sequences must take place, in the case of leadership. A superior who orders a crime is punishable; likewise, the employee who performs a crime is also responsible. At best, there is a penalty reduction if there is a strong co-dependency on the executive.

**Comprehension Questions**

1. What is the interdependence between management and employees?
2. What is an unofficial loyalty contract?
3. What is the duty of the employer to be a member of the employer's liability and therefore also the managerial power?

**7.3.5.2 Leadership Styles**

It is true that the concept of leadership styles is controversial. The concepts cannot be clearly delineated and the style depends on the personality of the executive and the situation.<sup>178</sup> Nevertheless, there are hardly any alternatives to define the directions for optimal handling of employees.

There are many different approaches, which differ essentially by the involvement of employees in the decision-making process. We want to summarize the various management concepts into three types. Lewin distinguishes leadership styles as authoritarian (also hierarchical), democratic (also cooperative) or laissez faire.<sup>179</sup>

**Authoritarian Leadership**

Leadership gives instructions as commands without involving the employees in the decision-making process. It also does not explain the decisions or tasks. It retains the information and the reasons for the decision (therefore autocratic leadership style). There is a great personal distance between management and employees, which is why we speak of hierarchical leadership. If the instructions are not carried out or are incorrectly executed, the management reacts with sanctions. Praise is rare.

The advantage of this style of leadership is that it can be implemented quickly, without explanations, discussions or contradictions. This is why it is used mainly in the military. It also enables the management of less qualified employees, but requires intensive control and a high level of expertise from the manager. As a result, the decisions are very much dependent on the supervisor, which is why this style is preferred by managers who do not shy away from force. Conversely, this style of leadership is less motivating, since the employees do not feel personally addressed and do not know the background of their work or task. The competences of the

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<sup>178</sup> See Rost, Joseph Clarence (1993), pp. 17.

<sup>179</sup> See Lewin, Kurt/Lippitt, Ronald/White, Ralph K. (1939a, b), p. 271.

employees is limited and their information is not of value, which means that the risk of making incorrect decisions is higher.

### **Cooperative Leadership Style**

In the case of cooperative management, the employee is integrated into the decision-making process by the manager, thus it is also called democratic or participatory style. This makes the employee more motivated, but the decision-making process takes longer. In the case of errors, the employee is not directly punished, but supported. The disadvantages of the authoritarian style of leadership are the advantage of the democratic leadership style and vice versa. The potential of the employee can be better used for the benefit of management and employees. The risk of incorrect decisions is reduced by including the competence and knowledge of the employee. The working environment is improved by cooperation and the associated recognition of the employee. However, employees and leadership must be more qualified for this type of leadership style.

### **Laissez-Faire Style**

This style of leadership, or free-reign style, is characterized by maximum freedom for the employee. The leadership does not interfere and delegates work decisions, the organization of procedures and their implementation to the employee. This approach is used in creative departments, such as the fashion sector. This approach is characterized by non-leadership, so it is not a leadership approach in the narrow sense.

Lewin, Lippit and White analyzed the influence of these three different leadership styles on the employees and their performance. In their study the autocratic style led to high performance in the short-term but also led to negative feelings. In contrast, the democratic style created positive feelings for team members but resulted in lower performance.<sup>180</sup>

There are many other leadership concepts. Daniel Katz and Robert L. Kahn distinguish between production-oriented behavior and relationship-oriented behavior as a leading style. Already Katz and Kahn assumed that an employee-oriented management style with a high level of satisfaction also increased the performance of the employees.<sup>181</sup> Robert R. Blake and Jane Mouton distinguish five leadership styles according to the different characteristics in the areas of task orientation and personal orientation. This results in different styles with varying or weak expressions of the two dimensions. Hersey and Blanchard extend these dimensions by incorporating the maturity of the employee, resulting in four leadership styles. The lower the personal maturity and education of the employee, the higher the task orientation, which in the extreme becomes the authoritarian leadership style. This is followed by an integrated management style for more mature employees. In the case of an above-

<sup>180</sup> See Lewin, K.; Lippit, R. & White's, R. (1939a, b) and Abu-Hussain, Jamal (2014).

<sup>181</sup> "A worker who perceives management as interested exclusively in cutting costs and getting maximum production at the least costs possible may easily conclude that the union organization offers a better means for the protection of his interests." Katz, Daniel/Kahn, Robert L. (1952), p. 652.

average maturity, a relationship-orientated style then becomes a participatory style and at the extreme maturity of the employee a delegational style.<sup>182</sup> There are two important aspects of leading in organizations: one is to emphasize that protecting the interests of the organization is the duty of the members and the second is to deal with the needs of the team members to have them doing extra efforts voluntarily. In the managerial grid approach of Blake and Mouton the ideal leader is the one who combines both aspects with the highest score from task orientation and human relation orientation.<sup>183</sup>

### 7.3.5.3 Leadership Theories

There are theories about the best method of leadership. In the 1950s the so called “great man theory” was the decisive leadership theory. It stressed special traits of a leader as a prerequisite to influence members. Leadership is accepted based on the character of the leader.<sup>184</sup> Because it was difficult to determine the appropriate traits, later research focused on the specific behavior of leaders, which was called the behavioral approach. The behavior was dependent on the situation, which led to the situational approach.<sup>185</sup> Later the approaches analyzed the variables which determine the effectiveness of leadership in organizations with reference to the members. The outcome was the transactional and the transformational leadership theories. Current research is still scrutinizing the effect of leader behavior and traits on employee’s performance and can be divided in a more quantitative cost and benefit approach of influencing the followers and a more qualitative relationship oriented approach.<sup>186</sup>

#### Transactional Leadership

Transactional leadership (path goal theory of leadership)<sup>187</sup> is guiding with goal agreements. This approach is based on the expectation-valence theory. Performance should be stimulated by an expected reward. The basic assumption is a contract approach. The employee has the expectation, from his employment contract, of exchanging performance for reward. It leads to a management-by-exceptions where the leader has to monitor the performance of the members and has to sanction and reward according to their performance.<sup>188</sup>

As a special form of the target-oriented transactional style, one can lead through existential coercion. This concept is known as the up-or-out concept is currently widely used. It is set as a reward and sanction system by the company management.

<sup>182</sup> See Hersey, Paul/Blanchard, Kenneth H. (1993).

<sup>183</sup> See Blake, R. R. & Mouton, J. S. (1964a, b) and Abu-Hussain, Jamal (2014), p. 1268.

<sup>184</sup> See Stogdill, R. M. (1948) and Abu-Hussain, Jamal (2014), p. 1268.

<sup>185</sup> See Wren, D. (2005) and Abu-Hussain, Jamal (2014), p. 1268.

<sup>186</sup> See Abu-Hussain. Jamal (2014), p. 1268.

<sup>187</sup> See Downtown, James (1973) and Bass, Bernhard M. (1985).

<sup>188</sup> See Abu-Hussain, Jamal (2014), pp. 1269.

Up-or-out means that the employee must leave the company if he does not reach the targets. This concept superimposes all other forms of leadership styles through uncompromising standards. The individual supervisor cannot meet this requirement using their own style.

The up-and-out leadership concept goes back to Jack Welch, General Electric's CEO. One of his most controversial rules was the 20–70–10 formula, or the rule of stars and lemons. The best 20% of the management, the stars, were rewarded with lush bonuses, the broad center was still supported and the weakest 10% were made redundant as so-called lemons.<sup>189</sup> This rule also applied to the leadership of Skillings, Enron's CEO. In the Enron case, two factors are related: a non-human-oriented management of the employees and an extremely short-term-oriented success measurement of the employees combined with draconian sanctions. How should an employee react when he knows that he loses his job if he does not reach a profit of X by the end of the quarter?

Can you force performance? Certainly performance and commitment sometimes also need some pressure, but too much of it has a counterproductive effect. Even a competent and efficient employee cannot achieve success against the market. They must have competitive products that meet the needs of demand. A short-term success measurement has a counter-productive effect when most of the successful business processes are long-term. The same applies to the risk-adequate remuneration. If the specifications are incorrect, the employee cannot work optimally. If measured at the end of the quarter, he cannot build anything for 2 years and thus productive forces cannot unfold.

How should an employee react when he knows that he loses his job if he does not reach a profit of X by the end of the quarter? Can performance be enforced? Is loyalty unilateral to the employer? Under such conditions, the employee can no longer behave loyally to the company and advise clients objectively. A bank employee, for example, cannot advise customers to their advantage in the long term if he has to sell several products for this customer every quarter. Instead of selling when the customers experience a need, he is forced to sell the customer products that they don't need to reach quotas. The employee has to think about himself. He cannot afford to be fired at the end of the quarter. To a certain extent, he has to work against the company. If the figures are not achievable because they are disproportionate, there is great incentive to manipulate them and the employee has less of a guilty conscience than if they had been proportionate.

At Enron, not only did the employees work against each other but the management worked against the employees. The result was that the employees also worked against the management and thus against the company. Management did not involve employees as people in the company, but put them under pressure. The employees were thus not motivated and were unable to work independently for the benefit of the company. Skilling created a climate of fear among his employees. If he saw that an employee did not deliver the expected performance, they could count on their dismissal. But he could not control them and did not know what was going on in his

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<sup>189</sup> See Ridderbusch, Katja (2010).

company. He had little interest in why performance was lacking. He did not care about the employees, which is why he did not include them in the company process either. Independent, constructive, decentralized action did not occur. Rather, the employees tried to blind the management with misinformation and eliminate their colleagues. The management was shown a successful pseudo-world, and whoever was best was promoted most. In the end, a climate of falsehood, fear and recklessness arose as a consequence of an unproductive business process.

For clarity, a recent study by the University of Hamburg is quoted here. The research group surveyed nearly 650 employees from various companies about what is important to them in their work. The result may be surprising. Most of the employees said that a respectful employer is more important to them than a safe place, good pay or a great career. If the executives do not treat their employees respectfully, employee commitment decreases and they are then more independent. If they are treated with disrespect, it is hard for them to respect their boss and follow his instructions. This can go so far as to cease independent thinking and only make “service according to regulation,” thus they internally check out.<sup>190</sup>

### **Transformational Leadership**

In the case of the management style concepts or theories, the approach of the transformational leadership emerges from an ethical point of view. This approach emphasizes the importance of leadership as a model. Burns emphasizes the importance of positive role models referring to political leaders, “leaders and followers make each other advance to a higher level of morality and motivation.”<sup>191</sup> “Transformational” is the approach because it wants to positively transform the behavior of the employee through the exemplary behavior of the executives and the creation of a trust base. According to this approach, the motivation and the behavior of employees can be influenced better by the positive example of the supervisor than by traditional methods.<sup>192</sup> The transformational leader addresses the intrinsic needs of the employees which are on a higher level of the Maslow’s Hierarchy of needs turning to values and ideals like freedom, justice, equality, peace, humanitarianism. Base feelings like fear, greed, hatred or envy are not used to enhance performance.<sup>193</sup> Bass supplemented Burns’ approach by stressing the motivation of the employees to achieve the company’s goals as an important task. A leader has to convince the employees that the team or company result is dependent on them and is of more importance than some of their own interests. Leaders therefore should be also charismatic in order to inspire their followers with visions and team spirit.<sup>194</sup> The transformational leader will create a shared interest that unites leader and followers to increase a company’s performance. If he has to punish them he will never decrease the follower’s belief in his self-efficiency but try to help him personally to perform better next time.

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<sup>190</sup> See Handelsblatt dated February 15th 2007, p. 10.

<sup>191</sup> Burns, J.M. (1978).

<sup>192</sup> See Pelz, Waldemar (2014) and Pelz, Waldemar (2015).

<sup>193</sup> See Abu-Hussain, Jamal (2014), p. 1270.

<sup>194</sup> See Bass, B.M. (1985) and Abu-Hussain, Jamal (2014), p. 1270.

Therefore transformational leadership requires a high moral and ethical development of the leader.<sup>195</sup>

Hebert's research shows the importance of emotional intelligence to address the employees personally.<sup>196</sup> Using data from the units of a regional restaurant chain via employee surveys, manager surveys, customer surveys, and organizational records, Koys shows that employee satisfaction, organizational citizenship behavior, and employee turnover influence profitability and customer satisfaction. Cross-lagged regression analyses show that employee attitudes and behaviors are related to organizational effectiveness.<sup>197</sup> A meta-analytic review of 25 years of research showed a positive correlation between transformational leadership and the performance of the workers not only at an individual level but also between transformational leadership and team and organizational performance.<sup>198</sup> There are also studies which compare the influence of transformational leadership with the influence of transactional leadership on company's performance. A study of Deluga shows that leader efficiency and employee satisfaction are more linked to transformational than to transactional leadership.<sup>199</sup> Effectiveness and innovation of organizations seem to be enhanced more by transformational leadership than by transactional leadership.<sup>200</sup>

Surveys about the influence of ethical leadership add to the picture. Empirical surveys showed that employees are more likely to be influenced by ethical management.<sup>201</sup> The integrity of leadership and the influence of the subordinates are positively correlated. As a leadership property, altruism, trust, politeness and cooperativeness were identified as the most important prerequisite for the influence of leadership.<sup>202</sup> Empirically, Seidel was able to demonstrate in the context of a meta-analysis that the cooperative leadership is tendentially superior to the directive leadership with creative and innovative tasks, but not for the management of routine tasks.<sup>203</sup>

It is thus shown that an ethical style of leadership is more effective than others. The following quotation sums up the conclusion:

“Effective leaders take a personal interest in the long-term development of their employees, and they use tact and other social skills to encourage employees to achieve their best. It isn't about being “nice” or “understanding”- it's about tapping into individual motivations in the interest of furthering an organization-wide goal.”<sup>204</sup>

<sup>195</sup> See Bass, B. (1999); Popper, M. (1994) and Abu-Hussain, Jamal (2014), p. 1270.

<sup>196</sup> See Hebert, E. (2011).

<sup>197</sup> See Koys, D. J. (2001).

<sup>198</sup> See Wang, G. & Oh, I.S., Courtright, S. (2011).

