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Corporate Social Responsibility: Part III

Strategy & Leadership

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1. CSR and Strategy

> I discern two sorts of inequality in the human species: the first I call natural or physical…; the second we might call moral or political inequality because it derives from a sort of convention, and is established, or at least authorised, by the consent of men. This latter inequality consists of the different privileges which some enjoy to the prejudice of others…
>
> Rousseau (1755) - A Discourse on Inequality

1.1 Introduction

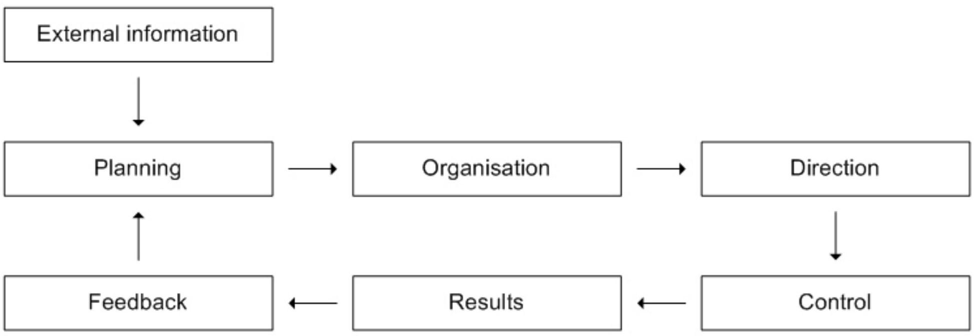
The development and implementation of strategy is of course important for every organisation, and this has always been so. Increasingly however in the present CSR is being considered as a crucial part of that strategy with corresponding advantages to the organisation. In this chapter therefore we will consider aspects of this in the context of the objectives of the firm and its procedures for governance.

1.2 The Role of a Business Manager

A manager of any modern business has a difficult job to perform. A crucial part of his job is to meet the objectives of the organisation of which he is a part and in order to do so he must pay attention to a number of important issues. Although the exact nature of a manager's job may vary quite significantly from one organisation or department to another, so that the role of a marketing manager, a production manager or a manager of a supermarket may appear to be quite different. there is however considerable similarity in terms of the fundamental tasks to be performed.

These tasks can be categorised as follows:

Fig 1.1
The tasks of management



Every manager plans his / her work and the work of others as well as organising him / herself and others, directing others as to what to do, motivating them and exercising control over situations and other people. The results are fed back into the planning process in order to modify future plans for the business.

All managers are concerned with working with people: those they work with, those they supervise, those they report to, and those who are the customers for the product or service which is provided by that area of an organisation which the manager is responsible for. All managers are therefore naturally concerned with the output for their particular area of responsibility and so are also concerned with the inputs to their area of responsibility, whether these be raw materials, information or goods to be displayed and sold.

Using the information available, a manager must plan for the future of the business. In this context a manager must decide upon the courses of action which need to be taken in order to achieve the best results, and must consider what alternative courses of action are available, and what the consequences of any particular decision might be.

Thus the manager of a restaurant, for example, will need to decide what its opening hours need to be and how these might affect possible customers who might want to dine when the restaurant is closed. The manager however needs also to decide upon the ingredients of the menu and how much of each to order; in doing so he needs to consider what the effect of not ordering enough of a particular item might be in terms of dissatisfied customers and the possible effect this might have upon the future of the business but also what the effects of overordering and having waste might be upon the profitability of the business. The manager therefore needs to consider alternatives and their consequences and decide what course of action to take after this consideration of the facts.

Decision making is a crucial part of the job of any manager, and decisions need to be made between conflicting alternatives. These decisions are often to a large extent conflicting in their possible outcomes and there is a degree of uncertainty surrounding the consequences. Selecting the best possible decision to make is therefore often a difficult and skilful process but it is important that the decisions made are the right ones. Because of this a manager needs tools to help him / her to evaluate the consequences of the alternative decisions which he might make. These tools will assist him / her in making better decisions.

1.3 The objectives of a business

A business manager must be concerned not just with the internal running of the business but must also be concerned with the external environment in which the business operates - that is with his / her customers and suppliers, with competitors, and with the market for the products or services supplied by the business.

Such concerns of a business manager comprise the strategic element of the manager's job and a manager must therefore be familiar with this aspect of management, and with the way in which accounting can help in this area. This chapter therefore is concerned with a consideration of the external environment of a business and with the strategic part of a manager's job. First however we need to consider the various objectives which an organisation might have.

The objectives of a manager need to be considered in terms of their helping to meet the objectives of the organisation in which he works. While most business organisations aim to make a profit this is not true of all, and the not-for-profit sector of the economy is one which is increasing in importance, and making a profit is not the only objective of most organisations. Nevertheless organisations do have objectives, and the following possible objectives of an organisation can be identified :

1.3.1 Profit maximisation

For organisations which exist to make a profit it seems reasonable that they should seek to make as large a profit as possible. It is not however always clear what course of action will lead to the greatest profit, and it is by no means clear whether profit maximisation in the short term will be in the best interests of the business and will lead to the greatest profit in the longer term. Thus profit maximisation may not be in the best interests of a business and it certainly may conflict with other objectives which a business may have.

1.3.2 Maximising cash flow

Cash flow is not the same as profit and an organisation needs cash to survive. In some circumstances this cash flow may be more important than profit because the lack of cash can threaten the survival of the organisation.

1.3.3 Maximising return on capital employed

This is a measure of performance of a business in terms of its operating efficiency and therefore provides a measure of how a business is performing over time. Comparative measures are useful in helping the owners and managers of a business to decides what course of action may be beneficial to the business.

1.3.4 Maximising service provision

This is the not-for-profit sector equivalent of maximising the return on capital employed and thus provides a similar means of evaluating decisions.

1.3.5 Maximising shareholder value

The value of a business depends partly upon the profits it generates and partly upon the value of the assets it possesses. These assets can comprise partly of tangible assets such as plant and machinery or land and buildings and partly of intangible assets such as brand names. Thus the value of Coca Cola as a business far outweighs the value of its fixed assets because of the value of its brand name which is recognised world-wide. Maximising the value of the business to shareholders therefore involves much more than maximising the profit generated.

1.3.6 Growth

Growth through expansion of the business, in terms of both assets and earnings, and the increase in market share which the business holds is one objective which appeals to both owners and managers. If this is an objective of the business then it will lead to different decisions to those of profit maximisation.

1.3.7 Long term stability

The survival of a business is of great concern to both owners and managers and this can lead to different behaviour and a reluctance to accept risk. All decisions involve an element of risk and seeking to reduce risk for the purpose of long term stability can lead to performance which is less than desirable.

1.3.8 Satisficing

It must be recognised that all objectives of an organisation are dependent upon the people who set them and business behaviour cannot be considered without taking this into account. Satisficing is a way of reducing risk and taking multiple objectives into account by making decisions which are acceptable from several viewpoints without necessarily being the best to meet any particular objective.

Any business is likely to seek to pursue a number of these objectives at any point in time. The precise combination of them is likely to vary from one organisation to another and from one time to another, depending upon the individual circumstances of the organisation at any point in time. The organisation will not however view all the objectives which it is pursuing at any particular time as equally important and will have more important ones to follow. These objectives will therefore tend to be viewed as a hierarchy, which may vary from time to time.

None of these conflict with socially responsible behaviour and there is growing evidence that social responsibility actually enhances the ability to achieve all of these objectives.

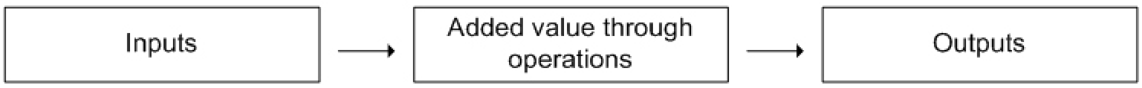
1.4 The Tasks of a Manager

We have seen how the role of a manager of a business will vary greatly according to his area of responsibility. We have also seen how the manager needs to help the organisation meet its objectives and that these can vary significantly from one organisation to another. The roles of different managers are therefore very different and the tasks which they undertake to perform their roles are also very different. Nevertheless we can classify these different tasks into one of several types according to their nature. These tasks can be classified as follows:

1.4.1 Planning

A manager needs to plan for the future in order to decide how best to meet the objectives of the organisation. He needs to decide what can be achieved and what inputs are needed to help him meet his plan. Planning therefore needs to be not just qualitative but also quantitative in order to evaluate the plan and determine inputs and outputs to the plan. All business processes can be considered as taking a set of inputs and performing operations in order to add value and transform them into outputs. The function of any business can therefore considered to be adding value through the transformations made during its processing. This can be illustrated as follows:

Fig 1.2
The transformational process



Planning needs to consider alternatives, not just in terms of alternative targets to set but also in terms of alternative methods of achieving these targets. Planning cannot be done in isolation but needs to take into account what effect the planning has upon the plans of other managers within the organisation. This is especially true when the inputs of this plan come from the outputs of the plan of another manager or when these outputs affect the planning of another manager.

