The Ethics *of* MANAGEMENT

Fifth Edition

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LaRue Tone Hosmer

The Ethics of Management

Fifth Edition

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School of Business Administration
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THE ETHICS OF MANAGEMENT

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This book is printed on acid-free paper.

3 4 5 6 7 9 0 DOC/DOC 0 9 8 7 6

ISBN: 978-0-07-299607-4
MHID: 0-07-299607-2

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Typeface: *10.5/12 Times Roman*
Compositor: *SR Nova Pvt Ltd., Bangalore, India*
Printer: *R. R. Donnelley*

Library of Congress Cataloging-in-Publication Data

Hosmer, LaRue T.
The ethics of management / LaRue Tone Hosmer.—5th ed.
p. cm.
Includes index.
ISBN 0-07-299607-2 (alk. paper)
1. Business ethics. 2. Industrial management–Moral and ethical aspects. I. Title.
HF5387.H67 2006
174'.4–dc22

2004063650

www.mhhe.com

About the Author

LaRue Hosmer is a mechanical engineer who, in 1955, founded a company to build waste-reduction equipment for sawmills and paper mills. The company was sold in 1968, and Professor Hosmer returned to the academic community and received a PhD in Corporate Strategy and the Economics of Competition in 1971. He has taught at the University of Michigan ever since, with visiting appointments at Stanford, Yale, Virginia, the Naval Post Graduate School, and Alabama. His interest in ethics dates from experiences while running the machinery company, and he offered the first course in ethics of management at the Michigan Business School in 1984. He currently is emeritus.

Preface

The Growing Importance of Ethics in Management

The past several years, starting with the financial and moral bankruptcy of Enron Corporation in 2001, have seen almost daily revelations of apparent ethical violations by persons working for large global companies. There have been fabricated statements of corporate profits, improper concealments of corporate debts, exploitive trading of mutual funds, self-serving reports by securities analysts, insider trading by brokerage firms, unauthorized payments and perks to senior executives, etc. This text contains new cases on all of the actions mentioned above, plus others dealing with harmful environmental discharges, unsafe working conditions, sudden plant closings, continuing job exports, untruthful marketing policies, etc. Tyco, Enron, Bank of America, New York Stock Exchange, WalMart, Electrolux, Whirlpool, and Martha Stewart are among the company situations and individual actions that are described in the following written cases for class discussions.

The students in those classes are going to have to deal with these issues soon after graduation; the pressures on entry-level employees to "get along by going alone" are immense in today's highly competitive, highly complex, and highly diverse global economy. Yet at the same time, the opportunities for those same entry-level people to "stand out by standing up" are equally great. My most basic argument is that all members of our courses are going to have to learn how to *convincingly* present their moral point of view to others in order to jointly serve their companies, protect their careers, and improve their societies. There are, in my view, five steps in making such convincing presentations:

1. Recognize that moral problems in business are complex and difficult to resolve. Moral problems in business inherently involve some individuals and/or groups associated with the firm who are going to be hurt or harmed in ways outside their own control, while others will be benefited or helped. Further, some of those individuals and/or groups associated with the firm will have their rights ignored or denied, while others will have their rights recognized and extended. There is a mixture of benefits and harms, of rights exercised and rights denied, in the moral problems of management, and this mixture makes it very difficult for business managers to decide upon a course of action that they can confidently say is "right" and "just" and "fair" when faced with a moral problem.
2. Understand that business managers cannot rely upon their moral standards of behavior or the intuitive ways they just automatically feel about what actions are

