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Nygaard, A., Biong, H., Silkoset, R., & Kidwell, R. E. (2016). Leading by example: Values-based strategy to instill ethical conduct. *Journal of Business Ethics*, 145(1): 133-139 DOI: <http://dx.doi.org/10.1007/s10551-015-2885-9>

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**Leading by example; Values-based strategy to instill ethical conduct<sup>1</sup>).**

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September, 2015

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## **Leading by example; Values-based strategy to instill ethical conduct.**

### **Abstract**

Years of research clearly shows that relying on traditional organizational power bases is not effective when companies want to promote business ethics and performance. It is not only that the use of legitimate power to establish ethics codes and coercive power to punish employees who do not comply does not work; this study - based on a multi-method research approach in the retail industry - indicates that the classic iron fist leads to unethical business values and lower service performance. But there is a light at the end of the tunnel for forward-looking managers. The ethical attitudes and behaviors of employees within international organizations is a dynamic variable that is possible to change by the use of values-based leadership. Our extensive study of a large grocery store chain owned by a multinational corporation indicates that managers who lead by example will boost team values and commitment.

## **Introduction**

Since Milton Friedman's famous statement that the social responsibility of a business is to use its resources to increase its profits, or as it appears in his writings, "the executive's responsibility (to his employers) is to make as much money as possible while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom," (Friedman, 1970) there has been an ongoing debate on the societal and moral obligation of the corporation (Karnani, 2011; Rivoli and Waddock, 2011). Should a company do well by maximizing profits and thus shareholder value, or should it do good by maximizing the welfare of society? Or is doing well by the shareholders also doing good by society?

Long gone are the days when consumers only cared about the price and quality of products and services. The media increasingly devote attention to social activists, who provide the public with access to new information regarding labor conditions, environmental degradation and questionable methods of production (McWilliams, et al., 2006). Many consumers, therefore, also care about the underlying processes for how prices are determined and quality is delivered (Freeman, 1994). For example, Wal-Mart (with 1.3 million employees in the United States alone) is praised for its low prices, efficiency, and brand power (Basker, 2007) but is also strongly pressured by external stakeholder groups regarding the retailer's ostensibly low wages and working conditions for employees (Palazzo and Basu, 2007). Similarly, revelations of poor work environments international fashion companies' suppliers raise doubts regarding the multinational retail clothing companies' ethical standards and societal obligations (The Clean Clothes Campaign, 2014).

In line with stakeholders' emphasis on corporate ethics, a corporate ethical identity is seen as a competitive advantage (Kleyn et al., 2012). There is a market for ethical companies. Managers recognizing that ethics matters to companies, have been assisted by many models in

“ethicalization” of their organizations (Dunfee, et al. 1999). But few of these models offer insight into their effects on company performance. Therefore, managers responsible for making money should be concerned about how deployment of management tools, such as various forms of social power, which are intended to coordinate business functions and compliance to company strategies, affect an organization’s ethics. On a societal level, when market forces alone for various reasons will not discipline firms to behave ethically, corporate behavior can be affected by government regulations. The regulations can be enforced by government’s use of power to coerce, for example, by prohibition or mandate. Alternatively, the government can use financial incentives such as tax policy to change firm behavior in the desired direction (Karnani, 2011). However, it has not been clear whether such mechanisms as coercion, rewards or authority would have the desired behavioral effects to enhance corporate ethics if deployed at the firm level; thus, we investigate this key issue in this study of a large retail firm.

### **Power and Ethics**

Power, the capacity to influence another’s behavior, has always been one of the key managerial tools to affect, control and develop business efficiency. However, it can also affect and alter ethical values. Although intentions may be good, coercive power, i.e., the power to punish, will lead to harmful ethical values. Our extensive study of a large grocery store chain owned by a corporation that operates in Europe, North America and Asia shows that nothing influences employees more than a good example. Leadership by role model, that is the “the good example” or “the good shepherd” (also known as referent power), is the best way to support and promote ethical values. Leading as “the good shepherd” is far better than forcing the effect. Development of explicit role models is crucial to the ethical values in the organization.

Our research also shows that ethical values promote service quality. Influence by example has far more impact than other sources of influence. Firms like Pepsico preaching “*Performance with Purpose*”, Chevron “*Human Energy*” and Wal-Mart “*Live Better*” now realize that values-based visions are flexible preconditions for business ethics, globalization and performance (The economist, 24. Sept. 2011). In the past, Wal-Mart presented its employees with a long list of coercive rules and threats of punishment for violations of appropriate workplace conduct. The company’s new Live Better strategy focuses more on ethical performance goals rather than a command and control approach (The economist, 24.Sept. 2011). Here a value-based approach inspires and motivates employees to support Wal-Mart’s vision.