Thus a sales manager cannot plan how much to sell without taking into account the plan of the production manager concerning how much will be produced, and the production manager cannot make his plans for production without taking into account the planning of the sales manager regarding how much can be sold. The planning tasks of the manager therefore are important but cannot be made in isolation.

1.4.2 Control

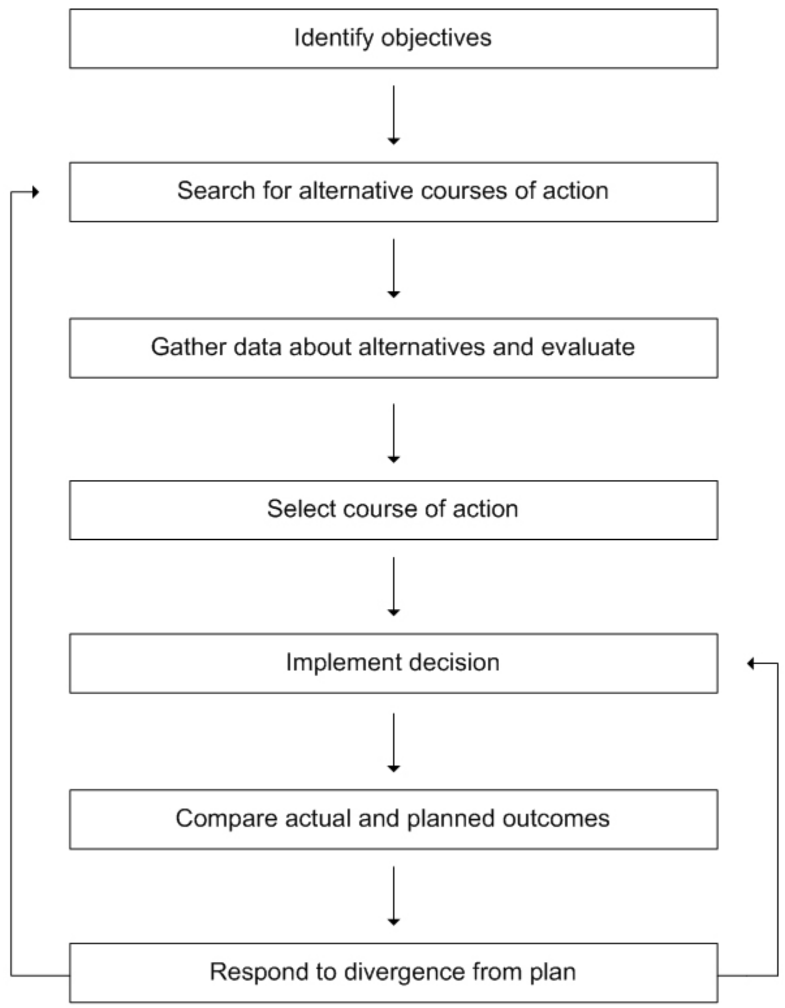
Control is concerned with making sure that things happen in accordance with the plan. It therefore involves monitoring the plan, and progress being made in accordance with the plan. It also involves taking action when things are not going in accordance with the plan in order to attempt to change things so that the plan can be achieved. Control is therefore an ongoing activity for a manager and involves comparing actual performance with targets, providing feedback on actual performance and taking action to change performance when it diverges from the plan.

Although the manager may be able to achieve this by physical observation and communication with people, it is likely that this will not be sufficient. He will probably need to rely to a large extent upon reports in order to exercise control. The reports which management accounting provide are therefore crucial in assisting a manager to exercise control.

1.4.3 Decision making

One of the key aspects of a manager's job is concerned with making decisions. There is always more than one course of action which a manager can take in any particular situation (even if one of the courses is to do nothing!) and so he needs to decide between the alternatives in order to make the decision which is most beneficial. In order to make a decision the manager needs to identify the possible alternative courses of action open to him, to gather data about those course of action and to evaluate the consequences of each particular alternative. The stages in the decision making process are shown in the diagram below, which illustrates that the decision making process is not complete when an alternative has been selected and implemented but that the outcomes of the decision need to be followed through into the control process.

Fig 1.3
The Decision Making Process



In order to make a decision a manager needs information. Management accounting is one tool which exists to help the manager by providing information about the consequences of the alternatives open to him.

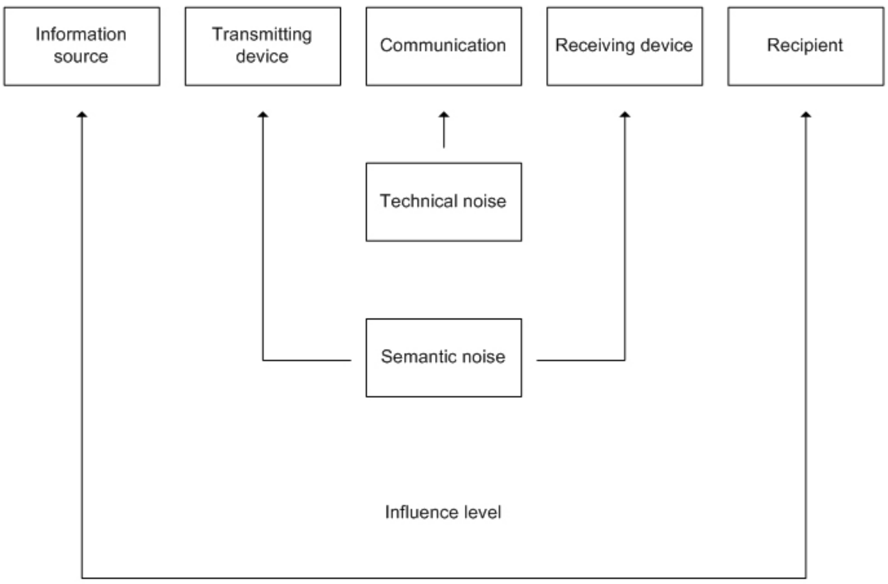
1.4.4 Performance evaluation

While the performance of organisations is evaluated by such measures as return on capital employed, the organisation in turn needs to evaluate the performance of its units and the managers running these units. The managers in turn need to evaluate the actual performance of their tasks against that which has been planned. In order to evaluate performance there needs to be acceptable measures of performance. Measurement needs to be relative to be meaningful - to compare performance with plans and with past performance. Performance measures also need to be quantitative in order to enable comparisons to be made and financial information provides important data for the measurement of performance. Unless performance can be evaluated managers have no basis upon which to exercise control, to make decisions and to plan for the future.

1.4.5 Communication

Information available to help managers in their tasks needs to be communicated to them, and managers in turn need to communicate their plans and decisions to others. Communication involves both the sender of information and its recipient, and for the information to be of value it needs to be understood by the recipient as intended by the sender. Any interference which prevents the message being received by the recipient is known as noise and the diagram below shows that two types of noise prevent a message being received as transmitted.

Fig 1.4
The Communication of Information



Technical noise is that such as occurs on a telephone or radio which is concerned with the technical means of communication. A more crucial type of noise however is semantic noise which occurs because a message is not transmitted in a clear and unambiguous manner and so is not correctly understood by the recipient. Quantitative information is less likely to be misunderstood than qualitative information and this is one of the importance features of accounting information. Management accounting therefore has an important part to play not just in enabling decisions to be made but also in the communication of this information.

1.5 The importance of performance measurement

In order for a business to be able to control its operations it is necessary that the managers of that business are able to measure the performance of the business and of individual parts of that business. A significant feature of business management therefore is the need to measure and evaluate performance, both of the business as a whole and of individual parts of that business. Of equal significance is the ability to evaluate the performance of individual managers. This is of importance to the business but particularly to the managers themselves, as their rewards are increasingly based, at least in part, upon an assessment of their performance.

