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EDITORIAL INFORMATION

Information for Prospective Authors

The Journal of Leadership and Organizational Effectiveness invites authors to submit articles in all areas of business, leadership, economics, and organizational behavior. We invite the submission of articles that are both theoretical and applied to business practices.

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Small Business Entrepreneurship: Utilizing Open Systems Structure to Gain Global Market Share

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ABSTRACT

The term “globalization” is a concept receiving substantial attention among business scholars. From theoretical frameworks (e.g., Gupta & Govindarajan, 2001) to specific cases (e.g., Kapur & Ramamurti, 2001), business faculty have been encouraged to assist students and others to better understand development of the global market in modern society. As faculty in schools of business, the task lies before us to provide insights into globalization for the benefit of world, national, regional, and local business leaders so they may better understand its market implications as well to understand more fully the impact of global markets in developing regions of the world.

Literally thousands of articles have been written about the interrelationship of various systems, to the point we have incorporated many of the concepts into our everyday language. We refer to political systems, social systems, plant and animal systems, banking systems, information systems, health care systems and more. Emphasis is often placed on describing differences in “open” and “closed” systems and, often as well, a value judgment is placed on one over the other. For the most part, open systems are seen as being far more fluid, less autocratic in nature, self-regulating, and capable of growth, development and adaptation. Closed systems are generally described as more fixed, bureaucratic, authoritarian, and with little or no give and take within the environment in which they operate.

In this paper, the authors present the argument that open systems theory provides a strong basis for organizing the global marketing activities of small entrepreneurial companies in developing countries. In other words, for a small, often rural business to be effective at interpreting the global environment and adapting to change, the overall organizational structure and management hierarchy should possess characteristics described in an “open systems” or “symmetrical” organization. A closed system is not able to effectively read, and thus interpret, the complex environment found in an increasingly global society.

In this initial study, a fledgling coffee cooperative with headquarters on the

outskirts of Palenque, Chiapas, México—the Tiemelonla Nich Klum Coffee Cooperative—is used to discuss open and closed systems marketing and organizational theory. The authors argue that systems theory provides a useful, and uniform, framework for classifying and analyzing the management structure of small entrepreneurial businesses in developing nations around the globe. It is concluded that such small businesses may be better served—in other words, be more successful in penetrating global markets—if principles inherent in an open systems management structure are employed.

Key Words: open systems, closed systems, marketing, coffee cooperatives, México, Chiapas.

INTRODUCTION

Globalization can be defined as “the physical expansion of the geographical domain of the global—that is, the increase in the scale and volume of global flows—and the increasing impact of global forces of all kinds on local life” (<http://www.sas.upenn.edu/~dludden/global1.htm>). Increasingly, a variety of courses related to globalization (economics, marketing, finance and more) are offered in business schools at colleges and universities around the world. Globalization received denotative status in 1944 when the word “globalize” first appeared in *Merriam Webster Dictionary* although it has a basis far earlier than that. For example, it was written that “in c.325 BCE: Chandragupta Maurya becomes a Buddhist and combines the expansive powers of a world religion, trade economy, and imperial armies for the first time” and that “Alexander the Great sues for peace with Chandragupta in 325 at Gerosia, marking the eastward link among overland routes between the Mediterranean, Persia, India, and Central Asia” (<http://www.sas.upenn.edu/~dludden/global1.htm>). Globalization expands one’s borders to create new links. Such global links are being aggressively pursued by many organizations today.

General systems theory was originally proposed by Hungarian biologist Ludwig von Bertalanffy in 1928. von Bertalanffy was the student of several diverse disciplines and began identifying key parallels among them. He eventually theorized that basic laws and principles could be identified that apply equally to many disparate systems. Characteristics such as order, progression, wholeness and differentiation resulted from his work. It was von Bertalanffy’s (1968) belief that, over time, what was discovered to be common among all systems would come to be applicable to life in general.