<sup>199</sup> See Deluga, R. J. (1988).

<sup>200</sup> See Lowe, K., Kroeck, G. & Sivasubramaniam, N. (1996) and Abu-Hussain, Jamal (2014), pp. 1270.

<sup>201</sup> See Turner, N./Barling, J./Epitropaki, O./Butcher, V./Milner, C. (2002).

<sup>202</sup> Like a sub-characteristic of “agreeableness”. See Judge, T. A./Bono, J. E. (2000), p. 760 and Brown, M. E./Treviño, L. K. (2006), p. 603.

<sup>203</sup> See Seidel, Eberhard (1978).

<sup>204</sup> Prentice, W.C.H. (2004), p. 102.

The modern, meaning-oriented concept of management addresses a person's need for meaning in life and tries to give the employees meaning through their work and thus also a motivation to get involved with the company. The sense-oriented style of leadership goes back to Plato, who saw in the logos, that is, the sense, the correct orientation for guidance.<sup>205</sup>

### 7.3.5.4 Leadership Authority

Leaders need authority in order to get employees to follow their orders. It is the basis for recognition of the superiors as leaders. Authority is a prerequisite for leadership. Here one differentiates traditionally into three forms of authority<sup>206</sup>:

#### 1. Official authority: conduct thanks to the power of the office

The office position is awarded by the company. It is entitled to give the employees instructions, which they must implement according to their employment contract. Whether they want this is a completely different question. The boss nowadays receives less and less respect for titles and positions. Official authority alone is not sufficient. If a supervisor relies only on the authority of his position, it is often similar to an authoritarian style of leadership, which leads to management problems. The more a supervisor appeals to his official authority, the more difficult his leadership becomes in the form of conflicts and authority crises. Necessary cooperation is made more difficult. Employees increasingly want to be seen as individualists and equal partners, not to feel themselves as subjects.

#### 2. Expertise authority: Leadership due to the development of knowledge

Employees recognize leadership because the supervisor has more expertise and knowledge than they do. Due to the high specialization, this is less and less the responsibility of the management. However, it is unbearable for the employee if he is to implement the factually incorrect instructions of his superior and thus harm the company. The employees want to work productively, not destructively. The supervisor is then not taken seriously. The employees ask other employees for information, which weakens the management. Others are quickly aware of the lack in knowledge of the supervisor and the manager loses the information exchange with his employee.

#### 3. Personal authority: Lead through trust and conviction through personality and role model

This is where the ethical leadership takes place.<sup>207</sup> The supervisor is credible in his or her personality and can motivate the employees, to work on a task for the company. For this, it is important that the supervisor is an example. The employees

<sup>205</sup> See Mascha, Andreas (2013).

<sup>206</sup> See auch [www.personaltraining-kratz.de/.../muessen\\_vorgesetzte\\_autoritaet\\_besitzen](http://www.personaltraining-kratz.de/.../muessen_vorgesetzte_autoritaet_besitzen) (20.06.2015).

<sup>207</sup> See Lay, Rupert (1989), pp. 147.

can trust him and accept him as a role model. Even without the backing of the company the employees in a group would choose him voluntarily as a group representative and group judge. An official authority is not required. Even in the absence of the superior, employees try to advance the task or their work. They need not be forced and supervised. For this, it is necessary that the employees are not only treated fairly by the supervisor but also feel represented in key interests. The management force must consider the employees as a partner without prejudice and arrogance, and also to communicate and treat them accordingly.

Therefore, the executive should actively involve the employees in the process of forming the will within their area of competence and use them according to their abilities, knowledge and experience. In order to understand the employees and not to overburden them with the assigned tasks it is necessary that the manager not only keep their ears open for the concerns of the employees, but also listen to them and even show some emotions, like compassion. The manager must be a role model for the employees in personal behavior. A leader cannot ask of their lower paid employees what they would not do themselves. Loyalty is not a one-way street. Privileges and disproportionately high pay in relation to work, training and risk lead to less motivation and even envy among the employees. It is not felt to be just.

Humanity and authority can be shown by the fact that leadership confesses its own mistakes. Management should show self-confidence through calm, even in difficult situations, and by empowering employees to strengthen their self-confidence. This includes delegating tasks to employees and giving them competencies and decision-making facilities. Criticism should always be objective and not personal. The criticism must be understood by the employee. The leadership tool of acknowledgement should outweigh criticism and strengthen the employee's self-confidence. This is then also projected back to the management by the employee. Otherwise, the executive would have made a mistake by overburdening the employee.

At the very least, management needs so much expertise that it does not make any mistakes that are obvious to the employees. Decisions should be consistent and without hesitation if possible; on the other hand, the decisions should also be weighed and reflected so that a negative outcome cannot be attributed to a mistake. Leadership must be recognizable and the delegation weighed, so that it does not give the impression that leadership wanted to avoid work or decision making. Too much delegation is interpreted as a weakness of leadership by many employees as well as exaggerated fraternization. Benefits and cooperation, to which the employees are legally and morally obligated as part of their employment relationship, must not be demanded by the supervisor.

In turn, the employee expects to be treated fairly. A pure command and obedience principle, that is, the treatment of the employees as subordinates, is not an objective here. It is also counterproductive to use the information monopoly, the exploitation of the power of information and power of the executive. The employee does not feel treated as an equal but rather marginalized. Dishonesty and manipulation are the opposite of personal authority. If management tries to vie with one another through intrigue or unfair praise and criticism, in order to gain a position of strength against the group, he provokes constant conflict among the employees and

a bad business climate, as well as a strong disregard, distrust and feelings of revenge on the part of the employees.<sup>208</sup>

It should be noted that all three forms of authority must be used for successful management of the personnel staff. Without executive authority, that is, without the powers of a leadership position, a leader can not reward and sanction, and thus cannot lead. With only a minimum of expertise, a leader can not make the right decisions and loses recognition among the employees. The executive is unable to evaluate the information that the employees have passed on to them, and aggregate them in the management hierarchy. However, if personal authority is missing, it means that the employee does not accept the personality of the executive, and rejects objectively correct orders only because they are based on this leadership. The employee executes the instructions only reluctantly, against his own will. He is then not only unmotivated to carry out the instructions, but it saps him of strength to perform them against his own will. To suppress his inner resistance to his superiors and not to “shout loudly,” the employee loses energy and thus productivity. Against this background, internal termination is only the first step. He will want to retaliate against the executive for this emotional damage. This may result in denying important information to the manager or denunciation of his superior.

According to executives, the motivating effect of salary and other material incentives will decrease in the future. Instead, the motivation and personal commitment of the employees is to be achieved more with appreciation, individual decision-making and self-responsibility. Status symbols become unimportant. Rather, autonomy and the perceived meaning of an activity determine the degree of operational readiness.<sup>209</sup>

Empirical studies on the leadership style of German managers are somewhat contradictory and reflect different attitudes and internal contradictions among the managers. According to a study that surveyed 400 German executives, most executives agree that hierarchical leadership is no longer appropriate because of the complexity and dynamics of the future world of work. The suitability of success-enhancing management tools such as goal management and controlling is reduced by increasing volatility and decreasing planning. According to another study in Germany, the leadership style still dominates for key figures with the aim of maximizing the return on capital (29.5% of the 400 managers interviewed).<sup>210</sup> According to their own perceptions, only 13.5% of the 400 executives surveyed take the lead in terms

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<sup>208</sup> See auch [www.personaltraining-kratz.de/.../muessen\\_vorgesetzte\\_autoritaet\\_besitzen](http://www.personaltraining-kratz.de/.../muessen_vorgesetzte_autoritaet_besitzen) (20.06.2015).

<sup>209</sup> See Initiative Neue Qualität der Arbeit (2012), p. 9.

<sup>210</sup> See Initiative Neue Qualität der Arbeit (2012), p. 7, 12.

of personnel security.<sup>211</sup> However, the majority of German top managers<sup>212</sup> say that in their opinion the most important is personality authority and only about 12% expertise authority. Thirdly, democratic authority comes from the involvement of the employees, team thought and a participatory management understanding. On the other hand, purely official authority is rejected. Two-thirds emphasize that in particular the authentic past actions and credibility constitute a legitimate source of authority. The opinion of a chairman of the Board of Managing Directors is characteristic: “Personality authority means that one can inspire peopl... this is achieved by a manager only if he demonstrates his own moral values credibly.”<sup>213</sup> There is a contradiction in business ethics and practical implementation. Although many companies are characterized by ethical principles, they are always violating moral principles.<sup>214</sup>

### Summary

It is true that the concept of leadership styles is controversial, especially because the concepts cannot be clearly delineated. The style also depends on the personality of the executive as well as the situation. Nevertheless, there are hardly any alternatives to define the directions for optimal handling of employees. Only the democratic or cooperative style of leadership is appropriate for taking full account of ethical aspects in decision-making; it involves the employees in the formation of opinions along with their information and interests. The transformational style of leadership tries to gain greater influence on the employees through ethical leadership. In the case of those in authority, the personality authority is suitable to motivate the employees ethically.

### Comprehension Questions

1. Identify and explain the leadership styles presented.
2. Name and explain the authority types presented.
3. Which management styles and types of authority do you consider appropriate for a medium-sized German company? Explain your choice.

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<sup>211</sup> “Good leadership is authentic, competent and possesses natural authority. Loyalty and satisfaction of the employees are the result of a personal role model and the assumption of responsibility.”. Initiative Neue Qualität der Arbeit (2012), p. 12. 15.5% of the 400 executives surveyed agreed on the democratic leadership style, which was intended to compensate stakeholder interests, 24% saw their main management task in the hierarchical network of the employees in the company and 17.75% in the coaching of teamwork. See Initiative Neue Qualität der Arbeit (2012), p. 13.

<sup>212</sup> Part of the survey were top executives who held the position of Chairman of the Board of Management, Chairman of the Supervisory Board or a member of the Executive Board in the 100 largest companies in Germany (in 2000).

<sup>213</sup> Quoted after Buß, Eugen (2009), p. 9.

<sup>214</sup> See Buß, Eugen (2009), pp.11.

### ***7.3.6 The Ethical Model of Company Management***

Moral behavior is important for every company. Immoral behavior reduces economic efficiency. Moral in this context means that the employees act for the good of the company, they benefit the company. It has long been considered obvious that employees should be loyal to their companies, but with the unscrupulous enrichment of managers in the recent company crises, this fact seems to have been somewhat forgotten. As we have already mentioned, a company is dependent on its employees to put the interests of the company before their own, at least while working. The employees must dedicate themselves completely to the company productivity and act loyally, as they can permanently damage the company if they do not. Employees are often entrusted with company information pertinent to competition and valuable company inventory. Moral behavior amongst colleagues is also to be expected from employees. Only when the employees are open and fair with one another is a cooperative effort and thus a common added value achievable. If the employees do not act morally, their supervisors can no longer rely on the information passed on to them or their performance. If the employees manipulate their success or the success of others, such as was the case at Enron, the managers cannot get the most out of the employees.

The employees at Enron not only worked against each other, but the management also worked against the employees. The result was that the employees worked against the management as well, and thus against the company. The management did not include the employees as people in the company, but placed them under pressure. They were thus not motivated and not capable of working independently for the good of the company. Skillings created a climate of fear among the employees. Whenever an employee did not provide the performance expected, he could expect to be dismissed. Skillings was unable to control them, however. He did not know what was really happening in his company. He did not seem interested in knowing why the performance was not sufficient, and did not identify with the employees, which is why they did not include him in the company process. There was no independent, constructive, decentralized action. It was much more the case that the employees tried to blind management with false information and to get a leg up on their colleagues. The management was successfully shown an illusory world, and whoever could blind the most ingeniously got ahead. All of this created a climate of falseness, fear and ruthlessness, the consequence of which was an unproductive company process.

In the case of Enron two factors come together. One factor was an employee management not attuned to the people involved, and the other was measurement of employee success on an extremely short time interval connected to draconian penalties. How should an employee react when he knows that he will lose his job if does not achieve X amount of profit by the end of the quarter? Is it possible to force performance? Surely the required performance sometimes needs a certain degree of pressure, but too much is counterproductive. Even a competent and hard-working employee cannot create a success contrary to the market. He must have a competi-

tive product that can find a demand with purchasing power. A short-term measurement of success has a counterproductive effect when most successful company processes are long term. When the parameters are wrong, the employees cannot work optimally. When they are judged at the end of the quarter they cannot build something up over 2 years, and their productive forces cannot develop.

Under these conditions the employees are no longer loyal to the company, and must think of themselves first. They cannot afford to be dismissed at the end of the quarter and must work against the interests of the company to a certain extent. A bank employee cannot advise the customer in the customer's best interest for buying stocks if he must sell the customer more products each quarter. He cannot make a sale when the customer has a need, he is forced to sell things to the customer that are not needed.

### **7.3.6.1 Virtue or Individual Ethics: What Should Be the Characteristics of an Optimal Management?**

#### **Group work with presentation: Characteristics of an optimal leadership**

What are the character traits of optimal leadership? Explain your position.

What are the character traits of optimal leadership? Should it be positive characteristics, defined as practiced and internalized dispositions to do good, dispositions to behave morally? Or are characteristics such as enforcement, hardness, recklessness and cleverness more important?

Dissatisfaction of the employees with management forces leads to a loss in productivity and increase of costs. For example, in 2014, a survey of 2687 employees and executives in Switzerland showed that 62% of the interviewees had already resigned because of a conflict with a superior. In a comparable survey in Germany in 2013, 50% of respondents said that they had resigned because of a superior and an additional 20% said they were about to quit.<sup>215</sup> The effects of unethical behavior of superiors and the effects on productivity can also be demonstrated by the example of ENRON. If the company treats the employees very badly, the loyalty contract is canceled. First comes the internal termination and then the employees try to defend themselves or compensate for the disadvantages by working against the interests of the company.

The following characteristics expected from ethically oriented leadership are found in the pertinent literature.<sup>216</sup> The four cardinal virtues are:

1. Wisdom and courage for truth (Plato, Socrates)

The ability to recognize reality and the ability to determine morally good behavior while weighing the consequences (goods) in every situation.