Increasingly also managerial rewards are based upon a variety of aspects of performance and this includes their effect upon the CSR activity of the corporation. This is another reason why CSR is being increasingly linked into the strategic planning process.

1.6 Managers and business ethics

Business ethics is a subject of considerable importance to any organisation and we have considered some of the high profile business failures which have led to the current interest in CSR. Freedom in the markets is of course another source of potential abuse and unethical behaviour and late 2008 provides just such an example where the misbehaviour in the housing lending market – the so called sub-prime scandal – has led the serious economic problems in the USA which then spread elsewhere.

Accounting information has often been accused of providing an excuse for unethical behaviour. Indeed this accusation has been extended to accountants and business managers generally who have been accused of behaving unethically in their search for profits to the exclusion of all else. The unethical ways in which accounting information has been used have been described in detail by Smith (1992) who describes the way in which new accounting techniques have been created with the sole purpose of boosting reported profits. these techniques have become known as creative accounting and have been the subject of much media attention. Smith's book, "Accounting for Growth", makes interesting reading for any prospective business manager.

Other writers have however been concerned with highlighting the value of ethical behaviour and have claimed that this actually leads to better business performance. Thus McCoy (1985) considers that ethics need to be at the core of business behaviour and that effective business management is based upon ethical behaviour. He claims that this recognition, and acting accordingly, actually increases the performance of a business. The UK accounting bodies are also concerned with business ethics and all have a stance in this matter, and have incorporated a requirement for ethical behaviour into their codes of conduct. The subject of ethical behaviour amongst businesses has also had an effect upon auditing practice and upon the financial reporting of businesses.

Any manager operating in a business environment needs to be aware of the importance of ethical behaviour. Equally (s)he will experience conflicts, in attempting to behave ethically, between different alternative courses of action, and may find conflicts between the firm's objectives and his / her own personal motivation and objectives. No ready solution to these conflicts is available but a manager should be aware that research has shown that ethical behaviour leads to better performance in the longer term, and so should be encouraged to act accordingly.

1.7 Corporate Governance

Another important issue which has been exercising the minds of business managers, accountants and auditors, investment manages and government officials – all over the world – is that of corporate governance (Aras 2008). Often companies main target is to became global – while at the same time remaining sustainable – as a means to get competitive power. But the most important question is concerned with what will be a firms' route to becoming global and what will be necessary in order to get global competitive power. There is more then one answer to this question and there are a variety of routes for a company to achieve this.

Probably since the mid-1980s, corporate governance has attracted a great deal of attention (Aras & Crowther 2008). Early impetus was provided by Anglo-American codes of good corporate governance[1]. Stimulated by institutional investors, other countries in the developed as well as in the emerging markets established an adapted version of these codes for their own companies. Supra-national authorities like the OECD and the World Bank did not remain passive and developed their own set of standard principles and recommendations. This type of self-regulation was chosen above a set of legal standards (Van den Barghe, 2001).

After the various big corporate scandals corporate governance has become central to most companies. It is understandable that investors' protection has become a much more important issue for all financial markets after the tremendous firm failures and scandals. Investors are demanding that companies implement rigorous corporate governance principles in order to achieve better returns on their investment and to reduce agency costs. Most of the times investors are ready to pay more for companies to have good governance standards. Similarly a company's corporate governance report is one of the main tools for investor' decisions. Because of these reason companies can not ignore the pressure for good governance from shareholders, potential investors and other markets actors.

On the other hand banking credit risk measurement regulations are requiring new rules for a company's credit evaluations. New international bank capital adequacy assessment methods (Basel II) necessitate that credit evaluation rules are elaborately concerned with operational risk which covers corporate governance principles. In this respect corporate governance will be one of the most important indicators for measuring risk. Another issue is related to firm credibility and riskiness. If the firm needs a high rating score then it will have to be pay attention for corporate governance rules also.

Credit rating agencies analyse corporate governance practices along with other corporate indicators. Even though corporate governance principles have always been important for getting good rating scores for large and publicly-held companies, they are also becoming much more important for investors, potential investors, creditors and governments. Because of all of these factors, corporate governance receives high priority on the agenda of policymakers, financial institutions, investors, companies and academics. This is one of the main indicators that the link between corporate governance and actual performance is still open for discussion. In the literature a number of studies have sought investigated the relation between corporate governance mechanisms and performance (eg Agrawal and Knoeber, 1996; Millstein and MacAvoy, 2003)

Most of the studies have showed mixed result without a clear cut relationship. Based on these results, we can say that corporate governance matters to a company's performance, market value and credibility, and therefore that company has to apply corporate governance principles. But most important point is that corporate governance is the only means for companies to achieve corporate goals and strategies. Therefore companies have to improve their strategy and effective route to implementation of governance principles. So companies have to investigate what their corporate governance policy and practice needs to be.

1.8 Corporate Governance Principles

Since corporate governance can be highly influential for firm performance, firms must know what are the corporate governance principles and how it will improve strategy to apply these principles. In practice there are four principles of good corporate governance, which are:

- Transparency,
- Accountability,
- Responsibility,
- Fairness

All these principles are related with the firm's corporate social responsibility. Corporate governance principles therefore are important for a firm but the real issue is concerned with what corporate governance actually is.

Management can be interpreted as managing a firm for the purpose of creating and maintaining value for shareholders. Corporate governance procedures determine every aspect of the role for management of the firm and try to keep in balance and to develop control mechanisms in order to increase both shareholder value and the satisfaction of other stakeholders. In other words corporate governance is concerned with creating a balance between the economic and social goals of a company including such aspects as the efficient use of resources, accountability in the use of its power, and the behaviour of the corporation in its social environment.

The definition and measurement of good corporate governance is still subject to debate. However, good corporate governance will address all these main points:

- Creating sustainable value
- Ways of achieving the firm's goals
- Increasing shareholders' satisfaction
- Efficient and effective management
- Increasing credibility
- Ensuring efficient risk management
- Providing an early warning system against all risk
- Ensuring a responsive and accountable corporation
- Describing the role of a firm's units
- Developing control and internal auditing
- Keeping a balance between economic and social benefit
- Ensuring efficient use of resources
- Controlling performance
- Distributing responsibility fairly
- Producing all necessary information for stakeholders
- Keeping the board independent from management

- Facilitating sustainable performance

As can be seen, all of these issues have many ramifications and ensuring their compliance must be thought of as a long term procedure. However firms naturally expect some tangible benefit from good governance. So good governance offers some long term benefit for firms, such as:

- Increasing the firm's market value
- Increasing the firm's rating
- Increasing competitive power
- Attracting new investors, shareholders and more equity
- More or higher credibility
- Enhancing flexible borrowing condition/facilities from financial institutions
- Decreasing credit interest rate and cost of capital
- New investment opportunities
- Attracting better personnel / employees
- Reaching new markets

Although corporate governance is primarily considered to be concerned with how a firm conducts itself in relationship to its investors, increasingly it is being extended to a consideration of how it conducts itself in relation to all of its stakeholders. This is a part of the current concern for greater accountability. Thus governance is increasingly being considered to be related to CSR and the concerns of the two are merging (Aras & Crowther 2009).

1.9 Conclusions

CSR is now generally considered to be an integral part of strategy for any organisation and built into the strategic planning process. There are many perceived benefits to an organisation from this. Governance also is an integral part of this process.

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1.12 Self-test Questions

1. What are the principles of corporate governance?
2. What are the objectives of a business, and which is the most important?
3. What are the tasks of a manager?
4. How many steps are there in the decision making process, and what are they?

2. Corporate Social Responsibility and Leadership

> There are few circumstances among those which make up the present condition of human knowledge, more unlike what might have been expected, or more significant of the backward state in which speculation on the most important subjects still lingers, than the little progress which has been made in the decision of the controversy respecting the criterion of right and wrong.
>
> John Stuart Mill (1863) - Utilitarianism

2.1 Introduction

Practical experience demonstrates that if an organisation is to be socially responsible then it needs the commitment of the senior managers of that organisation. All organisations of course have leaders but this is not what we are concerned with – rather it is the leadership process which we are going to look at. Effect change management requires leadership to instigate and drive the process and an understanding of this leadership process will help you become a more effective change manager.

Central to a consideration of leadership is the concept of power, and this was highlighted in that last chapter. Moreover Rowlinson (1997) has argued that power is central to understanding organisations. We will therefore devote a substantial part of this chapter to a consideration of power in organisations.