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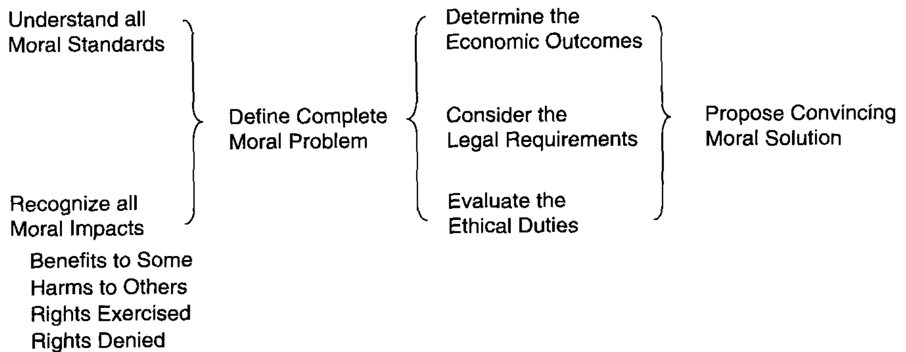
"right" and "just" and "fair" (and which are not) to make their decisions when faced with a moral problem. Moral standards of behavior differ among people, depending on their personal goals, norms, beliefs, and values, which in turn are dependent upon their cultural and religious traditions and their economic and social situations. The individuals and groups in a global economy come from very different cultural and religious traditions and live in very different economic and social situations, and consequently their moral standards of behavior, being subjective, are bound to differ substantially. Business managers have to understand, and deal with, those differences.

3. Accept that it is not enough for a manager to simply reach a decision on what he or she believes to be a proper balance of benefits for some and harms for others, of rights recognized and rights denied, in any given situation. Managers have to go further and *be able to explain convincingly why that balance should be viewed as "right" and "just" and "fair."* A convincing explanation requires objective methods of analysis rather than subjective standards of behavior. These objective methods of analysis include (1) economic outcomes based on impersonal market forces (2) legal requirements based on impartial social and political processes and (3) ethical duties based on universal human goals. This logical decision process starts with a listing of the benefits and harms, together with an accounting of the rights exercised and the rights denied, for each of the involved individuals and groups to make certain that everyone understands the magnitude of the problem, despite the differences in their moral standards of behavior, and then moves on to the tripartite analysis. This logical process is shown graphically in the following figure:

The Application of Objective Models of Moral Analysis in Management



4. Anticipate that if this proposed decision process is followed on a consistent basis, with moral solutions that are logically convincing to the individuals and groups associated with the firm, the result will be an increase in the trust, commitment, and effort evidenced by those same individuals and groups. Everyone wants to be treated justly in the workplace, but the only way most people can ensure that just treatment in the future is to work for managers they trust because of actions in the past. They tend to trust those managers who have logically and convincingly explained the economic, legal, and ethical foundations of their decisions and actions. The argument here is that trust leads to commitment, that commitment leads to effort, and that committed effort is essential for continuing success in a competitively intense, technologically complex, and culturally diverse global economy.
5. Believe that it is not enough for the senior executives in a firm to consistently recognize moral problems and convincingly present moral solutions in order to bring all of the individuals and groups associated with the firm into a committed, integral whole. Instead, this sense of corporate integrity has to be spread throughout the firm, and that requires a mission statement based on accepted organizational values and defined corporate goals and sustained by financial supports, performance measures, incentive payments, prohibited procedures, and leadership actions. Given the increasing intensity, complexity, and diversity of global competition, companies cannot continue to operate successfully without the resulting cooperation, innovation, and unification that come from trust, commitment, and effort.

It has often been said that ethics is essential for leadership. My argument is that leadership is also essential for ethics. Somebody has to be willing to stand up and say, "This is what we should do, and this is why we should do it." That is the combined character and skill that I think we should be teaching in our classes.

Bank of America and the "Market Timing" Trading of Mutual Funds

Bank of America is one of the largest financial institutions in the United States. It is headquartered in Charlotte, North Carolina, and has 4,200 offices in 21 states and the District of Columbia. Total assets in 2002 were $660 billion. The company provides retail banking (checking accounts, credit cards, mortgages, and mutual funds for middle-income individuals and families), commercial banking (loans, leases, and financial services for small to middle-sized business firms), and investment banking (bond/equity transactions for large corporations and trust funds and special services for high-net-worth individuals and institutions). It was the combination of the mutual funds for middle income individuals and families and the "special services" for high-net-worth individuals and institutions that brought about a substantial problem for Bank of America in the late summer and early fall of 2003.