2. Justice (Aristotle)

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<sup>215</sup> See Information Factory (2014), p. 4.

<sup>216</sup> See Kiefer, Heinz J. (1985), pp. 69 and Schmidt, Walter (1986), pp. 40.

The acceptance of the rights of others (tolerance) and the will to enforce these rights while weighing all the consequences for those concerned.

### 3. Bravery (conflict, civil courage) (Plato, Socrates)

The readiness to stand up for justice (the good) while accepting one's own disadvantages. Perseverance and endurance are also added here.

### 4. Mindfulness, moderation (Plato)

The opposite of greed. Greed precludes wisdom and prudence as prerequisites in making prosperous choices for oneself and others. Humility and modesty are included in mindfulness and moderation.

Other important properties are:

### 5. Altruism (compassion, benevolence)

The will to do good.

### 6. Loyalty, honesty and exemplary behavior

As far as human resource management is concerned, we have found that ethical behavior of executives increases their authority. Empirical studies have also shown that the exemplary leadership or good leadership perceived by the subordinates is correlated with the attributes of integrity, honesty, and trustworthiness.<sup>217</sup> Summarizing the results of the various surveys, ethical leadership is characterized by the employee as being honest, caring, just, promoting ethical standards and ethical education through reward and sanction and exemplary behavior.<sup>218</sup>

The managers are above all role models for the employees. The importance of the behavior of managers seems to be underestimated in the literature and in practice they have far more influence on the behavior of employees than is generally assumed.<sup>219</sup> There is a definition of leadership ethics that takes this into account:

“the demonstration of normatively appropriate conduct through personal actions and interpersonal relationships, and the promotion of such conduct to followers through two-way communication, reinforcement, and decision-making”.<sup>220</sup>

It must be emphasized that an ethical leadership style is not limited to ethical behavior, but rather postulates ethical values acts as a role model and rewards ethical behavior and sanctions violations. Empirical studies show that ethical leadership is primarily associated with fairness and honesty.<sup>221</sup> Ethical leadership also leads to

<sup>217</sup> See Kirkpatrick, p. A./Locke, E. A. (1991); Den Hartog, D. N./House, R. J./Hanges, P. J., Ruiz-Quintanilla, p. A./Dorfman, P. W. (1999) and Brown, M. E./Treviño, L. K. (2006).

<sup>218</sup> See Brown, M. E./Treviño, L. K. (2006), p. 597.

<sup>219</sup> See Schieffer, Alexander (1998), p. 242.

<sup>220</sup> See Brown, M. E./Treviño, L. K./Harrison, D. (2005), p. 120.

<sup>221</sup> See Bass, B. M./Avolio, B. J. (2000) and Brown, M. E./Treviño, L. K. (2006), p. 597.

a commitment to engage at an above-average level in the job (extra effort) and a willingness to report problems to the management.<sup>222</sup>

According to the theory of social learning, people emulate behaviors when the role models are in a socially elevated position. The power and status of the superiors are attractive and act as an incentive to copy their behavior. Ethical behavior must therefore also be taken into account in the case of promotions. Added to this is the credibility of the role played. If the model does not follow the ethical guidelines, it would be irrational to think the employee would.<sup>223</sup>

The saying “bad examples spoil the customs” applies both internally within a company as well as economically. Others will see that it pays to enrich themselves at the expense of the company or other economic operators and will emulate that. The top manager, who has become rich through the sale of his stock options, although he has harmed the company entrusted to him, will also find imitators as corrupt buyers. If this damaging behavior is not sanctioned, honesty would be stupid because it does not pay off. Moral decline of the supervisors not only harms the companies or individuals, but also the system as a whole.

Rewards and sanctions are signals, the rewards are positive motivating examples, and the sanctions are fear-based examples. Even the unwarranted enrichment of a top manager sets a signal, a “model”: If a higher-ranking boss does not have to strive to achieve above-average achievements through honest hard work, how can one then demand this from a much lower salaried employee? What would this mean for a company culture and what would the performance be if all employees were to behave like this? Immorality pays off. Loyalty, morals and honest work are devalued with such a remuneration, which greatly reduces the motivation to behave cooperatively and to work productively. If such behavior is allowed, this would not only be economically system-destructive, but also civilizationally backward. A democracy builds on certain values and principles, which are understood by society as the “contract sociale.” Égalité, fraternité and liberté also include a minimum of equality of opportunity. A publicly tolerated unjust enrichment should not only contradict these principles, but also provoke envy and thus threaten social consensus (peace).

### 7.3.6.2 How Can We Motivate Employees to Adopt Ethical Behavior?

Ethical corporate governance and goals alone are not enough to ensure ethical behavior. In addition, the behavior of employees must be ethically motivated and controlled. Numerous ethical instruments are available to motivate employees. The most common is compensation (salary, stock options, profit sharing) or transportation. In addition to these material rewards, there are still intangible rewards such as praise and recognition, status, power and interesting tasks. These rewards can also

<sup>222</sup> See Brown, M. E./Treviño, L. K./Harrison, D. (2005) and Brown, M. E./Treviño, L. K. (2006), p. 597.

<sup>223</sup> See Bandura, A. (1977); Bandura, A. (1986) and Brown, M. E./Treviño, L. K. (2006), p. 597. “if models do not abide by what they preach, why should others do so?” Bandura, A. (1986), p. 344.

be withdrawn as a sanction. Displacement, degradation and dismissals are also available as sanctions. These standards and sanctions are almost exclusively based on the assessments of the supervisors of behavior and performance within the company. This leaves space for subjectivity and power and underlines the importance of the superior to ethically influence employees. A collaborative team approach can be encouraged through complementary assessments from colleagues and a cooperative management style through additional assessments from employees.

In order to ensure a stable relationship between the incentives and the behavior of employees, it is important that the employees can safely assume that they will be rewarded for their positive behavior.<sup>224</sup> The same applies to the sanctions. The incentive to behave in accordance with the ethical principles must include a higher benefit for the employee. The ethical behavior and the effect of the employee in the company must therefore be isolatable and controllable. For example, an employee cannot influence the sales of a product if the quality of the production is bad.

The reward system must be transparent, consistent and fair. If an employee is rewarded for the performance of another employee, it sends a signal that it is not worthwhile to get involved. The same applies to rewarding or disregarding mistakes or disproportionate remuneration. If one employee does more for the company than another, he will also expect more reward. And if one wants to promote ethical behavior, this must also be rewarded.

What forms of justice are there? In a company, we differentiate between 1. Justice of requirements, 2. Justice of performance, 3. Justice of the market, 4. Justice of qualification, 5. Justice of success, 6. Justice of distribution, 7. Justice of needs and 8. Social justice.

### **1. Justice of requirements**

This refers to the requirements that are associated with a position in the company and are mentioned in the job description. E.g. travel, education, professional experience, etc.

### **2. Justice of performance**

The basis for remuneration is productivity in the company. What added value does the employee provide? Here the result decisive, not the effort. If the results of individual employees cannot be measured, as in large corporations, the effort and willingness to commit (commitment) are often chosen as a reward criteria. It can be advantageous for the employee to stay longer in the office, even if he does not do any productive work.

### **3. Justice of the market**

This relates to a demand for a special qualification from the market. For instance, there is low-demand for language-studies, and a high demand for managers.

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<sup>224</sup> See for the models of motivation Richter, Manfred (1994), pp. 171.

#### 4. **Justice of qualification**

Here, the employee's performance potential is rewarded. This means that even if the employee currently holds a position in which the job description does not require this potential, he receives a higher pay than someone else without this qualification. The potential is thus available to the company even if it is not being used.

#### 5. **Justice of success**

Since the employee works in the company, his remuneration depends indirectly on the success of the company. Even if he generates high revenues for the company, the company may not be able to reward him because of a poor economic situation. Often, the companies pour out special bonuses after an economic slump, once the economic situation allows it.

#### 6. **Justice of distribution**

Distribution is a relative measure and refers here to income and other rewards. There is a distribution within the company and a distribution of income in the economy. Both distributions are perceived as being justified only if they are transparent and their criteria are recognized.

#### 7. **Justice of needs**

Karl Marx proposed the quality of necessity ("each according to his needs"). This is about the urgency with which an individual needs an income. For example, a single-parent unemployed mother is in a state of emergency. In this respect, it would be more appropriate to give more to her than to a high-income woman without family obligations.

#### 8. **Social justice**

The goal here is that all individuals in society have the same income chances. For example, workers are to waive wage increases in order to employ others.

The first three forms of justice essentially determine the wage level in the company. Internal distributive justice has not seemed to exist in recent years. The difference between the manager's salary and the pay of a normal employee rose steadily, without the managers having done better than before and the employees were worse off. In 1997, a member of the Management Board of Deutsche Bank AG earned 50 times the average gross earnings of a worker in Germany, 80 in 1998, 200 in 1999 and 300 in 2000.<sup>225</sup> The US is modeled on this development. There, the average salary of a Chief Executive Officer (CEO) of the 500 largest companies rose by 700% between 1980 and 2001, while the average salary of an industrial worker increased by 15%.<sup>226</sup>

As with Homann's approach, the corporate institutions must be designed in such a way that they promote ethical behavior and sanction unethical behavior. There are also unethical incentives. Thus, in the suit against the automobile-service company

<sup>225</sup> See Härtel, Hans-Hagen (2004), p. 348.

<sup>226</sup> See Eckardstein, Dudo von/Konlechner, Stefan (2008), p. 10.

Sears, Roebuck & Company, the extreme incentives to increase sales led to an increase in the number of cases of customer fraud. There were stipulations of minimum hours for mechanics and minimum sales volumes for certain car parts as well as high premiums for high sales, which put the employees disproportionately under pressure. Successful employees had no scruples, and would sell the customer superfluous service and spare parts. There were therefore incentives to lie and deceive, thus endorsing unethical behavior.<sup>227</sup>

Incentives and penalties only apply if they are carried out within the scope of monitoring the performance and behavior of the employees. The employee must be able to understand the reward. This is referred to as a target-actual control.<sup>228</sup> Ultimately, every measure of leadership, forecasts, systems, models, etc., is also required for success monitoring, because errors must be identified for improvements to be made.

The goals set for the employee by his or her supervisor are matched with his or her performance and behavior. Control is part of the company's information system, without which control of the company is not possible. The superior can and must intervene if deviations from the target are recorded. If he does not intervene, it means that the company's objectives are not met and that regulatory violations are not sanctioned. There is then chaos, and the company targets are not reached.

To adhere to rules or to obey what the supervisor orders is equivalent with a loss of freedom for the individual employee. This also leads to benefit losses. However, it is only so order or better productive value can be realized from the organization enterprise (emergence). This is a prisoner's dilemma and the incentive to free ride is strong. The benefit is maximal for the individual when the others subordinate themselves in order to generate the surplus value and, he does not become subordinate. The ones who do not subordinate themselves still enjoy in the surplus value.

### 7.3.6.3 The Management Approach of Qualitative Leadership

Beginning with Enron, Subprime etc. we have examined the causes of the company crises and asked what went wrong. We have been able to come to several conclusions, but in particular we see that an exaggerated belief in figures and the neglect of incalculable soft facts can be very dangerous. What is more, we have found out that exactly the soft facts are decisive for the development of productive human forces and thus for the long-term success of companies and national economies. How can the soft facts be influenced for the good of the company, the economy and the employees? In the following we will now attempt to bring our newly won realizations together into a new management approach that provides for the optimal development of productive forces in a company.

The management approach for qualitative leadership does not offer anything new or undiscovered. It is meant to use the realizations and experiences gained to optimally develop the productive forces of a company through the best application of

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<sup>227</sup> See Paine, Lynn Sharp (1994), pp. 107.

<sup>228</sup> See Fallgatter, Michael J. (2004), pp. 670.

fewer management instruments. We might consider the focus and the combination to be new, although the most important thing here is to recall moral values, which were once obvious but apparently forgotten, in particular moral values.

The management approach of qualitative leadership is based on aspects from other approaches. For example, the process management concept focuses on organizing how processes are executed. Structuring the process is already seen as a multidisciplinary optimization task for company management. A process-oriented incentive and control system is meant to harmonize the interests of the company and its employees.<sup>229</sup> Lean management approaches and quality management approaches also demand that company management and organization be geared towards the internal value creation change, and the inclusion of employees in constant process improvement.<sup>230</sup> External benchmarking allows us to set goals for internal value creation to achieve. Hierarchical levels are dismantled in favor of teamwork and both internal and external communication is improved.

The re-engineering approaches emphasize that the company organization be continually evaluated and adapted to external changes. The perspective of so-called change management includes company strategy, organization, culture and technology, as well as the interdependent effects from interfering in the company processes.<sup>231</sup> This is incorporated into the qualitative management described in the following. It also contains individual aspects of various, well-known approaches such as the human relation approach, which derives improved performance from a positive social work environment, especially in the relationship to one's superiors and other employees. There are a couple of other approaches using motivational theories (organizational behavior) that stress supporting human resources as mental and physical labor potential. The socio-technical approach from Eric Trist sees company organization as an open, dynamic system with the goal of producing goods. This goal serves as the control quantity for technical and social subsystems. The function of supervisors is to monitor success and give constructive feedback (suggestions for self-monitoring).<sup>232</sup> The management approach for qualitative management places different emphasis and new accents in many areas. Our central question is, "How can we satisfy the human need for moral values in order to increase productivity in a company?"

In a study conducted by the international consulting firm Proudfood Consulting, they estimate that 33.5 days of wasted working time was lost per employee in the USA in 2005. In Germany it was estimated to be 32.5 days. The reason given by the consultants for the time lost was unclear organization or task delegation that led to double work, whereby a lack of understanding of the organization and in particular a lack of information about the lower company units on the part of top managers was a significant contributor. There are often too many managers attempting to be active in the company even though they are superfluous, and they end up being a

<sup>229</sup> See Vahs, Dietmar (2001), p. 222.

<sup>230</sup> See Lawler, Edward E. (1994), pp. 69–76.