2.2 The concept of leadership

When we consider the attributes of a good leader it is very common to come up with a list of the qualities which a good leader should have such a list might look as follows:

- Integrity
- Judgement
- Energy
- Humour
- Fairness
- Initiative
- Foresight
- Dedication
- Objectivity
- Decisiveness
- Ambition

And of course we can also come up with a set of attributes which we consider that a good leader should not have. This might include the following:

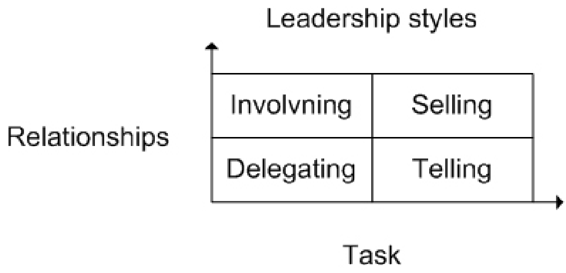
- Stubbornness
- Vainness
- Self centredness
- Ruthlessness
- Unfairness
- Prejudice

The problem with defining a leader through the definition of desirable and undesirable attributes is that what we a seeking is the perfect person. In reality of course such a person does not exist – moreover this kind of definition would exclude both you and me from being considered as a leader – and hence as a manager within an organisation.

A manager in an organisation is, by definition, assigned a role of leadership and every manager would probably claim to be able to exercise leadership in some form. This view would not necessarily be agreed with by the subordinates of that manager. We therefore need to distinguish between the role of a leader and the exercise of leadership. This leadership involves more than the assigning of tasks to subordinates and being accountable for their performance. Such tasks are merely administrative. It is in the way that those administrative tasks are performed that we should look to discover the features of leadership. At that point we will be in a position to consider whether leadership can only be exercised by those with administrative responsibility or whether anyone can be an effective leader.

Leadership itself is more concerned with how a person influences another to carry out various tasks and so it is more concerned with communication and motivation. Leadership is therefore concerned not just with the task I hand but also with relationships between the leader and others involved in the tasks. Heresy & Blanchard used this notion of the relationship between these two to models leadership styles in the following way:

Fig 2.1
Leadership styles



According to them those most concerned with performance of the task in hand will seek to get it done by assign the carrying out of it to their subordinates – telling. With concern for their relationship with their subordinates they will seek to persuade them to undertake the task in hand – selling. Those who are more concerned with relationships than with the immediate performance of the task in hand will seek to involve their subordinates in the decision making and planning process – involving. Those who are not overly concerned with either the completion of the task or their relationship with their subordinates will leave it to them to determine when and how the task should be performed – delegating.

This might make it seem that delegation is a symptom of indifference but in actual fact delegation – leaving the decision as to when and how to carry out a task – is the highest form of trust because in this case the manager keeps responsibility for the performance of the task but cedes control of how it is performed to others. Heresy and Blanchard argue that as managers mature in their roles and become more familiar with both the tasks required and the people with whom they are working they change their leadership style, moving from the telling style through the selling and involving styles to the delegating style. For them trusting others in this way is the ultimate form of leadership.

2.3 Styles of Leadership

These ideas suggest that the qualities of leadership are not fixed but rather that they depend upon the people involved, and their respective personalities. This in turn suggests that it is fruitless to study leadership in terms of defining a set of qualities which make a good leader. Good leadership depends upon the interaction between the leader and the led, but it depends upon more than this. It also depends upon the situation. The leadership style for a brand new start up business would probably need to be very different from that to lead a company which is long established but going through a difficult period. This in turn might be very different to a style needed to reorganize a business after a takeover. The demands of leadership depend therefore upon the circumstances as well as the people involved.

We can classify leadership styles into three distinct types:

- Authoritarian
- Laissez – faire
- Democratic

We can relate these back to the styles identified by Hersey & Blanchard by comparing the authoritarian style to the telling style, the laissez – faire style to the delegating style and the democratic style to the selling and involving styles. What we cannot do however is to state that any style is necessarily better than any other. This depends upon both the people involved and the situation in which the organisation finds itself. Thus we can state that there are three variable involved in the determination of good leadership. These are:

- The personality of the leader
- The personality of the followers
- The situation at the time

2.4 Organisational culture and styles of leadership

There are of course other factors which we need to consider and we have considered on of those in the last chapter – namely the culture of the organisation. Different styles of leadership will work better in different cultures so let us spend a while considering the relationship between organisational culture and leadership style.

We need to think about this firstly in terms of the structure of the organisation and it is possible to classify organisations according to their structure in a number of different ways. Thus Etzioni classifies organisational cultures into 3 types:

- Coercive – where the structure is hierarchical and conformity depends upon the imposition of sanctions for failure to conform. The ultimate example of this kind of structure is the military.
- Utilitarian – where the structure is focused around the completion of the tasks which need to be undertaken. Thus an organisation structured into departments such as Accounting, Production and Marketing would normally be a utilitarian structure.
- Normative – where the culture of the organisation is focused upon a shared vision which all members of the organisation buy into. For this type of culture the structure is largely irrelevant as it is the vision which prevails. Many of the new dot com companies have this type of culture.

A different type of classification was provided by Handy, who classified organisations into 4 types:

- Hierarchical – where the organisation and the people within it are organised into lines of responsibility reaching upwards and downwards in the organisation.
- Functional – where the organisation is organised according to the functions to be performed. This is similar to the utilitarian structure identified by Etzioni.
- Matrix – where the organisation has a mix of hierarchy and functionality to meet the needs of particular tasks. Thus a person may have two sets of responsibilities – a functional one depending upon his / her area of specialism (eg accounting or IT) and a task one – eg the implementation of a new project which requires a multi-disciplinary team.

- Individual – where people work largely on their own and only joint together into an organisation for administrative convenience. Examples of this type of organisation would be the doctors in a health centre of barristers in a practice.

A third type of classification was provided by Miles & Snow. They classified organisations into the following types, based upon their approach to change and development:

- Defender
- Prospector
- Analyser
- Reactor

2.5 Motivation

We can see that leadership is to a large extent concerned with dealing with people in order to optimise the results achieved. Indeed all managerial action is concerned with dealing with people. This has been expressed by McGregor in the following terms:

> "Every managerial decision has behavioural consequences. Successful management depends upon the ability to predict and control human behaviour"

McGregor also classified people according to two types , which he labelled as Theory X and Theory Y. According to him Theory X described the fact that people dislike work and can only be persuaded to work by coercion. His Theory Y on the other hand described the fact that people are conscientious and self motivated. As far as organisations are concerned they are often managed on the assumption that Theory Y applies to managers and senior professionals, who car motivated and can be trusted to perform effectively, while Theory X applies to other workers who need to be controlled and coerced through sanctions. The ideas of good leadership which we have discussed however show this to be problematic. What we should be aiming for as part of good leadership is to motivate people. There are a variety of different theories of motivation however which all suggest different thing about what motivates people.

2.5.1 Theories of motivation

The Expectancy Theory of motivation, developed by Vroom and Lawler, suggests that people are motivated by an internal calculation which they do. In this calculation a person works out how difficult a task is to do and how much the rewards for successful completion of the task are worth. The interaction determines the level of motivation. Thus a person may be motivated to attempt a difficult task if the rewards for success are highly desired but not otherwise. One implication of this theory however is that motivation is personal and that the same rewards for successful completion of the same task will motivate different people differently depending upon how hard they consider the task to be and how much they value the rewards on offer. This would suggest a problem with the kind of performance bonuses offered to people.

A different motivation theory was developed by Herzberg and is known as the Two Factor Theory. For Herzberg there are two types of factor (hence the name) which have different effects upon a person as far as motivation is concerned. These two factors, and their effects are:

- Hygiene factors – these do not motivate people if they are present but do demotivate people if they are absent. For Herzberg money, above a certain minimal level, is a hygiene factor and does not motivate people.

- Motivators – these motivate people if they are present but do not demotivate people if they are absent. Motivators are concerned with job enrichment, recognition and praise, and the social aspects of working life.

The Hawthorne studies provide a good example of the difference between hygiene factors and motivators. Initially Elton Mayo and his team thought that factors such as lighting and speed of work required were the motivating factors but further investigation and chance discovery showed that these did not motivate people but the fact that they were being researched (and someone was interested in them) provided the motivating force.

Another motivation theory is known as the Equity Theory of motivation. This theory argues that motivation is a comparative process and that people will compare what is expected from them and the rewards on offer for success with what they believe is expected from others and their rewards. Moreover this comparison is not necessarily a realistic one as people will tend to believe that others have to work less hard to achieve the same level of rewards or to gain greater rewards for the same level of effort.