Eliot Spitzer, Attorney General for the State of New York, charged that Bank of America had permitted Edward Stern, an exceedingly wealthy investor and the controlling manager of Canary Capital Holding (a large hedge fund), to engage in the market timing trading of the mutual funds sold by the bank to their middle-income customers. Market timing trading essentially is "buy today and sell tomorrow" investing. Mr. Stern and/or the hedge fund that his firm controlled would buy large quantities of shares in some of the mutual funds offered by the bank in the belief that they would go up, or sell those shares short in the expectation that they would go down, and then dispose of those same shares quickly within the next day or two to record the profit if their forecast was correct or to absorb the loss if their forecast was wrong.

> Say it's midafternoon in New York and the U.S. market is rallying powerfully on better than expected economic news. It's likely there will be a follow-up rally in Tokyo the next day. So a short term trader puts in an order to buy shares in a U.S fund holding Japanese shares before 4 p.m. If the Tokyo market indeed rallies, the trader simply sells the fund shares the next day at a quick profit. (*The Wall Street Journal*, September 8, 2003, p. C1)

Market timing trading is said by many to be a futile exercise. The "efficient market hypothesis," which is a mainstay of financial economics, posits that the existing price of any security (including mutual funds) reflects all currently available knowledge about the worth of that security, and consequently claims that market timers are just making random (coin toss, or 50 percent–50 percent) bets on the future direction of the market and should encounter as many losses as gains.

Mutual fund market timers, however, attempt to ensure that their bets are not fully random. They focus, according to the charges filed by Attorney General Spitzer, on mutual funds that hold large components of small company and/or foreign company stocks. Much of the information concerning these small company and foreign company equity issues is not quickly disseminated. Large-net-worth individuals (or more properly the investment advisors representing those individuals) and institutions (particularly the hedge funds, which operate with borrowed monies to increase their leverage), Attorney General Spitzer continued, established networks to gather that information, both positive and negative. They would then wait until just before 4:00 p.m. Eastern Time, when trading stops on the various stock exchanges within the U.S., and then place very large orders to buy or to sell shares in specific mutual funds.

Mutual funds are investment vehicles owned by banks, brokerages, or investment firms. They invest in a portfolio of stocks and/or bonds of different companies, generally with a focus on size—small cap (capitalization, or amount of equity), mid cap, or large cap—or on industry—pharmaceutical, electronics, telecommunication, etc—or on locations—United States, Europe, Southeast Asia, etc. The shares of these mutual funds are not sold on markets such as the New York Stock Exchange. Instead they are sold directly to customers by the banks, brokerages, or investment firms at prices that are computed by the funds at the close of the prior business day.

The managers and staff at each mutual fund compute the price at which they will either sell or purchase shares by adding up the net asset value of all of the stocks and/or bonds held in their portfolio. They multiply the closing price on the exchange where the stock or bond is listed times the number shares that they hold, add the value of their cash reserves, and then divide by the number of their fund shares outstanding to get the net asset value per share. That net asset value per share is then the price that all buyers will pay or all sellers will receive for that fund on the following day. The problem comes if there is information about some of those stocks and/or bonds in their portfolio that is not known by the average buyer or seller, but is known by the investment advisors and hedge funds. Then it is possible for those financial professionals to anticipate that the next day's closing prices for those stocks and/or bonds will be either higher (with positive news) or lower (with negative news), and make substantial profits based on their informational advantage.