<sup>231</sup> See Vahs, Dietmar (2001), pp. 204 and pp. 237.

<sup>232</sup> See Vahs, Dietmar (2001), p. 36.

hindrance to their employees and colleagues. One of the greatest resource wastes are meetings in which everyone informs everyone else and everything is discussed.<sup>233</sup>

Applying employees and machines according to their respective strengths and motivating them to work towards company goals on their own initiative can increase the output productivity of companies. This is the only goal of the qualitative management approach.

What does a company consist of and what comprises its success? If we want to know why one company is successful while another is not, we must examine the differing parts of the companies in more detail. We might also ask which components not easily obtainable by every company lead to success? What is not so easily replaced?

All companies have access to capital, machines, property and all other intermediate inputs traded openly via markets. The important difference between companies begins with the internal organization, or the delegation of functions, internal rules (company constitution or institutions) and especially in the people, the employees, which is expressed in the company culture or working atmosphere. The added values that advance a company in a lasting way, allowing it to grow productively, are always created by people – whether it is from intelligent individual researchers with an enormous individual capital, or from the group that uses its social capital to generate added value (e.g. in research) in the interactive network through cooperation. The manager or management team can be just as resourceful in this environment as the researchers. The success of the company depends on them in the end. Poor developments in a branch are not the cause of company crises. Crises are caused by poor managers, who have missed the trends and the necessary adaptations. With an ingenious management, the company can escape more easily from a branch crisis relative to its competition. Good management shows itself in a crisis. The main static components of a company and thus the criteria for company success are apart from real capital the company organization, the constitution, individual as well as social capital. These components are static however, and must be given life. In the end what determines the success of a company on the market are the dynamic processes within the company. These are significantly influenced by the static factors, but must be at least generally controlled in order to function optimally and achieve the desired results. This is where management comes in.

With what demands does a company today find itself confronted? What is the modern economic framework in which the company must prove itself? What production technology requires which organizational structures and which processes? Rapid technological progress allows more and more simple tasks to be performed by machines. The computer age has increased this trend in the last four decades. For people this not only means relief from the simple, primitive activities, but also increasing competition with machines in the production process. Machines (computers are machines as well) replace humans in more tasks in the production process, and yet they make it possible for humans to create more added value when

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<sup>233</sup> See Handelsblatt from 21./22./23.07.06.

working with the machines. This added value makes higher wages possible, and thus an increasing standard of living with continually more products (or free time). At the same time, the labor distribution between humans and machines is changing. More is demanded of people as more simple tasks are done by machines. This trend is clear in the greatly increased lengths of time for study and in the complexity and variety of educational programs. There are other facets here as well. More personal responsibility and initiative are demanded of people in the production process, while they must also monitor and control increasingly complex machines with more production output in the production process. Decisions must more often be made locally. Strict hierarchies with orders and obedience are too inflexible and slow. Monitoring employees continually becomes more difficult, more expensive and ends up being counterproductive. The productive forces from employees applying themselves for the company must come from the employees themselves. They must voluntarily and gladly make the interests of the company their own, thus motivation must come from inside.

As we have already mentioned, there must be a lot of space for individual decision-making and creativity in order for productive forces to develop optimally in an industrial market economy. Only through the largest possible degree of freedom and individual responsibility for one's actions can the positive effects of competition and market be fully enjoyed. Democracy is the only form of government to offer this. The economic system must assure that individual freedom develops productively and does not turn against the system as a whole. The freedom of the individual must have limits. They end where they prevent other market participants from realizing their productive freedom. This connection can be applied to the business level as well, for the company constitution, where the goal is get the most out of the productive forces of the employees. The most obvious would therefore be to organize a company like a national economy, with local decision-making freedom and responsibility from employees. Many management methods are based on this idea, such as the profit center approach. Outsourcing also tries to use the market and competition to improve and reduce the costs of the outputs offered by delegating company functions. The market system cannot be applied to a company system one-to-one because the company as a special organizational form must fulfill a function that the market cannot afford. The company must make a capable whole from the value gained by organizing the systematic assignment of functions. This includes the optimal structure of interactive networks, or the optimal task delegation according to the strengths of each employee.

The local decision-making of the market economy can be applied to a company to a certain degree. Except for assembly line production, most decisions are made locally by the active employees and managers. Seen in this light, a company works optimally as an organization when all lower units make decisions in the interest of the company as a whole. The agency expenses from control and its implementation costs would be eliminated. This is why not only an identification of the employees with the company and its goals has particular importance, but moral values such as loyalty and integrity are important as well. The employees must place the good of the company over their own to a certain extent. Let us take the example of calling in

sick. The employee must care for his health in his own interest, and in the interest of the company, yet he must not use calling in sick to have more free time and thus damage the company. Since the employer cannot control the employees 100%, or control is too costly, the employer depends on moral behavior from his employees.

When the individual is the center of the economic process however, a suitable management approach must place human nature at the center in order to best nurture their productive forces. Soft facts must be taken into consideration. Psychology and sociology become important sources for advice, and moral values take on central importance. As we have already addressed, most people need more than just material values to be happy. On the contrary, many people are searching for a meaning in life and have a strong sense of justice, wanting good to triumph over evil. Otherwise the bible and the film *Starwars* would not be so broadly popular. Moral values, in particular leading and motivating with moral values, constitutes the core of the qualitative management approach described in the following.

Let's look at a current study at the University of Hamburg to illustrate the point. The research group asked almost 650 employees at different companies what is most important to them at work. The results may surprise you. Most employees answered that a respectful employee is more important than a secure position, good remuneration or great career chances. If supervisors do not treat their employees with respect the employees will not be active and engaged. They become less creative. If they are treated disrespectfully they have a hard time respecting their bosses or following instructions. Such a situation can go so far that they stop thinking independently at all and resign internally, only performing the minimum required.<sup>234</sup>

How are processes executed within a company? What is important when trying to make the processes efficient and setting productive human forces in the company free? In the organization of a company, the processes are first structured by assigning functions in the production process to employees and departments. Qualitative management begins at this stage through a manager who attempts to delegate tasks to people according to their potential, so that the forces available in the company can be used as advantageously as possible. More exactly, this means that the processes comprising a company, the goal and added value for the company must be clarified first. Then the management can ask which employee would best be placed which position. Management must put local teams together as cooperative networks. They must decide which employee is best for which team and for which tasks depending on their education, talents and experience. Which employees are best for the cooperative networks and with what social and individual capital? For example, the basic capabilities for a team intending to develop a car might be controlling, engineering and marketing. Interpersonal and emotional intelligence must be considered as well. The organizational structure will then be adapted to the interactive networks and processes.

The final deciding factors are motivation, knowledge and minimization of friction; in other words interface optimization. The employees at lower levels not only have direct access to information relevant for decision-making through their contact

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<sup>234</sup> See Handelsblatt dated February 15th 2007, p. 10.

to production, their customers and the market, they must also implement most company actions. They are the operative side of business. Managers are dependent on the information they receive from the lower levels, as well as on implementation of their instructions. As we have shown above, technical progress has only increased the importance of the lower levels, as they become more of the local company management. On the one hand, the transfer of simple tasks to machines increased individual responsibility at the lower levels. On the other hand, decisions were transferred to the lower levels because they had to be made quickly and demanded flexibility.

Globalization has increased this trend. Globalization in this sense means that the markets are becoming global. This has been made possible by technological progress. Modern mediums of communication and transportation allow companies to produce anywhere in the world and to deliver anywhere in the world. One result is increased transparency, as a world market is being created out of many national markets, for all products, primary products and even the production factor of labor. However the production and sales process, in fact the entire business process is getting more complex with so many production and sales subsidiaries abroad. The increasing complexity makes employee supervision, information and decision processes, and company management as a whole, more difficult for managers. Management is a process of trial and error to an extent, since it is impossible to grasp all factors of influence. Management must be able to judge trends and make decisions based on their judgments. Errors are unavoidable in such an uncertain situation, making the timely recognition of abortive developments all the more important if there is to be a chance at redirection. Management must also react quickly to changes in the many influential factors. In such an environment, the timely control of successes is the most important part of the company process. With a consequent, timely control of success there should no longer be company crises, no change management and no market phase problems.

With the background described above, the requirements that a modern management concept must fulfill are obvious. Management must create a company that exists locally amongst the employees. The system to be created must be innovative and capable of learning, so it can react quickly to changes in market and framework conditions. The employees must collect information locally, evaluate it and then make decisions in the interest of the company. This means that the employees can only be controlled after they have made the decision. The classical management functions must be transferred more and more to the employees at lower levels. The central question is then, how can we assure that the employees live up to these requirements? They must be led and motivated by moral values. Qualitative management means encouraging and demanding the good in people, while negatively sanctioning the bad. Management in this sense includes motivating employees through a personal role model and personal convictions. This includes demonstrating moral and ethical principles beyond just adding qualitative goals to the existing quantitative goals. Motivation means creating enthusiasm for the goals of the company within individuals, groups, and networks. The better one is able to convince employees of the sense and moral value in a goal, the greater their motivation will

be. Who does not want to give their lives a purpose and do something good? In this context even production of the simplest object has a benefit for other people and is therefore good and important. The role model function also applies to conflict resolution within a company. Conflicts are often not resolved within a company, but are repressed, which causes motivation and the desire to work to suffer, and aggression to build. New conflicts are then guaranteed. All of this reduces productivity. It is possible to reconcile differences without losing face. Managers who never apologize and never explain their instructions will find it impossible to engage and motivate their employees. These managers do not understand that they are part of a group, the group being the entire company, branch or department.

Appealing to the good in people is often insufficient. Unacceptable behavior must be sanctioned as well, because it is to the disadvantage of everyone and cannot be allowed to pay off. People generally find it easier to behave badly than well. Being of use to others often means giving something up, and it is materially advantageous to augment one's advantage at the cost of others. For rules to be effective however, there must be general acceptance of them in the community. If one has the impression that breaking the rules is no exception there will be neither acceptance nor a willingness to submit to them. The maximum social benefit for everyone is created by everyone following the rules, yet it is especially worthwhile for an individual to break a rule if all of the others follow it. If everyone behaves this way however, we have anarchy with the worst results for everyone where no one follows rules. Qualitative management includes signals to the outside that show it is not worth it to break the rules. The less likely it is that misbehavior will be discovered, the higher the punishments must be in order have the same deterring effect.

Compensation oriented towards productivity and based on the opportunity and risk profile (risk corresponding compensation) is decisive for optimal local employee decisions, the goal being to harmonize interests between principals and agents.<sup>235</sup> This applies for all significant decision makers, not just top managers. Often employees that are not a part of management make decisions affecting the company results over the long term, but they do not participate in the opportunities and risks involved in the decisions. They receive the same salary for success but have to answer for losses incurred. This sanctions negative developments, but does not reward positive developments, encouraging risk-averse behavior. The decision-making situation is distorted by incentives inappropriate to the opportunities and risks. Positions with a strong inherent opportunity and risk characteristic must offer particular encouragement for personal engagement in information collection and processing by involving employees in success or failure. How is a supervisor to evaluate decisions made by an employee if he does not have the necessary information to judge the situation in which decisions were made? Without the right incentives a lot of money is lost, especially in large corporations. Only if the employees see their interests as being the same as those of company, can they make the optimal decisions based on the necessary information.

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<sup>235</sup> See Conrad, Christian A. (2015), p. 50–55.

The demands on employees increase within a company process that is continually becoming more complex, as do the demands on their know-how, or the human capital. Individual capital can be acquired through additional training, but what about social capital? As we have shown, social capital is a decisive factor for the development of productive forces in a company. Added value should be achieved through cooperation, teamwork and by bringing all information and knowledge together as a whole, making the added value the sum of the individuals. The six central characteristics of employees relevant to added value creation described above were: (1) Reliability, (2) Loyalty, (3) Ability to work in a team, (4) Willingness to perform, (5) Integrity and (6) System acceptance. These characteristics are what make or break a fast and complex system for local added value creation. Qualitative management in this context includes guidelines for the desired behavior through information, upbringing or socialization and the perception of a role model function. A role model function between people means treating the employees the way you would want to be treated. Support and encourage them. Everyone has good and bad sides and can decide between cooperative or uncooperative actions. If you speak to the good in your employees, as people, you will generally receive good from them. To positively influence employees the supervisors must first have the trust and acceptance of his employees. In order to receive and keep both, they must be people of integrity and act morally. This is also a prerequisite for the internal socialization process of a company. A manager can only demand of his employees what he himself gives, if not a little less. If a manager wants his employees to be loyal, open, fair, hard-working and cooperative, he must be all these things as well. A manager is a role model above all else (**first function of qualitative leadership**).

As we have shown, the attitudes of the employees are of crucial importance for productive social activity. A manager must use praise and censure to ensure that the attitudes of employees conform to the interests of the company, and to provide a positive, moral working environment (**second function of qualitative leadership**). The employees must be educated or socialized in the classical sense, although we choose to use the term “general company interest” to avoid the idea that a dictatorial company guardian be created. The manager has the job of being more like a modern teacher, who helps the children to reach independent and self-responsible behavior. Despite the decentralization of employee’s individual responsibility, it is incumbent upon management to take responsibility for the actions of their employees and to discourage poor performance as well as to reward exceptional performance. The manager is also responsible for assuring productive teamwork in the groups through their intervention. Teamwork without leadership and instructions runs the risk of letting human weaknesses get the upper hand. Team discussions can quickly become independent and lose track of the actual goal when showing off or other group dynamics become too strong. Not all projects and plans have to be discussed in meetings. Moreover these meetings are often abused as a way to foist individual responsibility onto the group. One of the greatest resource wastes are meetings in which everyone informs everyone else and everything is discussed.

The manager has to put the responsibility clearly on the employees and must prosecute nonperformance and reward outperformance. He must leave the employees the room they need to develop themselves personally according to the differences in each person. His task is to recognize and use the differences between employees for the good of the company. He should assign them to the interactive networks so that their strengths can have an optimal effect and their weaknesses can be compensated. This is how the productive forces of the employees can be fully developed, which also leads to self-satisfaction.