The recent actions of leaders have become increasingly inconsistent with the explicitly stated intentions of ethical behavior that one can find on the websites of most organizations. For example, the high profile head of the International Monetary Fund (IMF), Dominique Strauss-Kahn resigned for violating the IMF’s explicit rules of conduct (The Guardian, May 19, 2011). BP CEO Tony Hayward regretted going on a sailing trip during the largest oil spill in the history of oil exploration in the Gulf of Mexico (BBC June 20. 2010). Still, the code of conduct for BP’s employees was clearly stated on the company website. The retail company Ahold showed a substantial revenue growth during the late 90s and was the third largest grocery retailer worldwide. Ahold’s CEO Cees van der Hoven was praised for turning this company from a slow moving organization into a growth power house. Unfortunately, he deceived investors by encouraging the company’s managers to bend accounting rules, falsely claim profits, and to keep billions of debt off the balance sheet, in stark contrast to the company’s rules of conduct developed during the same period (The economist, 27. February 2003).

Increasingly, business performance and business ethics interact. Sir Terry Leahy, CEO

of Tesco, the British multinational retail chain, expressed the view that ethics increasingly affects financial decisions (The economist, Nov.18. 2005). The leadership role has become significantly more complex in the way stakeholder interests are balanced against profits (Freeman, 1984). The study we have conducted here indicates that to exhibit ethical codes on the webpage and to force codes of conduct into employee contracts with the company as an easy way to create ethical corporate conduct might have the opposite effect. For instance, Wal-Mart intended to force its global “Statement of Ethics” on its employees, but ended up in a destructive conflict with German Labor Unions (Talaucar, 2009). A fundamentally different approach is to create organizational consensus to moral commitment. Shared ethical values produce employee perceptions of belonging to the organization (Hunt et al., 1989). Programs that enforce ethical intentions may have opposite effects. The empirical evidence that we present in the next sections produces surprising insights.

## **Methods and Data Collection**

Ethics is defined with a focus on the underlying ethical values in a company rather than the specific ethical issues concerning products, services, or industry-specific issues. This study raises the question: - can management change business ethics and employee behavior? Power to affect business relationships is generally described as the potential to influence another party to change behavior (Gaski, 1984). Consistent with Emerson’s (1962) classic article, power is not a personal aspect but a social dimension in a relationship between two business partners (Emerson, 1962). The concept includes multiple sources of power available to management in its capacity to influence behavior as perceived by employees (French and Raven, 1959):

- (1) coercive power (the employee perceives that management has the ability to punish the employee)

- (2) reward power (the employee perceives that management can reward the employee to achieve specific goals)
- (3) referent or identification power (the employee identifies with management and therefore management objectives)
- (4) expert power (the employee perceives that management has special knowledge and expertise and that therefore it is rational to follow specific goals)
- (5) legitimate power (the employee perceives that management has a legitimate, often contracted, right to prescribe the employee to behave in a certain way).

There has been a long tradition of research that analyzes how sources of power affect performance (Gaski, 1984). We gathered data through questionnaires distributed at one of Ahold's European grocery chains. Ahold, a Dutch global retailer with yearly overall revenue greater than \$30 billion, owns Giant and Stop & Shop in the United States and has operations in America, Europe and Asia. We characterized the primary stakeholder interest groups as 1. Owners and top management in the retail chain, 2. Retail store managers (franchisees and employees) and 3. Customers (Freeman, 1984). The key informants in this study were retail managers combined with mystery shopper data which reflects service quality. Based on an address list of 509 units within the same grocery retail chain, 230 of these responded to a postal survey, representing a response rate of 45.2 percent. Out of these, five respondents were deleted due to incompleteness. Accordingly, the statistical analysis was based on 225 retailers. Among the respondents, 22.3 percent were internally operated, while 66.7 percent were franchise operated. On average, the stores carried between 3300 and 3499 different products. Variables measured in the questionnaire are presented in the Appendix.

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Insert Figure 1 about here

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Figure 1 illustrates the mean values of the variables in focus. On a scale from 1 to 7, where 1 is not at all, and 7 is very high degree, 33 percent of the respondents reported to use to a high or very high degree (6 and 7 of the scale) of coercive power, while the numbers were 11 percent for reward power, 42 percent for referent power, 46 percent for expert power, and 40 percent for legitimate power. The mean values reports to be 5.2 for coercive power, 5.3 for expert power, 5.3 for legitimate power, 5.1 for referent power, and 3.7 for reward power. For the variable ethics 17 percent of the respondents reported to have a high or very high degree (6 and 7 of the scale) of ethical value. The mean value of ethics was 4.9 and 5.2 for company commitment.