It is important therefore to be careful about making assumptions about what will motivate people. The obvious factor is not necessarily the motivating factor, which might be something quite different. Of equal importance to remember thought is that motivation is essentially personal. What motivate you will not necessarily motivate someone else good leaders who are successful in motivating others need to know the people they are trying to motivate in order to understand what it is which will provide the necessary motivation ofr people as individuals.

2.5.2 Motivation and behaviour

Research into motivation in the 1960's and 1970's showed variety of things which might be helpful to managers in developing their leadership abilities. Firstly Williamson (1964) demonstrated that people were motivated by a desire to achieve 2 sets of goals – those of the organisation & personal goals, suggesting that leadership should be concerned with the alignment of those two sets of goals. Ronen & Livingstone (1975) found that involvement in the making of decisions and the setting of targets led to higher motivation from those involved. This was supported by the findings of Rockness (1977) who found that people would tend to set higher targets for themselves than might otherwise be set and that difficult targets were more highly motivating for people.

There is one danger of this however in that if people set difficult targets then there will be a tendency for some to fail to meet those targets. This can have a problem for organisational planning purposes as not all plans will necessarily be achievable. Another problem, particularly in the present, is that many organisations are disapproving of failure and will punish people for failure, often by dismissal. This can have the effect of deterring people from striving to achieve high levels of performance and cause an effect which Schiff & Lewin (1970) observed, namely a tendency for people to create slack in their targets to allow some leeway in case of problems of achievement. Equally Peters & Waterman (1982) found that those companies which excelled were those which tolerated failure and thereby encouraged people to experiment and take risks in doing so.

2.6 Definitions of power

> 'Power is the capacity to affect organisational outcomes.' - Mintzberg

> 'Power is that which enables A to modify the attitudes or behaviour of B.' - Handy

The ubiquitous nature of power in organisational life is undeniable. This makes it essential that we have an understanding of the nature of power. Bachrach and Baratz (1974) state:

> 'Of course power is exercised when A participates in the making of decisions that affect B. Power is also exercised when A devotes his energies to creating or reinforcing social and political values and institutional practices that limit the scope of the political process to public consideration of only those issues that are comparatively innocuous to A.'

Power, or rather the exercise of power, can be recognised by all of us as existing within these definitions. Also existing within these definitions is an implicit assumption that it is observable and therefore measurable. It has been argued that it is an inherent part of the political system of an organisation but Lukes (1974) argues that this kind of definition of power fails as an analytical device as it is incapable of highlighting the way in which power operates 'beneath the surfaces', the way in which it acts in favour of some groups against others.

In spite of this reservation about the theory of power it remains popular within the realm of organisational theory. Indeed its very weaknesses are also its strengths; it can indicate the outcomes of power plays. In this sense it can provide insights into the tactics of power, which is a point articulated at the level of an individual by French and Raven (1959). Viewing power as being observable when exercised by one party over another, their findings were that individuals may possess power which can be derived from one of the following power bases; reward, coercive, legitimate, referent and expert power. These power bases have proved to be remarkably durable within the discourse of organisational studies in the last forty years. Indeed more instrumental texts have used them in order to advise 'how power may be gained'.

This dominant view of power regards it as being a possession i.e. a department has power or a department has lost power. Thus we can state that power is a commodity at both the level of the individual and at the collective. This is a sentiment that is shared by the strategic contingencies of power literature, which argues that the relative power of a department, in an organisation, can be calculated through an equation. The strategic contingencies perspective links in directly with the issue of organisational resources.

2.7 Sources of power

We all have some understanding of what power is, whether or not we agree with the definitions we have considered above. Consequently we all understand when power is being exercised. What is important to understand however is why people are able to exercise power over others in an organisation. For this we need to consider where power comes from – in other words the sources of power that exist.

We can consider that power comes from variety of sources and the following are the most common sources of power:

- Legitimate power – a leader has legitimate power if people believe that this leader has the right to give orders which they have an obligation to obey. In most organisations this legitimate power derived from a person's status and position in the organisation, which carries with it delegated authority.

- Reward power – if a person is able to give or withhold rewards from another (eg the giving or not giving of a performance related bonus) then this gives the person with the authority to grant those rewards power over the other. In a hierarchical organisation this ability to grant rewards exists for all people in the hierarchy who are above yourself.

- Coercive power – this power exists if the subordinates believe that the leader has the ability to impose penalties which are undesirable. In an organisation these can be social (such as loss of friendship or support), administrative (such as in the way work is allocated) or financial (such as loss of overtime opportunities, performance bonus or promotion). In most respects the ability to bestow rewards and coercive power are opposite sides of the same coin.

- Referent power – this source of power exists depends upon the personality and charisma of the leader. It exists if people believe that the leader has characteristics which are desirable and which command respect.

- Expert power – this exists if a leader has superior knowledge or expertise which is relevant to the task in hand. Expert power exists regardless of a person's role in an organisation and does not depend upon having an assigned leadership role.

- Information power – this is similar to expert power but arises not because of particular skills but rather because of access to a particular knowledge base.

- Contingent power – this form of power exists, as its name suggests, because of the demands of a particular situation. It is very often visible in an emergency where someone will assume a leadership role because of the needs of the situation.

Obviously not all of these sources of power will be available to everyone and will not necessarily be available to anyone all of the time. Thus, for example, contingent power will only be available to anyone when the circumstances make it appropriate. Equally expert power or information power may be assumed by all of us but only in the particular situations, or with respect to the particular tasks, for which this power is appropriate.

Most people use all of these sources of power at some point or other and very often use more than one of them in any particular situation. We can see that many of them are interrelated. The other thing to note about these sources of power is that they are to a large extent dependant upon the beliefs of people. To a large extent it is a truism to say that each of us have power over others if those others think that we have.

2.8 Systems of control

The exercise of power is part of the exercise of control within an organisation. Three different types of control systems have been identified as being used within an organisation (Ouchi 1979). These are:

- Behavioural control. This involves being able to observe people as they go about their work. Behavioural control works best when cause and effect relationships are well understood.

- Output controls. This form of control involves the collecting and analysing of information about the outcomes of work effort. The most common form of out put control in use in an organisation stems from its accounting system. The budgetary system is used to measure performance within the organisation but it is measured entirely in terms of output without regard to the inputs. Indeed the advantage of this form of control is that it is only necessary to collect information about outputs but his can be a problem in itself in that there may not necessarily be a relationship between effort and results.

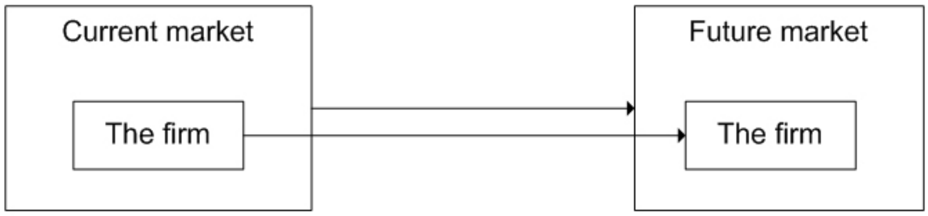
- Clan control. This is based upon the creation of a sense of solidarity and commitment towards the organisation and its objectives. It is thus strong in the normative type of organisation which we considered earlier. It is based upon a shared culture but in its extreme form can be viewed as repressive and as a form of social control.

2.9 Strategic planning

Strategic planning is concerned with the future of the business and with how the firm can best supply what the market desires. This requires an analysis of the market in which the business is operating in order to decide what the market (ie potential customers) wants and what price it is willing to pay for the satisfaction of its wants. This is then followed by an analysis of what the firm is able to produce and supply (and at what price). This then determines how the firm will organise its activities in order to provide these goods or services.