A faster and more complex company process formed by independently active employees demands a special working atmosphere of openness and trust. Since the manager cannot control the employees in a local, fast and flexible decision-making process, or at best can only control them partially, he is dependent on their cooperation. The employees must pass on information about markets and production to the manager, but they must also be able to tell him about poor decisions they have made so he can step in to help (which did not happen at Enron). The manager collects and filters the information received by the employees and passes it on via a lean hierarchy to the top management. The information is aggregated through the hierarchy and forwarded upwards where the strategic questions that affect the entire company are decided. At the top management level only broad information is received and directly evaluated, such as national economic or legal framework data. With qualitative management, middle levels of the hierarchy are only necessary to coordinate company processes and to aggregate information. The manager is thus an interface for information (**third function of qualitative leadership**). All managers in a company are committed to the principles of qualitative leadership. This way a fast, innovative and highly motivated organization is created that represents a unit for reaching common company goals.

In order to be able to create added value through cooperation in interactive networks, the employees must trust each other. Only then will they help one another to create common added value. Seen in this light it is much more important that the managers provide for the right characteristics and attitudes of the employees rather than controlling their individual decisions. Managers must impart positive feelings. The motivation of doing something positive for the company comes partially from the employees themselves. They feel a need to do so, and when they have been able to do something good for the company they feel they have been a part of something valuable. These are intrinsic incentives that have slowly been forgotten in the last few decades. Doing something only for money neither provides a good feeling nor does it make one feel loyal. Mercenary soldiers have always been less reliable than a country's own sons who go off to war to defend the home, country and family. The fighters of the Ottoman Empire reached Vienna not because they were paid more than the Europeans but because they were fighting for Islam as a good cause. In the end the most important part of qualitative leadership is that the managers form the employees to the employee's own advantage; motivate and instruct them so that they reach their best performance for the company gladly without management controls, be it alone or in a group. This makes it possible to have fewer managers, higher efficiency, flexibility and speed and proximity to the market. The employees

will also be more satisfied because they feel they are creating more than just monetary value, they are also doing something moral, good and purposeful. In this positive moral working environment friction between people will be the exception, which also increases efficiency. The productive performance competition amongst employees is not hindered. It is constructed positively because it is no longer about harming colleagues to secure a better position, as was the case at Enron. In a negative environment there would be no cooperation, only destructive conflict, preventing potential added values in the company from being realized as one employee works against the performance of another and harms the company in the end. In a generally fair and positive working environment employees endeavor to reach their best performance in common effort through constructive teamwork. Cooperation and fairness then usually means placing the company goals over one's own advantage and profit maximization. Cooperation and effort for a common goal is emphasized.

The managers can use their own judgment and the questions of the economic culture approach (see above) to grasp employee attitudes. Managers should also let themselves be evaluated anonymously. This is the only way to get feedback on their management. It is not necessary to make the results of such an evaluation public. It may even be better to keep the results private because it might otherwise stress the relationship between manager and employee. The evaluations will probably not be very objective since many employees lack the prerequisites to evaluate their managers from a balanced perspective. Emotions often come into play, and an evaluation might be uncomfortable for the manager even though he must never take things too personally. It is imperative that the manager interpret the results correctly. A qualitative leadership cannot be implemented without feedback, nor can the potential for improvement on the part of the manager or motivation on the part of the employees be realized. In such a situation productivity is impossible.

As we have seen, technical progress forms the economy and thus the conditions of social existence. There is therefore not just one optimal social order that fits to each economic or technical level of development, since a fitting social and economic culture can maximize economic productivity for the good of the community. Whether this optimal social culture matches the respective nation, can be achieved or is even desired, is another question entirely. Our goal is not simply the maximum economic production with the relative material benefit, rather the maximum satisfaction of human needs, or better yet the happiness of society's members. The economy in this case is only a means to an end, serving the people. We can thus summarize the results of our considerations thus: Morality is essential where human beings interact in order to pursue the same goal in the economy.

Management personnel have a central role to play in corporate ethics. They not only determine the internal handling of employees by shaping the corporate culture and decision-making structure, but also represent the company in external relations. They are ultimately responsible for the company and its internal and external decisions.

## 7.4 Summary

Management must behave as an example for the employee according to ethical criteria and must represent them externally. Here, justice is a key to the employee's acceptance of leadership. The aim of the management approach of the qualitative leadership is the leadership to shape, motivate and instruct the employees to their own advantage to feel ethically responsible for the interests of the company and to feel this as a positive pursuit.

### Comprehension Questions

1. What are the character traits of an optimal leader? Give reasons for your opinion.
2. Name and explain the forms of justice presented.
3. In your own words, sketch the management approach of qualitative leadership.

### 7.4.1 Ethical Staff Selection

#### 7.4.1.1 The Selection Process

Corporate culture can be influenced most by the selection of staff. Personnel selection means the internal or external occupation of positions in the company (definition). This has three important meanings for corporate culture. Firstly, in the case of external staff assignments, the decision is made as to which persons are allowed into the company, and they will in turn influence that corporate culture. Secondly, management is assigned power, that is, influence on enterprise culture. Thirdly, the selection of supervisors as promotions is a main incentive for the performance of the employees.

The selection of staff is also one of the most complex and significant company decisions. Complex and thus difficult, because the company does not know the character, abilities and intentions of the applicant due to asymmetrical information distribution, particularly in the case of external positions. It is important to note that these decisions can only be made at short notice with high costs, which have very far-reaching consequences for the company. The higher the position, the higher the consequences and costs for the company, which can include bankruptcy.

The selection of staff is the decisive instrument for the long-term organization of corporate culture. Many personal characteristics are so deeply anchored that they can no longer be influenced ethically. It is therefore very important to select the most ethically appropriate employees and, in particular, executives.

The ethical requirements must be included in the job descriptions. The company guidelines and codes of conduct must also be included. The higher up in the hierarchy, the higher the demands on that personality in order to meet employee expectations and thus ensure personal authority. In the next step, the job description must specify the exact requirements profile for the applicant. Then the vacancy notice and

finally the selection of the candidates are carried out by comparing the job profile with the applicant profile. The following are instruments to scan the profile of the applicant: curriculum vitae, personal questionnaire, testimonials, references, photographs, manuscripts, assessment center etc.<sup>236</sup>

Naturally, the selection procedure should also meet ethical requirements. Thus, no candidate may be discriminated against based on sex, color, religious affiliation, political orientation or the like. These criteria therefore also fall under the legal protection of privacy and may not be requested by the company.<sup>237</sup> Women may not be asked about pregnancy. A frequently discussed women's quota, which is to say the percentage of women employed, will lead to discrimination if unequal numbers of women and men applying are equally suitable or qualified. Nonetheless, one could prevent discrimination by applying a gender proportion in the selection committees. It is crucial that a pre-employment application process is externally transparent.

The selection criteria must be clear to the candidates. Otherwise they cannot decide whether they have any interest and a chance at getting the job (self-selection). If an erroneous impression is made by the job description, this results in unnecessary transaction costs for the applicant and the company. In order for both parties to be able to learn from the application process, a success check is to be carried out. It begins with the feedback talks with the applicants not selected and ends with the evaluation of the return of the first internal company assessments. The vacancy notice documents the criteria that must be checked within the selection procedure and also documented with the result.

The selection process itself has to be ethical. In particular, the applicant's human dignity must be respected. The applicant may not be exposed or compromised. This is especially important when simulating extreme situations so as not to create too much stress and pressure. Open honesty is an important prerequisite for the optimal selection of applicants on both sides. The applicant is also a long-term decision with far-reaching consequences. Other settings can not be used. Perhaps a move is also associated with the acceptance of the job.

Job posting is of particular importance since it is the first contact between the company and the potential applicants. For the success of a job call, it is crucial that the job description optimally sketches the requirements profile so that the reader has a basis for deciding whether his profile fits the job and whether he is interested in the company and the job. If mistakes are made here, the job advertisement responds to the wrong applicants or conveys a false picture of the company.

#### **7.4.1.2 Selection of Ethical Employees in Practice**

Group task: Discuss the following example for personnel selection. What type of employees are being sought here?

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<sup>236</sup> See Richter, Manfred (1994), p. 411.

<sup>237</sup> See Göbel, Elisabeth (2010), p. 230.

An example of personnel selection, according to William Cohan in the film “Goldman Sachs – eine Bank regiert die Welt”<sup>238</sup> (“Goldman Sachs – a bank governs the world”) was operated by Goldman Sachs. The trainees, who are still in the probationary period, will be invited to a meeting on Friday for 4 pm. Hours pass and no one comes. The trainees think they’ve been forgotten or treated badly. Some go. At 10 pm the head of the department will come and sign an unimportant paper from the trainees who are still present. All the others are rejected the next day.

Solution: You are looking for dedicated employees who do not ask questions and do not show their own initiative. Independence and criticism are not welcome here.

According to Stanford professor Jeffrey Pfeffer, successful managers are selfish, mendacious and reckless. Pfeffer is thus opposed to the dominant leadership theory that “good managers should be modest, sincere and authentic. This fallacy spreads especially in the leadership industry with its seminars, books, trainers, coaches and, of course, the business schools and personnel departments.”<sup>239</sup> Pfeffer does not question that companies would benefit from an ethical leadership, but he sees this as unrealistic and encourages young managers to behave unethically to make careers.

“Of course these are all wonderful qualities and there is also no doubt that companies and their employees would be better off if their leaders behaved morally. But they do not. They usually do the opposite of it. One reason are well-known psychological mechanisms. Whoever wants to be successful must not be modest, but must make as much self-promotion as possible. And lies are not only ubiquitous, but also very effective. According to a study, 74 per cent of companies say it is right to lie about their true chances of advancement, because they would be less involved.”<sup>240</sup> To be successful, according to Pfeffer, managers must be nasty. Successful managers are loud and lie to themselves and others.

“Managers often present themselves completely differently than they really are. They create their own reality and believe in it. This self-deception also has a tremendously positive effect: anyone who can deceive himself can also deceive others. Or the concept of moral licensing: when people have once behaved ethically or morally, they have the feeling that they are allowed a meanness. All of this is empirically proven.”<sup>241</sup>

According to Pfeffer, the good qualities, the virtues such as modesty, sincerity, and trust counteract career advancement. Only one who is striking is promoted. For this reason, narcissists, according to Pfeffer, are often leaders, because their superior self-confidence is mistakenly perceived by other people as competence. Lies are sanctioned in the company and are considered a part of leadership. Anyone who lies – especially about his own achievements – is therefore promoted. This also

<sup>238</sup> See <https://www.youtube.com/watch?v=pbCWfvn0mLU>

<sup>239</sup> <http://www.spiegel.de/karriere/manager-wer-erfolgreich-sein-will-muss-fies-sein-a-1115117.html>, translation by the author.

<sup>240</sup> <http://www.spiegel.de/karriere/manager-wer-erfolgreich-sein-will-muss-fies-sein-a-1115117.html>, translation by the author.

<sup>241</sup> <http://www.spiegel.de/karriere/manager-wer-erfolgreich-sein-will-muss-fies-sein-a-1115117.html>, translation by the author.

includes the breaking of promises. Pfeffer considers trust useless for a company because promises are so often broken with impunity.<sup>242</sup> Pfeffer's theses are in his book that was 2015 Finalist for the 2015 Financial Times and McKinsey Business Book of the Year.<sup>243</sup>

Pfeffer's thesis on the unethical behavior of managers is confirmed by a German psychotherapist Leitner.<sup>244</sup> She sees a development: "Psycho-games are working out in these big companies because they often have no values. Above all, more and more ego-types are spreading, who only think of their own career, which the company's well-being is indifferent to." And further: "My experience is that generally the sly and the powerful prevail and the decent, motivated have to go. It is an unequal struggle that mostly women almost always lose. Most people only realize that they have been fought when they have already lost the war."<sup>245</sup> Bodo Janssen seems to have been such a leader. After an employee questioning, it turned out that his subordinates hated him, which surprised him very much: "The survey was a shock. Suddenly, I was no longer an all-knowing top manager, but a flop manager. But I have faced the problems. We now have a completely different corporate culture, without power, pressure and control. Satisfaction has risen by more than 80 percent since then, the employees are much less sick, we receive five times as many applications and have more than doubled company's sales."<sup>246</sup>

Derler surveyed 138 executives from the middle (52.9%), lower (33.3%) and top management (13.8%) from the service, automotive, IT and engineering sectors about the criteria in the selection of employees, specifically the selection of non-executives. Reliability, productivity and loyalty are most often mentioned here. Furthermore, the majority of the companies surveyed prefer well-adapted employees. Desired characteristics are also diligence, politeness, team ability, self-awareness, instability, and deviation from company trends. Derler sees this as a contradiction between external representation and practice, as most of the surveyed companies considered themselves innovative and open to new developments.<sup>247</sup>

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<sup>242</sup> See Pfeffer, Jeffrey (2015), *Leadership BS Fixing Workplaces and Careers One Truth at a Time*, New York: Harper Business.

<sup>243</sup> See <https://www.amazon.com/Leadership-BS-Fixing-Workplaces-Careers/dp/0062383167>

<sup>244</sup> Madeleine Leitner is a graduate psychologist and has worked for a long time as a psychotherapist in hospitals, as a court-appointed expert and as a personal consultant for big corporations and is currently working as an independent career consultant. See <http://www.spiegel.de/forum/karriere/psychospiele-im-management-konzernen-machen-sich-ego-typen-breit-thread-228194-14.html>.

<sup>245</sup> <http://www.spiegel.de/forum/karriere/psychospiele-im-management-konzernen-machen-sich-ego-typen-breit-thread-228194-14.html>, translation by the author.

<sup>246</sup> <http://www.spiegel.de/forum/karriere/erkenntnisse-eines-chefs-ich-war-ein-flopmanger-thread-449737-1.html>, translation by the author.