> Most foreign companies announce earning increases or reversals, or corporate policies and competitive trends likely to bring about those increases or reversals, after the close of the financial markets in their region or time zone. But the price used by mutual funds in the United States to establish the value of their holdings in those foreign companies is the closing price on the regional (Asian, African, or European) exchanges set before the announcements concerning those increases or reversals. Hedge funds and professional advisors in the United States are working with current information they have gathered from their contacts abroad to set up their buy or sell orders for the next day; the mutual funds are using stale data they were sent from the regional stock exchanges abroad to establish the price at which their fund shares will be purchased or sold on that next day. This current information versus stale data difference represents a tremendous competitive advantage for the hedge funds and financial advisors. (Compound statement of a group of financial professionals called to ask to explain the process of market timing trading)

The extent of this competitive advantage can be seen in the returns posted by the Canary Capital Holdings hedge fund. *The Wall Street Journal* reported (September 9, 2003, p. C1) that Mr. Stern's fund had gains that were "eye-popping" despite the generally adverse market conditions that were prevalent during the period. The Canary Capital Holdings hedge fund was up 50 percent in value in fiscal year 2000, 29 percent in 2001, and 15 percent in 2002. The Standard & Poor's 500 stock index lost a cumulative 40 percent of its value over this same three-year time span.

Market timing trading is legal, allegedly because it is open to all: anyone with money and information can place an order to purchase any number of mutual fund shares just prior to the 4:00 p.m. closing time on the New York Stock Exchange when prices for those shares are set for the following day, and then sell those shares at the time of their choosing on the following day or days. But there is a form of market timing trading that is totally illegal, and even more profitable. This is the form known as "late trading."

Late trading is based on an honor system that brokerage companies and security firms have established with the large mutual funds. The brokerage companies and security firms are allowed to accumulate and process all orders for mutual funds

that they received from their customers and investors before 4:00 p.m., and then send them along to the mutual funds later in the evening. This allows time for the bookkeeping chores that, despite the obvious automation of electronic records, is still a lengthy process.

The problem here comes from the tradition that American companies generally delay any announcements concerning increases or decreases in their expected profits, or in improvements or declines in their competitive positions, until after the 4:00 p.m. close of trading on the New York Stock Exchange. If a brokerage company or security firm was willing to accept orders from their customers and/or investors after that 4:00 p.m. deadline yet report them to the mutual funds as having been received before 4:00 p.m., it would give those customers and/or investors—including the hedge funds—an unbeatable advantage.

The Wall Street Journal reported (September 9, 2003, p. C1) that the "special services" section of the investment banking division of Bank of America had installed special computer equipment in the offices of the Canary Capital Holdings hedge fund that allowed that fund to buy or sell shares of the mutual funds sold to individuals and families by the retail banking division of Bank of America far after the 4:00 p.m. standard closing time, yet be stamped with a much earlier time of submission.

Everyone was shocked by this obvious evidence of late trading permitted by one of the country's largest and most respected financial institutions. No one defended the practice. Many members of the financial community, however, did defend the original market timing or "before 4:00 p.m." trading. Their argument was that this short-term trading by high-net-worth individuals and hedge fund institutions did not adversely affect the middle income individuals and families who held the mutual funds as long-term investments for retirement accounts or college expenses.

> I know that it sounds perfectly awful: wealthy plutocrats taking advantage of hardworking, middle-income families. But it doesn't work that way. There is absolutely no harm being brought to the small investors who hold mutual funds for their own retirement savings or their children's college expenses. They can sell their shares at exactly the same price on exactly the same day as do the in-and-out traders. There is one price calculated for each fund, and that is available to all. I've never met anyone associated with Canary Capital Holdings, and I don't think I would like them very much if I did meet them. But all that those people are doing is to take advantage of an inefficiency in the market by gathering information before it became widely disseminated; in reality they are providing a service by making the market more efficient, more reflective of actual events. (Compound statement of a first group of financial professionals called to ask for comment on market timing trading)

Members of the financial community who opposed the market timing trading of mutual funds cited first the additional operating costs that were created by the rapid movements of large amounts of money in and out of the funds. Those additional costs were classified as part of the overhead expenses that were assessed against the value of each fund at the end of each quarter and thus borne by the long-term holders. These assessed charges admittedly were small—on the order

of 0.25 percent—but it was felt that they did add up for investors who held the fund for 10, 20, or even 30 to 40 years. The main objection of persons opposed to in-and-out trading, however, came not from the additional overhead but from what was termed the "dilution effect."