## **Results and Conclusions**

Figure 2 illustrates the magnitude the different power dimensions have on ethics. Each impact factor represents the standardized regression coefficient, which ranges from -1 to +1. A negative value illustrates a diminishing effect on ethics, while a positive value illustrates an increasing effect on ethics.

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Insert Figure 2 about here

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### ***Conclusion #1: Using coercive power makes the situation worse***

Coercive power relates to the practice of compelling employees to adhere to ethical values under the threat of punishment. These types of influence strategies have been rooted in

command and control, rules, punishment and reporting, but influence strategies involving non-coercive power tend to be associated with fewer conflicts (Tyler et al. 2008; Gundlack and Cadotte, 1994). The failure to fulfill obligations or to reach deadlines might lead to the threat and/or use of coercive power. Some studies have found negative effects of coercive power on ethical behavior (Pullen and Rhodes, 2014; Gundlack and Cadotte, 1994). Our study strongly supported previous findings. The chain management's use of coercive power negatively affected ethical values among retailer managers. We also found that coercive power jeopardized service quality performance. A command, control and monitoring approach to ethical values most probably has a significant negative effect. Our results, which were obtained in a European setting, are consistent with conclusions in a U.S. survey by the Boston Research Group (BRG). More than half of the employees in the iron fist (BRG uses the term "blind-obedience" firms) companies observed unethical behavior in contrast to only one fourth of the employees in value based strategy category of companies (The economist, Sept. 24. 2011). Similarly, the fraudulent behavior revealed in Ahold is partly ascribed to the pressure exerted by the management team on subordinates to achieve unrealistic earnings and revenue goals. More specifically, Ahold misrepresented its results by (1) improperly consolidating revenues and earnings from foreign joint-ventures, (2) improperly accounting initial investments in foreign joint ventures, and (3) conducting extensive frauds in its accounting records. Furthermore, BRG also found that only a fourth of the companies that used coercive power had potential whistle blowers against unethical behavior versus more than 90 percent of companies in the values- based strategy group (The economist, Sept. 24. 2011).

Walmart's strategy to impose on its German employees the requirement to obey the standards put forward in its global ethical rules in 2005 led to a destructive conflict with the employees and a law suit that the company lost. Walmart handed a 33-page code of conduct

to each employee. The process of imposing these ethical rules on the employees, although considered legitimate from Walmart's perspective, violated German rules of codetermination. Furthermore, the standard of banning fraternization was considered an illegitimate intrusion into the employees' privacy (Talaular, 2009). This case indicates that the situation is different in the United States than in Europe. The formal use of authority is more present in the U.S. because of ethics consultancies, ethics conferences, journals, awards and media focus.

***Conclusion # 2: The use of legitimate power cannot improve business ethics***

Treviño et al.'s (1999) survey of 10000 employees in six industries showed that formal ethics programs did not work as well as values-based informal programs. Consistent with this research, we found that a rule-based regime that uses position power to prescribe ethical behavior did not make a difference. We found no relationship between legitimate influence and business ethics values. We believe that legitimate power indeed affects behavior and operations. However, based on the statistical model we do not think that it influences ethical values. We did not measure whether employees perceived if rules were morally right. There might be a good reason to follow rules that are morally right especially if employees believe that the company's legitimate procedures are fair (Tyler et al. 2008).

The use of legitimate power to intentionally achieve ethical behavior is also fueled by events like Enron and WorldCom. Although the logic of prescribing specific rules (codes) of ethics seems rational, it does not mean that it will work to change employees' ethical behavior.

***Conclusion # 3: Rewards do not improve ethical behavior – Money can't buy you values!***

Along with common practice in business life, one should assume that ethical values can be stimulated when employees are given economic incentives. Economic incentives have been shown to be strong motivators aimed at specific behaviors from employees, salespersons, agents, and franchisees. But the conventional wisdom rooted in franchising, bonuses, stock value options and other rewards for almost all other desired outcomes does not work when it comes to ethical values. Our results do not support the idea that financial incentives improve ethical values. Outcome performance systems like bonuses or other incentives, however, might instead deteriorate ethical values in the organization because they jeopardize what the employees believe are fair. Lack of perceived fairness in outcomes might weaken ethical values and commitment (Tyler et al. 2008). In a worst case scenario, the use of performance rewards may lead to brazen unethical behavior. For example, Ahold's stock option and bonus programs based on growth and value added combined with unrealistic earnings and revenue goals, may have provided strong incentives for the fraudulent accounting and financial reporting practices discussed earlier.