<sup>247</sup> See [https://www.fernuni-hagen.de/universitaet/aktuelles/2015/03/2015\\_03\\_23\\_am\\_studie\\_der\\_ideal\\_mitarbeiter\\_fernuniversitaet.shtml](https://www.fernuni-hagen.de/universitaet/aktuelles/2015/03/2015_03_23_am_studie_der_ideal_mitarbeiter_fernuniversitaet.shtml)

The selection process of executives has different criteria than those for employees. Schneider evaluated the job advertisements of various cross-regional German newspapers in order to produce an average managerial profile<sup>248</sup>:

Leadership characteristics, in 46.2% of ads (number of responses):

(11), general leadership style or sensitivity (10), employee-oriented (7), the ability to be motivated (70), success and goal orientation (32), general leadership quality (32), cooperative management style (32), employees can develop (7).

Social characteristics, in 39.2% of the ads (number of mentions): negotiating skills (72), assertiveness (71), co-operation skills (54), team ability (48), communication skills (47) (32), conviction (31), empathy (21) (33), analytical thinking (28), conceptual thinking (23), economic thinking, cost-orientation (22) (11), strategic thinking (11), sales-oriented thinking (11), fun, motivation, pleasure (10).

Task-related characteristics, in 39.1% of the advertisements (number of mentions): organizational gifts (97), commitment (59), self-employment (49), commitment (43), flexibility (17), reliability, diligence, conscientiousness and patience (17), mobility (16), decision-making (14).

Personality-related characteristics, in 19.7% of the ads (number of responses):

managerial personality or vendor personality (92), personal qualities such as integrity (17).

The conclusion of the study is that ethical characteristics play a subordinate role in the selection of managerial staff. Although the managers have creative leeway, they have to subordinate themselves to the corporate objectives. The management features (23.8% of the total sample) dominated the management with a staff-oriented approach with 51% of the nominations.<sup>249</sup> In addition, there is an ethical aspect (“employee-oriented,” “sensitivity,” and “cooperative leadership style”) in many leadership areas, and some terms show overlapping traits (“employee-oriented” and “encouraging and developing employees”).

Indirect ethical properties can be deduced from the required properties. Conscientiousness, reliability, and integrity also contain a social (moral) orientation as secondary competencies. Furthermore, social skills such as empathy, co-operation and communication skills are required, which form the basis for discourse ethics. The requirements established under the leadership are indicative of a partnership-oriented leadership style.<sup>250</sup>

In job advertisements the concept of social competence is widespread. It is seen as a criterion for leadership and competitiveness. However, the term is generally not specified in detail.<sup>251</sup> The term acts as a collective term for social or group-specific abilities. This is generally understood to mean that the person is in a position to assume responsibility within the community and to contribute positively to social development. In particular, one has to respect morality and ethics, to work on one-

<sup>248</sup> Schneider, however, relativizes the statement meaning, since the indications also have a PR character. See Schneider, Armin (1993), pp. 82.

<sup>249</sup> See Schneider, Armin (1993), p. 87.

<sup>250</sup> See Göbel, Elisabeth (2010), p. 233.

<sup>251</sup> See Große-Oetringhaus, Wigand F. (1993), p. 273ff and Graf, Andrea (2002).

self in order to develop their own morality and to recognize and acknowledge their own responsibility towards the community or nature. This results in a respectful, fair, sincere, tolerant, compromising and sensitive attitude towards others.<sup>252</sup> In this way, social competence would correspond to interpersonal and intrapersonal as well as emotional intelligence.

The classic way to check applicants for their ethical attitudes and assessments is the personal interview. Surprisingly, the company's guiding principle, as well as the values and norms of the company as guiding principles, are rarely a basis for the selection of candidates, as an older survey shows. They are also not legally binding.<sup>253</sup> However, there are companies, such as BASF AG, which try to select their executives according to fundamental values and guidelines.<sup>254</sup>

As described in [Sect. 5.1](#). Economy and freedom – a historical overview, the current economy seems to lack knowledge about the importance of ethical values for long-term enterprise success. Only one in three top managers<sup>255</sup> says that morality plays an important role in the economy as a whole. Another third see the importance of morality in German leadership as more ambivalent, and the last third of top executives believes that moral questions are of secondary importance in practice. However, 13% believe that the moral value is absolutely inadequate, and 13% is not just the belief that morality does not belong to the economy, but on the contrary, that the economy requires a minimum of amorality. Only one-third of German top managers consider ethically responsible action to be not only desirable, but also largely implement it in day-to-day business. About 13% of the top executives in Germany even believe that the economy and morality are ultimately incompatible.<sup>256</sup> A typical statement from a top manager is: "In the end one is measured by their success, and one does not survive if one upholds morals."<sup>257</sup>

In a survey of 443 executives, 32.9% of respondents said their boss was morally questionable from time to time. Six percent even stated that the actions of their superiors were mainly problematic. Only 61.1% of executives rated the behavior of the superiors as "correct." More than 80% of executives said they had had to act against their personal convictions at least once, and every ninth (11.3%) felt that this was often the case.<sup>258</sup>

According to Buß's survey, about one-third of German executives correspond to the type of morally indifferent manager, who argues that economics and morality are ultimately incompatible, and that in cases of doubt, it is necessary to resort to

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<sup>252</sup> See Faix, Werner G./Laier, Angelika (1996), p. 63 and Thommen, Jean-Paul (1995), p. 17.

<sup>253</sup> See Schneider, Armin (1993), p. 101 und 126.

<sup>254</sup> See Schneider, Armin (1993), p. 102.

<sup>255</sup> Part of the survey were top executives who held the position of Chairman of the Board of Management, Chairman of the Supervisory Board or a member of the Executive Board in the 100 largest companies in Germany (in 2000).

<sup>256</sup> See Buß, Eugen (2009), pp.11.

<sup>257</sup> Buß, Eugen (2009), p. 18..

<sup>258</sup> See Die Akademie für Führungskräfte der Wirtschaft (2012), p. 18.

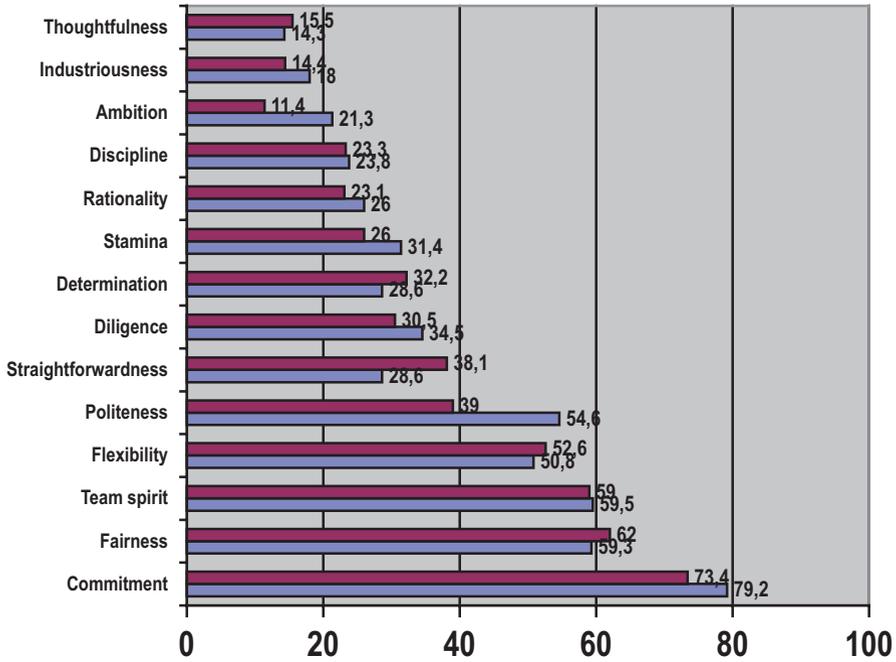


Fig. 7.17 Characteristics and Behaviors of Executives

immoral means.<sup>259</sup> A typical opinion of a morally indifferent manager is: “I seriously doubt whether one can always hit immediately with the great moral hammers. Not everyone can carry around an ethics catalog. False morality disturbs me, that we are a moral institution and that we should make profits by mistake. This kind of hypocrisy is not my world.”<sup>260</sup>

However, the managers themselves assess their leadership orientation differently. They see their behavior characterized by fairness, team spirit and commitment, and their general life orientation is oriented towards loyalty, recognition and success (Figs. 7.17 and 7.18).

Answers of the managers in percent to the question “Which of the following factors have the greatest importance for you in your life and determine your behavior in a sustainable way?”, Multiple selections possible (n = 443). Source: Die Akademie für Führungskräfte der Wirtschaft (2012), author’s translation.

It therefore appears that the social and ethical abilities are sought during the selection process above all for the subordinates, not for the leaders, which is clearly demonstrated by a knowledge deficit in the economy. Another contradiction was already apparent in the early 1990s. The executives demanded obligations from their employees, such as order, discipline, loyalty, thoroughness and reliability, but

<sup>259</sup> See Buß, Eugen (2009), p. 16 f.

<sup>260</sup> Quoted after Buß, Eugen (2009), p. 17.

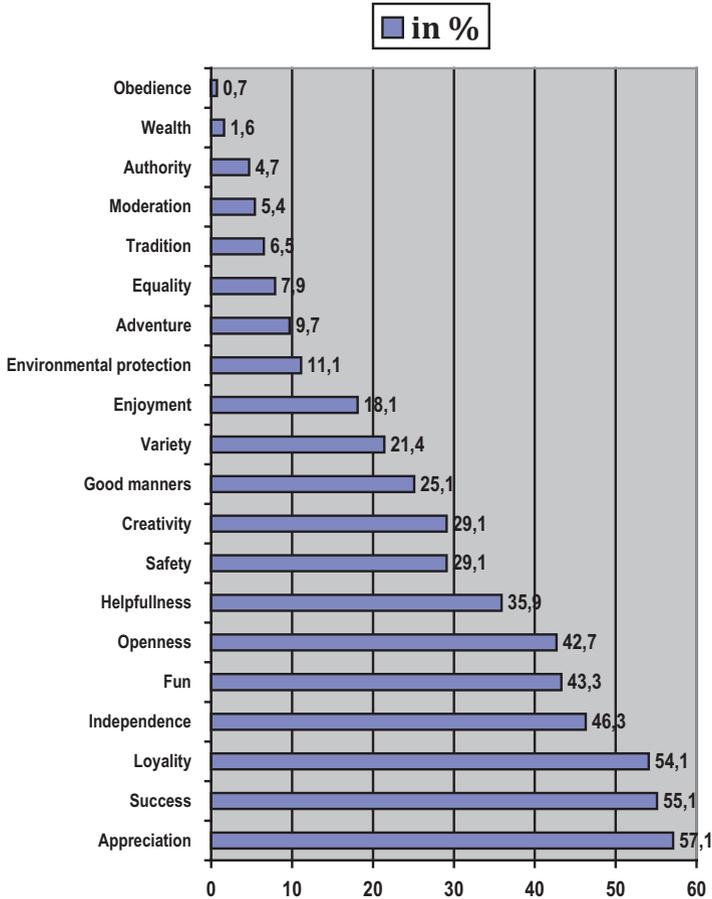


Fig. 7.18 Behavior Factors for Managers

emphasized values of self-determination, self-responsibility, participation and creativity.<sup>261</sup>

This is all the more serious as Windolf, in his investigation of the fraudulent Enron and WorldCom, found that the company selection mechanisms for executives resulted in the selection of persons who are aggressive and, in the extreme, also strive for a high income with criminal energy.<sup>262</sup>

Even among themselves, executives are often characterized as self-centered, self-absorbed, vain, power and status-driven, distant and non-communicative.<sup>263</sup> This would also make it impossible for executives to hold a personal ethical assessment and selection. Would they be able to run a company?

<sup>261</sup> See Dahm, Karl-Wilhelm (1993), pp. 4.

<sup>262</sup> See Windolf, Paul (2003), pp. 195.

<sup>263</sup> See Schieffer, Alexander (1998), p. 296.

### 7.4.1.3 Reasons for the Ethics Deficit in the Personnel Selection

Due to the above-mentioned complexity of the personnel selection procedures, they are regarded as particularly error-prone. In order to increase acceptance and to ensure ethical transparency, a selection procedure should be explained in its main features.<sup>264</sup> An applicant may prepare for the selection process, for which there is extensive literature. In this sense, it is an illusion if one hopes to get an objective picture through such a procedure. There will always be the subjectivity of the candidate, the artificial test situation and the manipulation or acting of the candidate. The question of social engagement is also known to be often partially fabricated, as the applicants have sought such an activity solely for their CV. Against this background, social activity can no longer be interpreted as a sign of sacrifice and group orientation.

It is to be assumed that the appropriate candidate is often not recognized, so that inappropriate candidates get the job. While enterprise-wide testing procedures such as assessment centers are increasingly being used, their validity and reliability are very controversial. Often, the requirement profile is not detailed enough, or there are subjective judgments of the personnel. The applicant can also feign suitability by acting as well as manipulating the application documents.<sup>265</sup>

Assessment centers make it easy for human resource managers to assess a large number of applicants according to objective criteria in a relatively short period of time. These tests can be prepared for, and to be successful the candidates have to optimize their answers according to the given criteria. In these mass tests there is no place for the edges of a creative personality. And the internal selection procedures often call for adaptation. Contradiction does not pay off.<sup>266</sup> Moreover it is difficult to adjust the selection criteria properly if assessment centers are used for external and internal staff placements. First, if the employees are chosen by criteria like obedience and absolute loyalty it might be difficult to later find the critical individuals who chose their own unique way as leaders among this selection. Second, assessment centers have negative effects if applied for internal promotions. The question that arises here is, why should one use an assessment center to check people who are already known in the company and have proven their abilities on more than a thousand occasions. An assessment center will never be able to match this. If employees have worked hard to be promoted and fail in the assessment center they are frustrated and are compromised in the company. They might then want to leave the company. This might be acceptable if the assessment centers were an infallible and precise tool to assess people's attitudes and capabilities, but this is not the case. In real life the selection criteria are often not communicated and transparent. They are executed by people so they will not always be repeatable with the same outcome.

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<sup>264</sup> See Wittmann, Stephan (1998), p. 423.