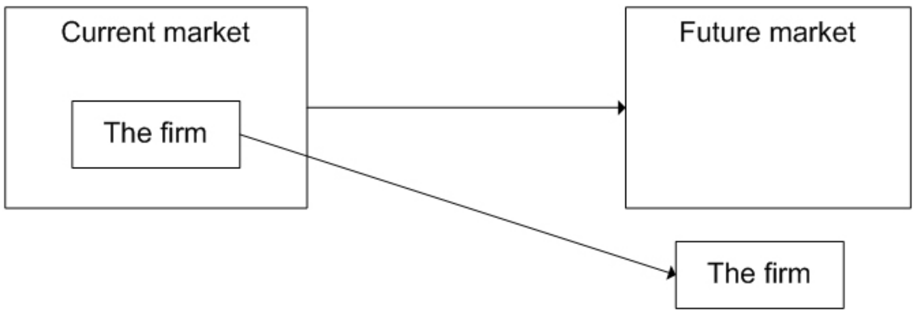
Strategic planning is not concerned with the present but rather with the future and is therefore especially concerned with changes to current patterns of demand, and with ensuring that the firm's capabilities change to meet the changes in market demand. Thus strategic planning is concerned with ensuring the future of the business by ensuring that the firm changes to reflect changed market conditions. This can be modelled thus:

Fig 2.2
Strategic planning and market development



Without strategic planning there is a danger that the market would change without the firm being aware of this change and reflecting it in its own changes pattern of operations. thus the firm would find itself outside the market, thus:

Fig 2.3
Market development without strategic planning

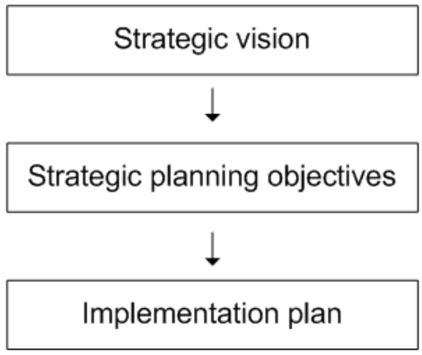


and the firm would effectively go out of business.

Strategic planning therefore is concerned with the future direction of the business. This planning must of course ensure that the business has the capability of achieving whatever direction and objectives are determined in this planning stage. Thus the strategic plan must define a set of objectives for the business and the steps necessary to ensure the achieving of these objectives - in other words an implementation plan. Most managers of organisations, at the commencement of their strategy development process, start with a vision of where they see the organisation being in the future. This is known as a ‘strategic vision’ and is often promulgated throughout the organisation in the form of a Mission Statement, which sets in very broad terms the reason for the firm’s existence.

Thus the strategic planning process can be modelled as follows:

Fig 2.4
The strategic planning process



The implementation plan will involve the following aspects of planning:

Operations plan: to ensure that the firm has the resources (ie manpower, capital investment, working capital) and capabilities to achieve the objectives of the plan. These capabilities include:

- technological capability
- capacity planning
- ability to produce required costings

Marketing plan: to ensure that the firm is able to:

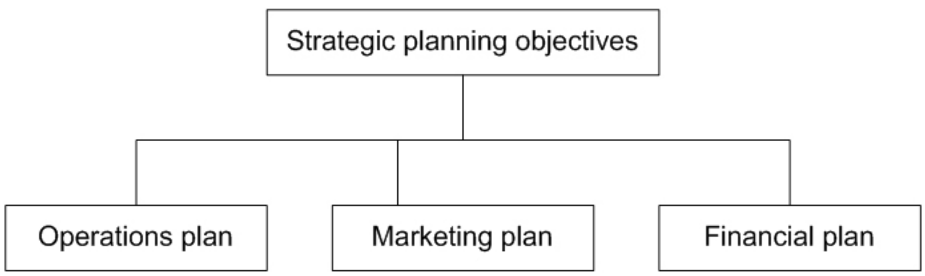
- produce the requires amount and maintain adequate stocks
- to price the product correctly

Financial plan: to ensure that the firm has the financial resources to:

- manage operations
- undertake any necessary capital investment

Thus the strategic plan will need to be as follows:

Fig 2.5
The components of the strategic plan

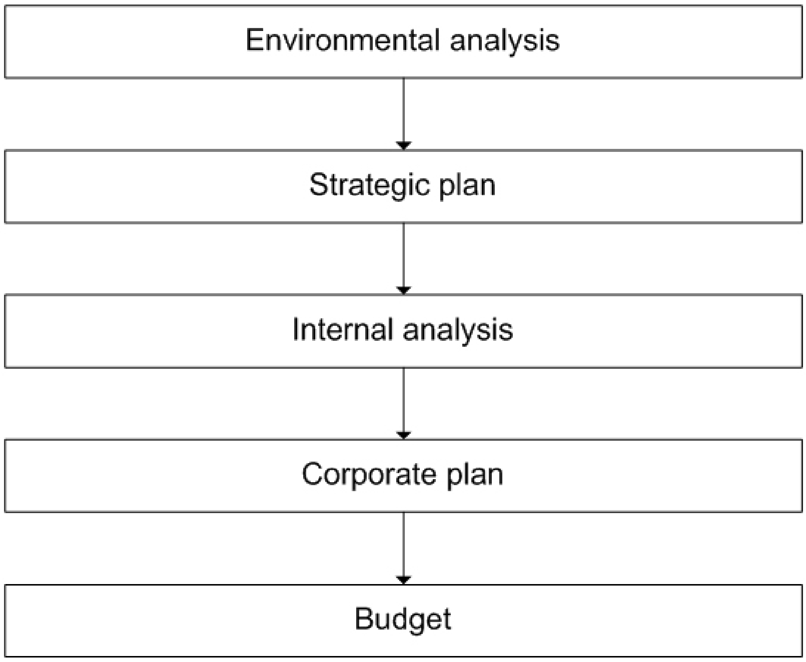


2.10 Corporate planning

The strategic plan sets out the objectives of the business for the future in outline terms and considers the options available to the business and the capabilities of the business to meet this plan. Once the future direction of the business has been determined by this planning there is a need to change this plan into a more definite plan which can be expressed in quantitative terms. This is the function of the corporate plan, which provides a detailed plan for the organisation, and its components parts, in order to enable the organisation of the future activities of the firm and to communicate this planning throughout the organisation. This in turn leads to the development of the short term plan, or budget, of the organisation.

Thus the planning stages of the organisation are as follows:

Fig 2.6
Stages in the corporate planning process



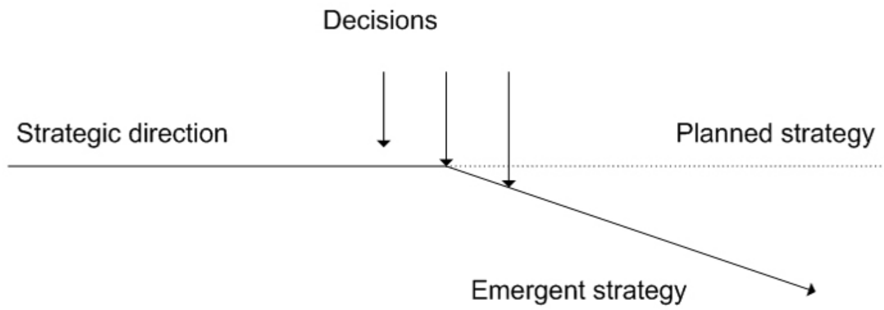
The environmental analysis will enable a firm to develop its strategic plan through an examination of the external environment in which the firm is operating. An examination of the internal environment will enable a firm to translate this plan into a corporate plan for implementation. part of this analysis will comprise a GAP Analysis which will inform the managers of the firm of the ability of the firm to meet the plan and any gaps in resources which need to be addressed. Thus this GAP Analysis will enable the managers of the business to determine what resources are needed in order to implement the plan and this will feed through into both the operating budget and the capital investment budget.

We can see that the business manager needs to be involved at all stages of this planning process and that the accounting techniques which we have discussed have an important part to play in helping at all levels and all stages of the planning process. Thus management accounting is of importance to a business and its managers, not just operationally but also strategically.