> The claim that there is absolutely no harm to small investors in mutual funds would be valid if each fund issued a set number of shares. But they don't. If you call up a mutual fund and buy a hundred thousand shares just before 4:00 p.m., they take your money and electronically create new shares, credited to your account. But the managers of the mutual fund don't have time to buy additional shares of stock in the various companies listed in their portfolio; instead they place your money into their uninvested cash account. Then, when you call the mutual fund back the day after your shares were purchased and tell them to sell your hundred thousand shares, they will send your money back from their uninvested cash account, and electronically destroy your shares. But, and this is the critical element, you get the computed price that reflects the value of the stocks and bonds in their invested accounts. Essentially you are taking some of the money from the invested accounts that are owned by the long-term holders of the mutual fund. These are called "dilution" costs. Most people say that this dilution costs the long-term holders somewhere between 1 percent and 2 percent of their holdings each year. That really adds up over time. (Compound statement of a second group of financial professionals called to comment on market timing trading of mutual funds)

> In both cases [market timing and late trading] the damage done to individual investors is the same. When these strategies are successful, short-term traders of mutual funds are siphoning off some of the profit what would otherwise have gone to the funds' long-term investors. (*The Wall Street Journal*, September 19, 2003, p. C1)
>
> "It's like having guests crash a party," says Jason Greene, an associate professor of finance at Georgia State University. "Once they are on the scene there's less food and drink to go around for everyone else." (*The Wall Street Journal*, September 19, 2003, p. C1)

The complaint issued by Attorney General Spitzer added that Mr. Stern and Canary Capital Holdings had similar arrangements with many other mutual funds, including some of the largest such as those operated by Strong Financial Group, Bank One, Putnam Investments, and Alliance Capital Management.

> "This seems the most egregious violation of the public trust of any of the events of recent years," says Arthur Levitt, a former SEC chairman. "Investors may realize they can't trust the bond market or they can't trust a stock broker or analyst, but mutual funds have [traditionally] been havens of security and integrity." (*The Wall Street Journal*, October 20, 2003, p. A1)

It was soon discovered that many mutual fund managers had not only permitted market timing and late trading of their fund's shares, they had actually encouraged it because, if the in-and-out traders left their money in the fund's uninvested cash account between trades, it raised the recorded net asset value of the fund, and fund managers were paid an annual commission based on that recorded net asset value.

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This practice also was found to be widespread, and it was not limited to managers in the small or marginal mutual funds.

> The case [filed by Attorney General Spitzer against Edward Stern and Canary Capital Holdings on September 3, 2003] ignited one of the biggest financial scandals in U.S. history, which has so far implicated 15 mutual funds, 12 brokerage firms, 4 banks and dozens of individuals. The list reads like a who's who of the fund world. (*BusinessWeek*, December 15, 2003, p. 98)

Class Assignment

1. Why did this happen? What were the factors, in your view, that led so many managers at so many mutual funds, investment banks, brokerage firms, and hedge funds to take actions that they knew would harm the retirement accounts and college savings of ordinary citizens?
2. Why didn't people who were not directly involved speak out? At Bank of America, managers in the Special Services section of the Investment Banking division arranged for the in-and-out trading of mutual funds held by the Mutual Fund section of the Retail Banking division. Managers and staff in that Retail Banking division must have recognized what was being done; very large amounts of money cannot go into a fund one day and go out the next without attracting attention. Why did some of those managers and staff not complain loudly?
3. If you yourself were a member of the management or staff in the Retail Banking division of Bank of America, or in any of the mutual funds, investments banks, brokerage firms, and/or hedge funds, would you have complained loudly? Who would you have complained to, and how would you have worded that complaint to ensure that it was effective? Remember, before you answer, that all this occurred during the 2000 to 2003 recession when jobs were a bit scarce in the banking and financial services industry.
4. What should Bank of America have done to make absolutely sure that this market timing and late trading of the mutual fund shares owned by their middle income customers did not occur? Why do you suppose that the bank did not take any of those actions?