<sup>265</sup> See Göbel, Elisabeth (2010), p. 230.

<sup>266</sup> See Handelsblatt dated October 20/21/22nd 2006, p. 1.

Assessment center results would also be more accepted if they had been proven with all the employees and executives. Finally assessment centers seem to increase the conformity of employees in the company by using the same selection criteria, which must be seen also as a disadvantage as a diversity of characters will increase the benefits of labor division (synergy) and the innovation and problem solving capacity of the company.

The problem of asymmetric information about one's ethical orientation exists particularly in the selection of executives from external candidates. Contrary to this the internal applicants have usually been observed by the company for many years. Not least for this reason, the management positions have traditionally been occupied by internal managers.

Then there are still paradoxes in the internal promotion. As already shown, performance is not always transparent. Often it is important to seem more qualified than one is. Then there are the so-called networks. When a strong leader is promoted, he generally pulls his loyal subordinates upwards with him, but these are often not qualified executives, but employees who never criticize leadership and never disagree – the yes men. They do not have their own personality and therefore they have no leadership skills. As a rule, a strong leader not only prefers unconditional opportunists to the cross-thinkers because they are more comfortable, but he will also be careful not to take any of the equals or even a more qualified leader into their circle of power. Skilled leaders could steal his show and then his position. Better there is only one light that shines in the dark. The Citigroup boss Prince followed his charismatic career father Weill into the chief post. The trained lawyer is said to have had no experience in the operational banking business when he took office.<sup>267</sup> The deputy of Richard Fuld, the head of Lehmann (Joseph Gregory) has said that his greatest strength was that he could not become dangerous to Fuld.<sup>268</sup>

Of course one must be able to afford such a politically motivated and unproductive placement. At best, this can be afforded by a large company in which sufficient other employees compensate for the reduction in value added through the lack of the unskilled executive. The more important the company's position, the higher the cost of such a wrong human resource decision. In general, such missions can only be sustained if the people either do not have to prove themselves or the effects of their wrong decisions are not noticed, for example, in the absence of clear responsibility assignment or in the absence of functional controlling. In general, the larger a company, the more positions are politically occupied.

It is therefore not surprising that the employees of family businesses are more satisfied with 75% than the employees of large conglomerates, where only 65% are satisfied or very satisfied. These are the results of a study in which 389 specialists and managers aged over 40 in 2015 were interviewed by the professor Erika Regnet and the company consultant Boris Gloger. Gloger attributes this result to "tactical games and meeting delusions." There is too little entrepreneurial freedom, which is why much in meetings is to be collectively agreed. According to Gloger, fewer hier-

<sup>267</sup> See Handelsblatt dated October 11th 2007.

<sup>268</sup> See Der Spiegel No. 11 (2009), pp. 43.

archies and a stronger focus on results lead to higher productivity and satisfaction among the highly motivated specialists and executives. Andreas Schüren, a partner and entrepreneur consultant at Ebner Stolz, sees family businesses as long-term oriented, they think in 10–15 year periods and not in quarters like the big public corporations.<sup>269</sup>

Perhaps, however, the career paths of adaptation are also unattractive with partial immoral preconceptions. If it is only about adaptation and subordination to the company's goals, or rather to the superior, there will be neither time nor strength for other human goals such as friends, family, and social obligations. The top positions and the path to them are unattractive for personalities. A balanced life according to the goal of Aristotle can not be carried out here, which is why usually only the opportunistic careerists follow this path. They are above all concerned with power, personal advantages and, at best, self-assurance, but they are not willing to self-sacrifice for the company.

Another reason for the business hurdles seems to be overwhelming corporate leaders. Jeff Skilling at Enron, Bernie Ebbers at Worldcom, Percy Barnevik at ABB, John Chambers at Cisco, Jean-Marie Messier at Vivendi and Cees van der Hoeven at Ahold and last but not least Dennis Kozlowski from Tyco led the entrusted enterprise as a lone ruler with their charismatic and exaggeratedly self-assured personalities. Blinded by initial successes, companies and capital providers followed them to their downfall. This is a human group phenomenon, which is often observed with a strong concentration of power. At some point, the rulers themselves believe in their infallibility, become light-hearted, uncritical and only tolerate yes men in their environment. In the case of companies, this is often expressed in a quest for ever-greater power through sprawling acquisitions, which in some cases are no longer controllable and overwhelm the company. Tyco holds the record with up to 200 company acquisitions during the peak periods.<sup>270</sup> Later, Kozlowski was sentenced to 25 years imprisonment for fraud and other offenses, and Tyco's shareholders and creditors were judicially allowed to sue ex-Tyco auditors PricewaterhouseCoopers. The Group had reported revenues of \$5 billion too high, which is why the new management, in an out-of-court settlement, agreed to pay \$3 billion as indemnity to the plaintiffs.<sup>271</sup>

Many top managers have great weaknesses in their personality as well as in their abilities, which have almost ruined some companies (such as ABB and DaimlerCrysler) and have ruined others (Enron and Worldcom). What is the cause? How are leadership positions given when performance, ability and integrity are not the key criteria? As already mentioned, job placements (especially the external) have the risk of hidden characteristics. People who have good self-representation and do not take truth very seriously are always in the advantage here. An employer, including a supervisory board, can only be accused of making a mistake, but they did not act for a long time if the weaknesses of the appointed managers have come

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<sup>269</sup> See Tödtmann, Claudia (2015).

<sup>270</sup> See Probst, Gilbert/Raisch, Sebastian (2004), pp. 38.

<sup>271</sup> See Handelsblatt, 16.05.2007, p. 11.

to light. But another aspect is much more important: a company is first and foremost a functional grouping of many people, an organization. And this is where people are concerned with power, influence, prosperity and the distribution of it. In this environmental sociology, the behavior of people in the group comes into play.

Let us assume that humans descended from the monkey. As has also been observed in groups of monkeys, the pith arrangement, that is, power and recognition, is not directed at the strength of the individual, but at political influence in the group. The relative strength of all group members, whose support can be won by an individual, is decisive. If a group member wants to have more influence than others, they must form alliances. As a rule, the people who are supported are strong, otherwise they could not get along within the alliances, but the qualification and the strength needed for them does not have to be the same as a professional or moral qualification or ability to lead a company. Above all, political qualifications are required to give others the impression that their personal interests (primarily power, influence and salary) are best represented in the company. Finally, if two rival alliances are each not strong enough to push through their desired candidates, they often agree on a compromise candidate. He is then often weak in both technical and political terms, so that he cannot harm the alliances in the key position to be filled.

### **Conclusion**

If many executives do not have the appropriate personality and attitudes to show personal authority, and are not an ethical role model who leads ethically, it creates a productivity and security issue for the enterprise. For the shareholders it is not possible to identify the unsuitable executives from the outside due to the asymmetric information.

Personal interviews and anonymous executive evaluations are required in addition to personality questionnaires in order to make the management structure and culture more transparent to the company's management. Otherwise, independent organizations are created in the company that can pursue objectives different from those of the company. Lower superiors become dictators who harass their employees, who in turn check out internally. The information image is manipulated by the superiors to appear in the best light possible. Company management then makes decisions on the basis of false information, which are either partially implemented or not at all.

From this perspective an ethical aptitude test would be required for managers. Especially when a company is developing badly, this can also be due to the lack of ethical orientation from the managers. Then the positions of these employees would be occupied again if one wants to increase the productivity of the company. How to establish ethical attitudes?

The value orientation of employees and managers can be determined by questionnaires, case studies, group discussions and planning games. For example, an ethical dilemma (see below) or the desirable qualities of managers can be discussed in a group.<sup>272</sup>

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<sup>272</sup>See Göbel, Elisabeth (2010), p. 235.

Various test methods have also been developed specifically for assessing the ethical orientation and judgment of executives.<sup>273</sup>

### **Roleplaying: Behavior as a Criterion for the Ethical Selection of Staff**

A balloon has to throw ballast or it will crash into the sea. Who should go?

Four seminar participants sit in an imaginary balloon. The rest of the seminar participants evaluate the behavior of the four and their solutions. Who is faithfully ethical and yet constructive?

#### **Summary**

The selection of staff is one of the most difficult and important corporate decisions. Due to the asymmetrical distribution of information, the company does not know the characteristics, abilities and intentions of the applicant, particularly in the case of external positions. Standardized procedures such as the assessment center do not alter this problem. On the contrary, there is also the danger of an incorrect pre-selection. At present, there is too little emphasis placed on ethical criteria, particularly in the selection of executives, which explains some of the shortcomings of corporate policy in recent years.

#### **Comprehension Questions**

1. What are the main problems of personnel selection? Can assessment centers help solve problems? Explain your opinion.
2. According to which criteria are employees and managers predominantly selected?
3. What do you propose to take more consideration of ethical criteria in the selection of staff?

## **7.4.2 Ethical Personnel Development**

Traditional personnel development is part of personnel management, which also includes the external job placement. The aim here is to adapt the qualifications of the employees and executives to the requirements of the company by means of suitable measures. This includes the further development of employees within strategic business planning for future tasks. Personnel development therefore depends on personnel selection. More specifically this means optimizing job assignments by means of transfers and promotions, adapting the qualification of employees to the job profile by means of training, continuing education and training, and, conversely, adapting a job to the qualification of an employee (so-called organization ad personam). Regular performance and potential assessments should reveal the targets and actual deviations of the job requirements. These gaps are then closed by personnel

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<sup>273</sup> See Staffelbach, Bruno (1994), p. 248 and [http://www.tuev-nord.de/cps/rde/xbcr/tng\\_de/pdbethi\\_2089553937k.pdf](http://www.tuev-nord.de/cps/rde/xbcr/tng_de/pdbethi_2089553937k.pdf)

development measures. If this is not successful, the positions must be changed internally or externally.<sup>274</sup>

This can be transferred one-by-one to ethical personnel development. The goal of ethical personnel development is to increase the moral competence of the employees. An immediate advantage is the avoidance of scandals and court proceedings and thus gaining a better reputation. Indirect advantages, such as a higher level of employee satisfaction and ultimately higher productivity have already been shown above. Furthermore, as we have seen, the ethical preconditions are the basis for overcoming moral hazards, that is, the pursuit of corporate objectives by the executive without enriching the company at the expense of the principal. Ethics thus ensure motivation and productivity. Regular behavior evaluations as well as attitude and character evaluations should also reveal the target and actual deviations from the job requirements. These gaps are then closed by ethical personnel development measures. If this is not successful, the points must be changed internally or externally. How to measure ethical behavioral dispositions?

#### 7.4.2.1 The Step Model of the Moral Judgment from Kohlberg

In his step model Kohlberg shows the development of human moral judgment in life phases. In his approach, Kohlberg blends different characters and affective actions and concentrates exclusively on the way ethical problems are addressed (ethical problem-solving complexity). This leads to the modes of action which we would call good, moral or immoral. Kohlberg carried out a structural analysis of the responses.

Kohlberg used the so-called Heinz dilemma to test the ethical weighing of the subjects. A man named Heinz has a wife who is dying. There is only one remedy that a pharmacist has developed. But the pharmacist only wants to sell it for ten times the price of the production costs. Heinz tries everything to get the money, but unfortunately unsuccessful. In his despair, Heinz finally breaks into the pharmacy and steals the drug.<sup>275</sup>

##### A. Preconventional Level

(Corresponds to children up to 9 years of age, some adolescents and criminal adults)

###### 1. Level

Initially, actions are carried out solely on the basis of a determined reward and punishment. There is no self-reflection.

###### 2. Level: Recognition of reciprocity

As in the market, one sees the actions that affect others in terms of what you get for yourself. The exchange principle is dominant. Like is rewarded with like (tit for

<sup>274</sup> See Oechsler, Walter A. (1997), pp. 440 and Berthel, Jürgern/Becker, Fed G. (2013), pp. 413.

<sup>275</sup> See Kohlberg, Lawrence (1971) and Kohlberg, Lawrence (1996).

tat / do ut des). There is no questioning of one's own position, no weighing of the effects of self-action, thus no conscience or sense of justice. People are beneficial because they are oriented towards the user.

### **B. Conventional Level**

(Is the level at which the majority of adolescents and adults are located)

#### 3. Level: Interpersonal concordance or external orientation ("Nice boy/girl")

The moral expectations of others are recognized. Social recognition is considered important. The social norms and values of reference persons, authorities or the society (group) are decisive for this reason, which is why they are oriented to this (third-party determination). If one does not live up to the moral expectations of others, one develops feelings of guilt, but also develops moral expectations for the group.

#### 4. Level: Understanding the system

One recognizes the necessity of law and order and social norms and rules, which is why one is prepared to behave morally without reward or punishment or recognition of a reference person.

### **C. Postconventional Level**

(Is achieved only by a minority of people, and if at all, then only as an adult older than 20 years)

#### 5. Level: the legalistic orientation to the social contract

Moral norms, rules and laws are not accepted as given by the outside, but are questioned and acknowledged only if they are logical or cause societal advantages. This requires a strong analytical ability. One is in a position to form a moral judgment. It is, however, a diffuse moral image. About a quarter of all people reach this level.

#### 6. Level

Behavior is based on universally valid values which are recognized and taken into account as the basis of human action, such as the categorical imperatives and values such as justice, human dignity and equality. The moral action, the respect for others, comes from inner conviction. Man is self-centered ethically and not on the search as in level 5. One is in a position to weigh the consequences for others according to these universal criteria within the framework of discourse ethics and to arrive at the morally right decision. This level is reached by approx. Five percent of people.

Kohlberg's theory was also tested empirically by others. Turner found that Kohlberg's levels of moral judgment are positively correlated with the acceptance of leadership as an example from the point of view of the employees.<sup>276</sup> This also confirms the approach of personal authority.

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<sup>276</sup>See Turner, N./Barling, J./Epitropaki, O./Butcher, V./Milner, C. (2002).

The Kohlberg model can also be summarized in three stages of moral judgment<sup>277</sup>:

1. Level: morality according to regulation

There is only an orientation to the laws and norms, more precisely to the sanctions. If there is only a small risk of being punished, or the penalties are light, one behaves unethically. By way of example, the speed limits are exceeded if there are no speed controls.