***Conclusion # 4: The Good Shepherd – the power of a role model exemplar***

Referent power in this case measures a store manager's identification with the brand owners (Pfeffer and Salancik, 1978). Brand owners specify ethical values that managers desire to follow by example. The store managers are guided by their own voluntary values to follow the brand owner. The power of the ethical role model can be illustrated by considering the case of Richard Panico, founder and CEO of Integrated Project Management (IPM), a consulting firm headquartered in Chicago, IL. Years ago, Panico set out to form a company that reflected high ethical values in its culture and conduct by modeling those values to

employees. The company engages in an extensive screening process to ensure that the company only hires people who reflect those values and fit into the company culture. In addition, the company established a form of open book management in which all financials are shared with employees, and Panico has taken the lead as an exemplar of ethical behavior by turning down contracts with organizations that engage in practices that are antithetical to the ethical culture of IPM and by advancing ethical and socially responsible causes in the community (Kidwell, 2002).

Our results showed that people are guided by identification with the company's values. Integrity guides role models that diffuse values through the company, integrate new employees into desired values and, by example, discourage unethical behavior. Referent power is strongly allied with values-based strategies. Consistent with our findings, research indicates that values-based strategies resulted in fewer reports of unethical behavior, higher attention to ethical behavior and a culture that reports unethical behavior (Treviño et al. 1999).

#### ***Conclusion # 5: The ethical power of expertise helps***

We know that knowledge and expertise have a close interaction with trust in general. Without trust, it is difficult to transfer knowledge within the organization. This pertains especially to active business formats such as business innovation and growing new ventures, where nurturing and developing managerial talent and market knowledge within the company is essential. Staff members follow knowledgeable leadership because they believe they make better decisions (Kohli, 1989). The professionalization of business ethics based on expertise in the area should affect the ethical values. For instance, General Dynamics has a program director that handles unethical behavior reported by other employees (Tyler, et al. 2008). Similarly, Ahold's "Road to Recovery" program included "Global Conduct and Ethics" – a

set of shared values needed to “safeguard the decision-making processes.” This is part of a larger integrity program consisting of web-based value training and courses on “Financial Integrity” and “Conflicts of Interest” as well as training on antitrust issues and on making appropriate supplier agreements. Consistent with these examples, our investigation indicates that store managers ethical values are positively influenced by the perceived expertise of the headquarters central managers.

***Conclusion # 6: Ethics nurtures organizational commitment and improves service quality***

Organizational commitment is the bonding between the retail store managers and the brand company (Jaworski and Kohli, 1993). Organizational commitment reduces the gap between the interests of the brand owners and the store managers (Alchian and Demsetz, 1972). It eliminates goal conflict embedded in the delegation of responsibility to manage a brand to another person or firm. Our data show that store managers ethical values significantly affected the level of commitment to the entire organization (Figure 3).

As a byproduct of enhanced organizational commitment, the employees and franchisees consistently work in the interests of the entire organization. On the other hand, one of the disadvantages of the strong commitment might be that people are loyal to the old culture. Thus one question might be whether high commitment can reduce the dynamic change necessary to adapt to new market developments (Sørensen, 2002). However, organizational commitment puts the customers and not employees’ interests in the center of business attention (Brown and Lam, 2008). We find a line of correlations between solid knowledge, strong ethical values and satisfied customers.

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Insert Figure 3 about here

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## **Summary and Conclusions**

Our findings emphasize that business ethics cannot be isolated from its antecedents and context. Despite rational intentions to create favorable ethical values within the organization through the command and control process, our study shows that the use of coercive power to achieve such goals might be counterproductive. Our data from a multinational retail company show that voluntary and non-coercive influence is much more effective in creating a climate of ethical values, which our examples also illustrate. Both the referent power of the role models as well as expert power stimulate and foster ethical values. Moreover, ethical values result in increased organizational commitment. Commitment creates and builds better bases for service quality in the organization. Our investigation showed that perceived organizational commitment by the store managers affected service quality measured by “mystery customers.”

Leadership in the form of role models and good examples may be underestimated in organizational research. Our research shows that the power of a role model (referent power) is the crucial instrument to create ethical values, commitment and performance. Consequently, our findings should alarm managers who believe they can outsource ethics to consultants, research or ethics conferences. The old recipes to set a good example are still very much alive in the business sector. Yet, leadership roles are often passive and sometimes negative. Unconsciously, they are harmful role models demanding something different from their employees than themselves. The long time effects of negative role models are most probably destructive both to ethical values, commitment and long time performance. We also found that employees trust influence in the form of expertise. Consequently, investments in

knowledge are crucial not only to produce service and products in competitive markets.

Expertise is a constructive device that builds ethical values, commitment and performance.

In closing, this research indicates the importance of organizations seeking to establish and encourage ethical conduct to nurture role models and expertise in key managers who can thus influence the ethical behavior of their employees. It is less a matter of establishing official codes and decrees backed by punitive action against violators - and by rewards for compliance - than it is a constant informal effort to encourage exemplars and experts who have greater impact.

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