2.11 Planned and emergent strategy

Although an organisation develops its strategy through this planning process, it is often the case that the effects of this strategy do not materialise in the manner intended. while following this strategy the managers of the business will continue making decision on a day to day basis. These decision will inevitably affect the strategic direction of the organisation and may cause changes in the way the strategy is manifest in the operations of the organisation. this is known as emergent strategy, and can be modelled as follows:

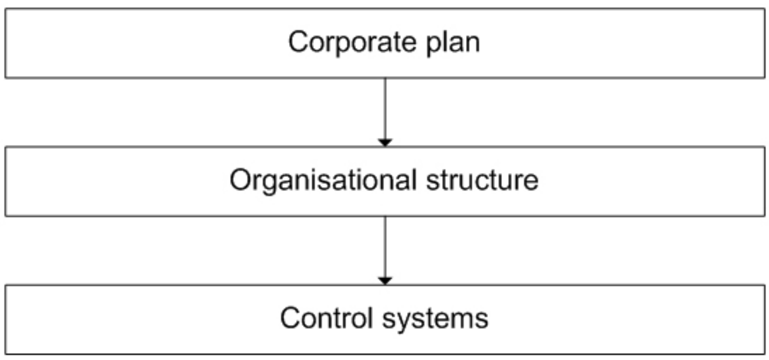
Fig 2.7
Planned and emergent strategies



2.12 Feedback

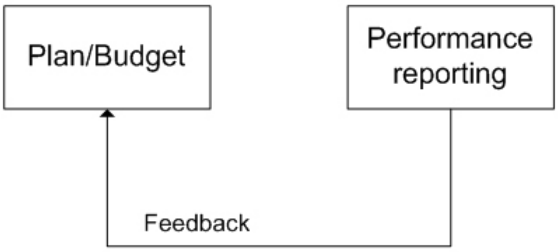
An important part of strategic planning is to ensure that the organisation is structured in such a way that the plan can be achieved, and that the control systems of the organisation provide appropriate feedback to managers. This feedback is necessary in order to ensure that managers are able to measure performance against the plan and take corrective action as necessary. Thus the structure of an organisation needs to be determined by its planning while its control systems need to determined by its structure, thus:

Fig 2.8
Planning and control systems



and the control systems provide a feedback loop thus:

Fig 2.9
The feedback loop



Organisational design is therefore dependent upon the planning of the business and accounting information is used to provide managers with feedback via the control systems in order to measure performance.

Feedback is necessary so that individual managers can be informed of how the business is performing in relation to the planned level of performance and in order to indicate what corrective action needs to be taken in order to correct deviations from the plan. Thus individual managers need feedback on the performance of that part of the business for which they are responsible. Accounting information from the accounting control system, in the form of reports on current performance, is an important part of that feedback. This feedback needs to be frequent and regular but also needs to timely so that the feedback is received as soon after the action as possible. This is important in order to ensure that the feedback can be related to the actual decisions made and to ensure that any corrective action can be speedily taken. Detailed feedback given long after the event is of little value in the operations of a business.

Emery and Thorsrud (1963) identify 6 criteria which a job needs to have in order to maintain the interest of an employee. Such a job must:

- be reasonably demanding in terms other than sheer endurance, yet provide a certain amount of variety
- allow the person to learn as (s)he works
- give the person an area of decision making or responsibility which can be considered to be his / her own
- increase the person's respect for the task (s)he is undertaking
- have a meaningful relationship with outside life
- hold out some sort of desirable future, and not just in terms of promotion, because not everyone can be promoted.

The management of a business therefore needs to take into account the needs of the people working in that business, and this must be reflected in the control system of that business. Specifically this needs to be reflected in the setting of targets, the recognition of achievements and the reward structure for the level of performance achieved.

2.12.1 Setting of targets

The targets set for managers need to be achievable but research has shown that targets which are difficult to achieve and which stretch managers have a higher motivational effect than those which are relatively easy to achieve. On the other hand targets which are too difficult to achieve are felt to be unreasonable and therefore lead to a loss of motivation. Targets are set in the budgeting process, which we will consider later, but it is important to recognise here that research has also shown that people tend to set harder targets for themselves than those which are set for them by others. This suggests the need for managerial involvement in the budgeting process.

2.12.2 Recognising achievements

Recognition of achievements has a powerful motivational effect not only for the person recognised but also for others who are aware of the recognition given. It is for this reason that firms have tended to introduce achievement recognition systems such as the award of merit certificates, distinctions, 'manager of the month' schemes, and prizes for the best performance.

2.12.3 Rewarding performance

The reward structure for managers needs to be related to their performance in such a way that a manager can relate his / her rewards directly to performance. This performance however needs to be measured in such a way that individual managerial performance can be directly translated into company performance. Rewards systems normally operate in the form of bonuses and the payment of a bonus can be related either to the individual manager meeting or exceeding his / her target level of performance or to the performance of the company as a whole. The first method aims to maximise individual performance while the second method aims to maximise company performance and stresses the fact that each individual is contributing towards company performance. There is merit in both methods of reward and it is for this reason that managerial rewards and payment tend to be linked to both with a bonus payable partly for individual performance and partly for company performance.

The operational control systems of a business need to recognise the problems associated with setting standards of performance which are realistic and allow for the revision of standards on a regular basis. The systems also need to recognise that business circumstances can change, and that the economic and competitive climate can also change, thereby making theses standards inappropriate. The control systems therefore need to be flexible and to encourage maximum performance rather than merely the achievement of the standards set. This is particularly important in a modern business environment where the emphasis is upon quality and level of service rather than merely the control of the costs identified within the accounting system.

2.13 Agency Theory

It is important to recognise that the firm is assumed to exist for the benefit of its owners who are assumed to be solely interested in the maximisation of their wealth. Managers, on the other hand, are the decision-makers in an organisation and they are implicitly assumed to automatically act in the best interests of owners, either because they are also the owners, or because they share the same interests. In other words, managers are assumed to make the same decisions that owners would make, irrespective of the effect on their personal interests.

Managers are, therefore, assumed to assess objectively alternative actions, and always select the option favoured by the owners of the firm. The management accountant, therefore, is then concerned with providing the 'right' information combined with the 'right' decision-model which will help the manager make the 'right' decision. An obvious criticism of this approach, however, is that it fails to recognise that managers may not share the same interests as owners, and that this is likely to impact upon real-world decision-making. Agency theory attempts to address this problem, by providing a more realistic representation of decision-making.

Agency theory therefore recognises that people are unlikely to ignore their own self interest in making decisions; in other words people do not behave altruistically. It is a relatively new approach to analysing decision-making which provides a framework within which the political and behavioural aspects of decision-making can be considered as part of the decision making process. The theory is therefore positive rather than normative as it seeks to understand and explain what happens in practice rather than seeking to prescribe what ought to happen. It recognises that the manager is an agent of the owners of the firm, whose actions the management accounting system seeks to influence.

An agency relationship exists whenever one party, the principal (P), hires another party, the agent (A), to perform some task. This relationship applies to many superior / subordinate relationships in business and elsewhere, and in a management accounting context, agency relationships can be seen to exist between shareholders and directors, between directors and managers (including divisional managers), and between managers and other employees. In this chapter, we will concentrate on the relationship between the owners of the firm and its managers – in other words the owner-manager principal-agent relationship.

Under Agency Theory both P and A are assumed to be rational economic persons: in other words they know what they are doing and they act consistently and rationally. They are both assumed to be motivated by self-interest alone, although the theory recognises that they possess different preferences, beliefs and information. Both wish to maximise their own 'utility' (the value or benefit they place on any economic good they receive). P and A may also have different attitudes to risk, an issue to which we return later. Agency theory is concerned with the design of effective contracts between the P and A, which specify the combination of incentives, risk-sharing and information system which maximise the utility of P subject to the constraints imposed by ensuring that A's self-interest will also be served through his / her actions. Thus Agency Theory provides a means of establishing a contract between the principal and the agent which will lead to optimal performance by the agent on behalf of the principal. This can be depicted thus:

Fig 2.10
Optimal Contracts: balancing risk, incentives and choice of information system

Focusing on the shareholder-manager agency relationship, the key elements of agency theory will now be examined.

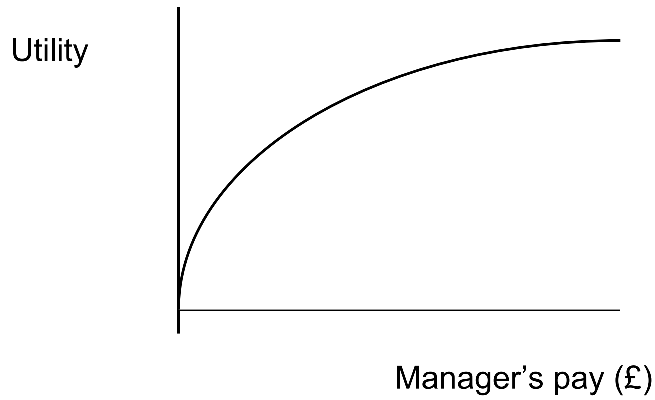
The owners of the firm provide capital to the firm, and are assumed to be interested solely in the returns to be derived from their use of capital in the firm – in other words the expected monetary value of their investment. Managers, on the other hand, not only derive utility from their wealth, provided through their employment in the firm, but also from their leisure time, when they are not employed by the firm.. thus managers drive utility from all their activities, whether or not these activities are associated with the firm by which they are employed It is important to appreciate this distinction between 'utility' and 'monetary wealth' in this context, as utility applies to well being in general rather than simply to wealth.