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Chapter 1

Moral Problems in Business Management

Moral problems occur frequently in business management. They extend far beyond the commonly discussed issues of bribery, collusion, and theft, reaching into such areas as corporate acquisitions, marketing policies, and capital investments. A large corporation has taken over a smaller one through the common practice of negotiating for the purchase of stock. Then, in merging the two firms, it is found that some of the positions in one are duplicated in the other. Is it "right" to fire or demote executives holding those duplicate positions, many of whom have served their respective firms for years? A manufacturer that has grown rapidly in an expanding market was helped greatly during that growth by wholesale distributors that introduced its products to retail stores. Now the market has become large enough to make direct distribution from the factory to the store in truckload lots much less expensive, and the market has become competitive enough to make the cost savings from direct distribution much more meaningful. Is it "just" to change distribution channels? A paper company in northern Maine can generate power and reduce its energy costs by building a large dam on land that it owns, but the dam will block a river that canoeists and vacationers have used for years. Is it "fair" to ruin recreational opportunities for others?

"Right" and "just" and "fair" are moral terms. They express a judgment about our behavior toward other people that is felt to be morally correct. We believe that there are "right" and "wrong" ways to behave toward others, "just" and "unjust" actions, "fair" and "unfair" decisions. These beliefs help to form our moral standards of behavior. They reflect our sense of obligation to other people, our feeling that it is better to help rather than to harm other persons. The problem, however, is that frequently it is difficult to avoid harming other people, and this is particularly true in business management. Why? Various groups are involved in business—managers at different levels and functions, workers of different skills and backgrounds, suppliers of different materials, distributors of different products, creditors of different types, stockholders of different holdings, and citizens of different communities, states, and countries—and benefits for one group frequently result in harms for others.

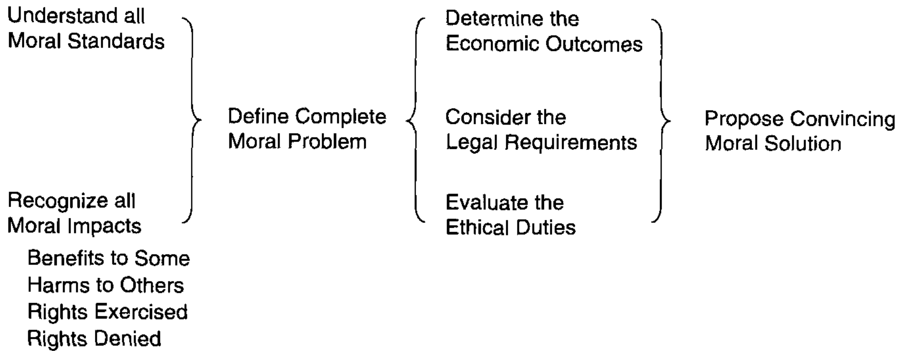
We can illustrate this problem of mixed benefits and harms with examples from the introductory paragraph. It would seem "wrong" at first glance to fire executives who happened, through no fault of their own, to hold duplicate positions in the merged firms. Yet, let us assume that the two companies are in a very competitive industry and that the basic reason for the merger was to become more efficient and better able to withstand foreign competitors. What will happen if the staff reductions are not made? Who will be hurt, then, among other managers, workers, suppliers, distributors, creditors, stockholders, and members of the local communities? Who will benefit if the company is unable to survive? Even if survival is not an issue, who will benefit if the company is unable to grow or if it lacks the resources necessary for product research and market development? The basic questions are the same in the other two examples. Who will benefit, and how much? Who will be penalized, and how greatly? These are easy questions to ask, but difficult ones to answer. In many instances, fortunately, alternatives can be considered. Duplicate managers, instead of being fired, might be retrained and reassigned. Inefficient distributors are a more difficult problem, though a place might be made for them by introducing new products or developing new markets or allowing them to participate in the new distribution processes. The dam across the waterway poses the most difficult problem: It either exists or it doesn't, and making it smaller or putting it in a different location does not really resolve the dilemma.