2. Level: Moral on reciprocity

“Treat others as you want to be treated, for instance by your colleague or your competitor” (Golden rule or part of the categorical imperative as well as “live and let live”). Man achieves the insight that we are dependent on one another in the workplace and that other interests are also to be accepted.

3. Level: Superior morality of responsibility

There is no reciprocity when the ethical behavior serves overarching goals, values that have been understood for themselves (ethos). Behavior is based on principles that are thought to be right and one tries to weigh the consequences of their own actions ethically.

### Conclusion and Criticism

Kohlberg shows in his step model the development of the human ethical judgement capability in life phases. Kohlberg’s test methods can, for example, determine the moral judgment of the executives. In order for executives to be able to fulfill the complex tasks of employee management and balancing the various stakeholder interests, they must have arrived at the postconventional level.

It is undoubtedly true that people who have a good character and weigh the consequences of their actions can proceed from the child level as described by Kohlberg when the environment encourages ethical behavior.<sup>278</sup> However, there are also adults who are on one of the lower moral development stages. The question is whether this is a development that can be carried out by all people and how they can be influenced externally. Kohlberg has been criticized for only declaring the moral judgments, but not the behavior, and that the ethical behavior does not necessarily follow from the judgment.<sup>279</sup> Nevertheless, judging is the prerequisite for behavior and so is decisive. In the meantime, the relationship has also been demonstrated empirically. Ashkanasy et al. showed that ethical decisions are positively correlated with the ability of moral judgment.<sup>280</sup>

<sup>277</sup> See Dahm, Karl-Wilhelm (1993), pp. 8.

<sup>278</sup> See Staffelbach, Bruno (1994), pp. 248; Achouri, Cyrus (2015), pp. 223; Kohlberg, Lawrence (1971) and Kohlberg, Lawrence (1996).

<sup>279</sup> See Staffelbach, Bruno (1994), pp. 248.

<sup>280</sup> See Ashkanasy, N. M./Windsor, C. A./Treviño, L. K. (2006).

### 7.4.2.2 The Moral competence of the Employees in Line with Staffelbach

The moral competence of the employees can be subdivided into three sub-competencies based on Staffelbach.<sup>281</sup> First, one has to wish for the good and then to recognize the good.

#### 1. Moral attitude

If the good is not wanted by the employees, they will not have any thoughts about the consequences of their behavior. Because certain character traits are given, it can only be a matter of sensitization and the mediation of the ethical corporate guidelines, so that the employee recognizes what the company wants.

This includes the inner willingness to recognize and take into account the rights and interests of other people, such as colleagues and other stakeholders, as fundamentally equivalent (affective component). But there are also situations in which one has to move emotionally into the situation of others. This requires empathy as a skill.

A study of the moral development of apprentices has shown that there is a change of relationship between an existing moral sense of responsibility and the possibilities to stimulate it through more self-responsibility. If there is a sense of responsibility, the employees want more self-determination and this is also the prerequisite for a sense of responsibility.<sup>282</sup>

#### 2. Moral cognitive abilities

There are people who act without worrying about the consequences of their actions. This can be due to their attitude or the ability to recognize the consequences. What is needed here is an analytical ability to recognize cause-and-effect relationships. It is necessary to assess the spatial, temporal, and distant consequences of one's own actions. This includes the ability to achieve a certain mental distance,<sup>283</sup> intelligence, imagination as well as experience.

#### 3. Comprehension

The employee needs competence to exchange his opinions about the consequences of the company behavior and its evaluation with colleagues and other stakeholders in the context of a discourse according to the approach of discourse ethics or the ethical stakeholder analysis and then to reach a consensus result. For this purpose, employees need communication, co-operation and conflict management.

However, ethical comprehension competence in the sense of discourse ethics is not strategic "bargaining," in which one interrogates, lies, tricks and manipulates,<sup>284</sup>

<sup>281</sup> See Staffelbach, Bruno (1994), pp. 421.

<sup>282</sup> See Lind, Georg (1989), pp. 306.

<sup>283</sup> See Retzmann, Thomas (1997), pp. 297. See zum Rollenansatz von Rawls Rawls, John (1979), pp. 158 and 341, and in the original Rawls, John (1971), pp. 10, 12, 139.

<sup>284</sup> See Ulrich, Peter (1998), p. 13 and Göbel, Elisabeth (2010), p. 260.

or makes the assertion of one's standpoint in the sense of a rhetoric competition, but balances all interests for a socially (stakeholder-related) optimal solution, that is, a utility maxim taking into account the values and goods for each concerned.

For this purpose, the employee needs a real consensus, honesty, openness and mutual recognition in the sense of "argumentation integrity" by Blickle. Blickle et al. varied the violation of expectations in experiments with discussion participants and came to the following recommendations<sup>285</sup>:

1. Do not argue intentionally in uncompromising ways.
2. Do not justify your allegations.
3. Do not say something is true or objective, when you know it is false or subjective.
4. Do not seek excuses, to deny responsibility, or to defer.
5. Do not circumvent your own or foreign positions in a **disassembling** manner, for example in order to create exceptions.
6. Do not deliberately reproduce the meaning of your own or third-party contributions wrongly.
7. Do not place demands on the discussion or negotiation partner, if you know they are incapable of fulfilling them.
8. Do not discredit or ridicule the other.
9. Do not treat others as an enemy, so as to offend, provoke or intimidate them.
10. Do not allow other participants to be excluded, for example by deliberately clouding the issue, by refusing to discuss issues, or by using frequent technical terms.
11. Listen to the other person, evaluate his arguments in the weighing of goods with yours, and bring a counter-argument only after you have understood and validated their point.

The importance of comprehension competence must not be underestimated, because without a fair and open discourse, without an honest discussion, no optimal result for the company can be found.

The employees are socialized through the corporate culture as well as through role models, rewards and sanctions of the managers. The ethical influencing of employees via the mediation of values is also called value management (Wieland).<sup>286</sup> According to Wieland,<sup>287</sup> there are four levels of ethical consciousness, three of which are appropriate to convey values:

### 7.4.2.3 Levels of Ethical Awareness and Wieland Management

#### 1. Character

<sup>285</sup> See Blickle, Gerhard (1996), pp. 116.

<sup>286</sup> See Wieland, Josef/Fürst, Michael (2002), p. 5 and Wieland, Josef (2014).

<sup>287</sup> See Wieland, Josef/Fürst, Michael (2002), p. 5.

The human being has an innate character, in which values are laid down indirectly as behavioral dispositions.

## 2. Childhood Socialization

In childhood man is socialized by his parents, that is, educated. Praise and blame, including sanctions, adapt his behavior to that desired by the parents. Parents also give him their value system through conversations and enlightenment. Added to this is socialization through the circle of friends and school. For the first time, society is given the opportunity to directly influence human development. There is often also the influence of religion via the parents and common church visits (communion, confirmation etc.).

## 3. Socialization as an adult

The socialization of adults (secondary socialization) takes place in the respective societal environment such as in the workplace, or depending on the religious character, the church may have influence.

## 4. Self reflection

Finally, the adult has the possibility to form his own reflection on moral values and define values for himself. This conscious assumption of values yields ethos.<sup>288</sup>

Is it possible to change employees as adults in their behavior? Insofar as the employees adapt themselves in the company environment, the group, they can also adapt to ethical requirements. Sociology speaks of a “secondary socialization”.<sup>289</sup>

It has to be taken into account that an ethical training of the employees up to the 6th level of the Kohlberg model is indeed desirable and striking, but unfortunately also unrealistic. Even Kohlberg assumes that only a small part of people reach the top two ethical levels. A realistic goal seems to be the 5th level. In order to achieve this, it is necessary to highlight the benefits of ethical behavior for companies and society and to provide employees with an ethical armament for evaluating everyday situations. The first step in this direction is to inform the public and the companies about the productivity advantages of ethical behavior, thus gaining acceptance for ethical personnel development.

The task of ethical personnel development would be, as with the Kohlberg model, to strengthen the cognitive ability of the employees to moral judgment, that is, no indoctrination or ethical brainwashing. It changes the structure of judgment and not the value base. The employee then finds values using his own knowledge.<sup>290</sup> An instrument for this would be the Socratic conversation within the framework of ethics seminars. The employee should be able to select the morally correct action independently of his own advantages or disadvantages or company specifications and to persist in his viewpoint.

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<sup>288</sup> See Berger, Peter L./Luckmann, Thomas (1972), pp. 148.

<sup>289</sup> See Berger, Peter L./Luckmann, Thomas (1972), pp. 148.

<sup>290</sup> See Staffelbach, Bruno (1994), p. 249.

#### 7.4.2.4 Ethics Seminars

In addition to the publication of ethical corporate guidelines, many companies use corporate ethics seminars to convey the company's ethical orientation. First of all, it is important to make the employees aware of their own ethical position. The already described "value clarification" method is used.<sup>291</sup> Again, the Socratic conversation can be applied as a method. Socrates applied a special open questioning technique to motivate people to self-knowledge (māeutics or midwifery). Midwifery because the questions raised something from the interviewees that had already been there. This is a philosophical dialogue for the purpose of gaining an insight in an open-ended research process.

The goals and wishes of the employees are listed, chosen among alternatives, and the values hierarchy is derived from them. Alternatively, concepts such as social Darwinism, conventionalism, legalism, etc. can be put to ethical discussion. From the positions of the participants the values can then be worked out. Employees are also asked to apply these approaches to their business experience and to critically deal with these ethics concepts, in which their own attitudes become clear and they learn to critically question ethical positions. Ultimately, they should say what they would be willing to do for their values.

In order to provide employees with the implications of economic activity, role-playing games are particularly suitable, in which they assume the role of the affected person and argue for his or her interests in the group. It is customary to hold ethics seminars in the form of external workshops, in which, in addition to role-playing games (including, if necessary, planning games) case studies and discussions, ethical awareness is conveyed interactively. Basic ethical knowledge can be taught through lectures. Alternatively, presentations or group work can be selected as an intermediate form. Discussions of ethical dilemmas, in particular, inspire the employees with intensive discussions, reveal ethical attitudes and lead to a critical reflection on the morally appropriate solution, which also challenges their own standpoints.

In order to support the moral balance, workshops can be used with questionnaires that include previously elucidated ethical criteria or decision trees with handling options and their results. In addition, there are value tree analyses in which the values and norms as well as the goals of the employees or the company are transferred to a hierarchical tree structure according to their value and dependency. Test criteria can then be derived from this. Structural forms can be used to evaluate action options based on the criteria listed there, or to evaluate the ethical behavior of the workshop participants in their roles. Interdependent analyses can be used to record stakeholder relations.<sup>292</sup>

With these means, complex contexts can be disassembled, simplified and subsequently structured and analyzed. Ethical awareness is thus possible. However, most of the effects of an action are not workable and therefore not comparable. Since it is

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<sup>291</sup> See Staffelbach, Bruno (1994), pp. 336.

<sup>292</sup> See Dahm, Karl-Wilhelm (1993), p. 3 and Staffelbach, Bruno (1994), pp. 302.

ultimately always a moral consideration of the consequences, there will also rarely be a unanimous agreement of all workshop participants. The comprehension competence can be increased by means of argumentation exercises, business games and role play, team development and group dynamics training (encounter groups, sensitivity training, etc.).<sup>293</sup>

#### **7.4.2.5 Corporate Volunteering**

In the sense of an ethical maturation or awareness-raising, so-called Corporate Volunteering can be especially useful for executives. In doing so, the employee is released from the company for a so-called social task. For example, a board could help one day to feed the needy or go on the street for the homeless. This also leads to an ethical increase in the awareness of leadership. A different life role allows previously unknown insights and identifications. Such a program signals a positive example in the company that ethical aspects are taken seriously. At many universities as a comparable approach, social learning as a compulsory subject was included in the curriculum.<sup>294</sup> The students take on social tasks as a project in groups.

#### **7.4.2.6 Training-Near-The-Job**

In the case of training-near-the-job, employees meet in circles in order to discuss ethical aspects of their work in the company. It is therefore an application of discourse ethics. Employees can be clear about the consequences of their own work through the ethical evaluation as part of the group discussion and also receive feedback from their colleagues. At the same time, the company's horizon is expanded.

An inclusion of external people is recommended if the expertise and experience with ethics seminars are not internally available or the authority, neutrality and objectivity of an external perspective is needed. This can be an advantage, particularly in the case of executive seminars and mixed workflows with employees, in order to overcome internal power structures.

In general, the company can increase ethical awareness and behavior by giving employees more room for decision-making, and more responsibility. Employees cannot develop when they are restricted by command and obedience.<sup>295</sup> As organizational measures, training-near-the-job offers employees the opportunity to be confronted with morally relevant conflict situations within the company. In this way, they can gather experience of cooperation and responsibility and communicate their ethical considerations.<sup>296</sup>

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<sup>293</sup> See Staffelbach, Bruno (1994), p. 423.

<sup>294</sup> See Göbel, Elisabeth (2010), p. 264.

<sup>295</sup> See Retzmann, Thomas (1997), p. 301.

<sup>296</sup> See Porter, Michael (1993), pp. 814.

## Summary

The goal of ethical personnel development is to increase the moral competence of the employees. An immediate advantage is the avoidance of scandals and court proceedings and thus a better reputation. Indirect advantages, such as a higher level of employee satisfaction and ultimately higher productivity have already been shown above. Furthermore, as we have seen, the ethical preconditions are the basis for overcoming moral hazards, that is, the pursuit of corporate objectives by the executive without enriching the company at the expense of the principal. Ethics thus ensures motivation and productivity. Regular behavior evaluations as well as attitude and character evaluations should also reveal the target and actual deviations of the job requirements. These gaps are then closed by ethical personnel development measures. If this is not successful, the points must be changed internally or externally.

## Questions of Comprehension

1. What are the goals of ethical personnel development?
2. Name and explain some instruments of ethical personnel development.
3. How far can the ethical awareness be influenced?

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