While it is certainly true that managers derive utility from additional wealth, it must be recognised that this is unlikely to be in the form of a linear relationship whereby each increment to wealth results in the same addition to utility. Managers will derive greater incremental utility from additions to wealth from lower levels of wealth, but as wealth increases the extra amount of utility gained from each unit addition to wealth will diminish. In other words, the utility which managers derive from wealth is subject to decreasing marginal returns.

For example, a manager who is paid £100,000 per annum derives greater utility from the first £10,000 of pay then that which takes his pay from £90,000 to £100,000. At higher levels of pay, non-financial factors associated with employment such as status, job-related pressure and so on take on greater significance.

The manager's utility function in relation to income received from employment can thus be shown as follows:

Fig 2.11
The manager's utility function



In addition however, managers are assumed to value their own leisure time, which means that they attach disutility to effort. The extra utility which is derived from higher levels of compensation is offest, therefore, by the negative utility which is derived from any extra effort required of the manager to achieve that higher level of compensation. The term 'leisure' in this context is defined as the opposite of any effort that increases the expected value of the firm to its owners. It includes the manager's consumption of so-called 'perquisites' (commonly known as perks), which are benefits relating to the job such as company cars, lavish offices, and so on. The consumption of such perquisites diverts the owners' capital away from what the owners would regard as desirable productive investments into the manager's own consumption.

Therefore, to summarise, the owners supply capital to the firm and hire managers to act on their behalf. Managers allocate their time at work between productive effort and leisure ('shirking'), and also allocate the firm's resources between productive investments and the consumption of perquisites.

An intuitive solution to the above situation would be for owners to simply monitor the actions of managers to reduce shirking and the over-consumption of perquisites. This, however, can be extremely difficult in practice. There are several reasons why this monitoring is difficult in practice. Firstly, the tasks undertaken by managers are generally considered to be relatively complex and consequently not well understood by the owners who are not involved in the detailed running of the business. Secondly, the decisions made by managers are taken in an uncertain environment, which makes it difficult for owners to judge the appropriateness of managerial actions in any particular set of circumstances. Finally, and perhaps most importantly, information is not evenly distributed between managers and owners. This problem is known as 'information asymmetry' and has two separate, though related elements: moral hazard and adverse selection.

2.13.1 Moral hazard

Moral hazard arises where it is difficult or costly for owners to observe or infer the amount of effort exerted by managers. In such a situation, there is an inevitable temptation for managers to avoid working to the terms of the agreed employment contract, since owners are unable to assess the 'true picture'. Managers may also have the incentive as well as the means to conceal the 'true picture' by misrepresenting the actual outcomes reported to the owners. Accounting provides one such means for misrepresentation through its ability to represent outcomes from any course of action in more than one way – a point which we will return to in subsequent chapters.

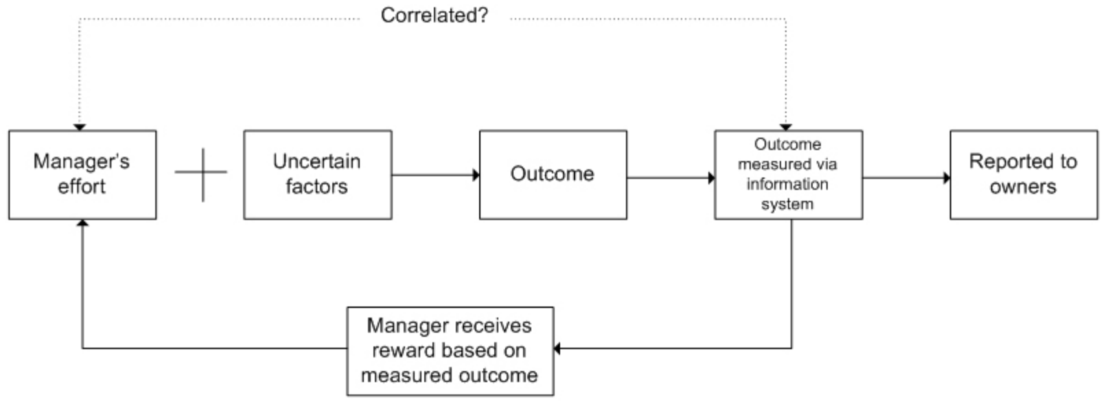
2.13.2 Adverse selection

Whereas moral hazard relates to the ‘post-decision’ consequences of information asymmetry, adverse selection is concerned with the ‘pre-decision’ situation. Since all the information that is available to the manager at the time a decision is made is not also available to the owner, then the owner cannot be sure that the manager made the right decision in the circumstances. In addition, the manager has no incentive to reveal what he knows since this will then make it easier for the principal to properly assess his actions in the future. This is known as ‘information impactedness’.

The existence of ‘information asymmetry’ means that for owners to obtain relevant information concerning the manager’s effort, they must either rely on the communications received from the managers themselves, or must incur monitoring costs. An example of monitoring costs would include the annual audit of the firm’s financial statements; indeed such auditing of financial statements was instituted as a means of safeguarding such investments in firms made by those who had no part in the operational activity of the firm. In the context of the agency relationship between top management and divisional management, such monitoring costs would include the cost of employing head office staff to monitor the performance of divisions. One approach to this problem is to get managers to commit to acting in the best interests of the owners, but in this situation the owners will incur a bonding cost to effect this relationship. Even in this situation however since managers may not share the same beliefs and preferences as the owner, there may still however, be a ‘residual loss’.

Information asymmetry can be depicted as follows:

Fig 2.12
Information Asymmetry



Agency theory, as applied in practice, is concerned with the design of employment contracts which reduce shirking and the consumption of perquisites, so that instead of managers acting in their own interests they are encouraged to act more in the interests of the owners of the firm. Solutions to agency problems are often described as ‘second-best’. This is due to the conflicting implications of the incentive-effect and the risk-sharing aspect of the agency relationship. These should be interrelated as follows:

Fig 2.13
Risk sharing

On the one hand, the optimal contract should achieve optimal risk-sharing. As the owner is able to hold a diversified portfolio of shares, it is usually assumed that he is risk-neutral and will not take risk into account in deciding between one course of action and another. The manager, on the other hand, clearly cannot diversify his job, and is more likely to be risk-averse and hence to make risk minimising decisions. In this situation therefore optimal risk-sharing would imply that the owner of the firm should bear the most risk, since the manager will require compensation for risk-bearing, whereas the owner will not.

A flat fee paid to the manager irrespective of performance achieves this, since the manager's salary is shielded from the uncertainty which affects expected outcomes. Such a flat fee as remuneration for the manager's effort, however, provides no incentive for the manager to exert optimum effort. Due to the fact that the manager's effort cannot realistically be observed, then only if the manager's income is linked to performance will the manager be motivated to contribute more effort. This, in turn, exposes the manager to risk. A double-edged sword is evident. The more a manager's income is dependent upon performance, the greater the incentive effect, yet at the same time, the sharing of risk becomes increasingly sub-optimal.

The 'first-best' solution would be to pay a flat fee to reward 'conscientious' managers who do exert optimum effort. Such a 'first-best' solution is not viable, however, since it is not realistically possible to judge whether or not a manager has acted 'conscientiously' in any particular set of circumstances.

2.15 The Limitations of Agency Theory

While Agency theory offers a number of advantages in the way in which it explains managerial behaviour in organisations it is necessary to recognise that it also suffers from a number of limitations:

1. It is based on a single-period model. In other words, it is not a dynamic model, and may not be applicable in more realistic multi-period settings.

2. Its assumption that both principal and agent are rational utility maximisers is questionable.

3. The analysis is limited to one principal and one agent, and therefore the results may not be applicable in multi principal and multi agent settings.

2.16 Conclusions

We have covered a lot of ground in this chapter, but leadership is a complex subject and crucial to the understand of the operation of CSR in an organisation. There are a lot of leadership theories which have some application and relevance. Equally Agency Theory is an important aspect of understanding organisational behaviour.

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2.18 Further reading

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2.19 Self-test Questions

1. What leadership styles are there?
2. Why is feedback important?
3. What is moral hazard and why is it important?
4. What is emergent strategy?

Notes

[1] An example is the Cadbury Report.