Moral problems truly are managerial dilemmas. They represent a conflict between an organization's financial performance (measured by revenues, costs, and profits) and its social performance (stated in terms of obligations to persons both within and without the organization). The nature of these obligations is, of course, open to interpretation, but most of us would agree that they include protecting loyal employees, maintaining competitive markets, producing safe products, and preserving environmental features.

Unfortunately, the dilemma of management is that these obligations are costly, both for organizations evaluated by financial standards and for managers subject to financial controls. The manufacturer that distributes directly from the factory to stores will be more profitable and better able to withstand competition than the manufacturer that ships to wholesale warehouses for additional handling and transport. The salesperson, to use a new and more troublesome illustration, who gives small bribes to purchasing agents will have a better record and receive higher commissions than the salesperson who refuses to countenance unethical payments. The design engineer who finds questionable ways to sharply reduce material costs is more likely to be promoted than the design engineer who places product quality and consumer safety above cost considerations. The plant manager who dumps toxic chemicals out in back of the plant will show greater profits than the one who pays for proper disposal.

Some of these problems doubtless appear very clear to you. Others may seem much more debatable. Frequently there is a balance between the financial outcome and the social impact of an organizational decision or action, and the dilemma of management comes in attempting to find the point upon that balance that is "right" and "just" and "fair." The purpose of this book is to examine the factors that enter into that balance and to consider a very specific analytical structure that should help

FIGURE 1.1 Analytical Process for the Resolution of Moral Problems



you reach a point you consider to be "right" and "just" and "fair." Those factors, and that analytical structure, are shown in Figure 1.1.

Before going on to describe each of these steps in greater detail, let us consider an example of a large and complex moral problem. It is one that for many people truly does constitute a managerial dilemma in that it generates substantial benefits for some individuals and great harms for others, and it both recognizes and denies the rights of different groups. It is, in short, an issue in which one side cannot be said to be absolutely "right," or the other side clearly "wrong." We will use it later in the chapter to illustrate the seven steps in the analytical process.

Example of a Large-Scale Moral Problem

Hydro-Quebec, a large public utility owned by the province of Quebec, has proposed building a huge hydroelectric generating station in the remote wilderness of northern Canada. The company plans to construct a dam 17 miles long across the valley of the Great Whale River, close to the mouth of the river where it empties into James Bay. The dam will create a lake covering 9,100 square miles, leaving only isolated peaks and upland areas as islands in a partially forested but primarily open tundra region. That region stretches 300 miles to the east, almost to the border with Newfoundland, and 200 miles to the north, nearly to the Arctic Circle. It is an area with heavy snowfall in the winter and plenty of rainfall in the summer. The soil is rocky, and the water does not penetrate the ground; instead it collects in rivulets and streams. The land has a constant slope toward the west, and the rivulets and streams are channeled into larger rivers that coalesce into the Great Whale River near the coast. One dam will store massive amounts of water covering this extensive area for hydroelectric power generation.

The dam would serve a hydroelectric generating station that could produce 14,000 megawatts of electric power, equivalent to the total output of 14 modern coal-fired or nuclear-based generating plants, but of course without the acid emissions or radioactive residues that are associated with those energy sources. Approximately half of the power would be used in southern Quebec, where it would aid in the industrialization

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