Littlejohn (1983) defined a system as “a set of objects or entities that interrelate with one another to form a whole” (p. 29). Systems can be either open or closed. An open system is dynamic and responds directly to changes in its environment. A closed system, on the other hand, has virtually no interaction with its environment. Physical systems are generally thought to be closed; in other words, they do not exchange energy with their environments and eventually die. For example, an automobile is a physical system that eventually stops working and rusts away. Most biological and social systems, however, are open in nature. They are oriented toward change and growth. A family or a business is constantly adapting to its environment in order to survive and prosper.

Successful, dynamic systems are constantly adapting and changing and are in dynamic balance with each other. No successful system exists in isolation, but instead interfaces with other systems that may be of a similar or dissimilar type or style. With the possible exception of the universe itself, on one extreme, and of the smallest component of matter on the other, all systems are part and parcel of larger systems and, therefore, are composed of smaller systems. For a system to survive and, indeed, to thrive, these various subsystems must work in tandem toward specific goals. This constant interaction results in a constant state of flux and change. From an organizational and managerial perspective, a successful system must be highly adaptive, fluid, and receptive to environmental changes.

Systems theory provides a uniform methodology for classifying and analyzing much of the world. A key consideration is that it provides a universal approach to all sciences. As von Bertalanffy (1968) pointed out, “there are many instances where identical principles were discovered several times because the workers in one field were unaware that the theoretical structure required was already well developed in some other field. General systems theory will go a long way towards avoiding such unnecessary duplication of labor” (p. 33).

BASIC PRINCIPLES OF AN OPEN SYSTEM

Malone and Crowston (1991) argued that increasing global interdependencies as well as the rapid pace of change in the modern world dictate the need for more adaptive organizations. They (1984) defined organizational flexibility in terms of “vulnerability” and “adaptability” and stated that vulnerability can be decreased by reducing the cost of failures and adaptability can be enhanced by reducing the cost of adjustment. Rockart and Short (1989) stated that due to such competitive pressures as globalization, market risk, and emphasis on customer service and cost reduction, there is an ever-increasing need for organizations to effectively manage their interdependence with the environments in which they operate. Bennis (1974) wrote that “the organization’s response to the environment will continue to be the crucial determinant for its effectiveness” (p. 22).

The fundamental characteristics of an open system relates to the dynamic interaction of its components as they relate to environmental uncertainties. Open systems are found at higher levels in organizations and are generally more successful at surviving in a world of change and uncertainty. Organizational development makes extensive use of open and closed systems theory in attempting to explain why some organizations are more effective than others. Originally, organizational theory emphasized the technical aspects of various work activities in a particular firm and plotted these in a flat organizational chart. The rise of systems theory encouraged academicians to view organizations as open systems that interact directly with their environments. A standard organizational chart is often seen to be of little use in explaining the complex nature of an open system.

Gillies (1982) identified several key components of an open system, including:

- A system is greater than the sum of its parts.
- Though each sub-system (contained within a system) is a self-contained unit, it is part of a wider and higher order.

- The central objective of a system can be identified by the fact that other objectives will be sacrificed in order to attain the central objective.
- An open system and its environment are highly interrelated.
- A complex system may have to be broken into sub-systems so each can be analyzed and understood before being reassembled into a whole.
- A system is a dynamic network of interconnecting elements. A change in only one of the elements must produce change in all the others.
- All systems tend toward equilibrium which is a balance of forces within and outside of a system.

Gillies continued by stating that, in order to be viable, a system must be strongly goal-oriented, governed by feedback, and have the ability to adapt to changing circumstances. An open system is characterized as having the following traits:

- Permeable boundary.
- Adaptive to environmental change.
- Accommodative.
- Holistic.
- Ethical.
- Encouraging of feedback.

Meanwhile, a closed system has the following traits:

- Impermeable boundary.
- Non-adaptive.
- Historicist in nature.
- Traditional.
- Authoritative.

ORGANIZATIONAL STRUCTURE UNDERSTOOD THROUGH OPEN SYSTEMS THEORY

“Uncertainty” in an organization is the difference between the information required to perform a task and the amount of information that is possessed by the organization (Galbraith, 1973; Schoderbek, 1967). An organization that maintains an open system approach is better suited to read environmental variations and respond accordingly. Such “environmental scanning” is the process by which organizations obtain valuable information for effective decision making. In an authoritative, bureaucratic organization, decision making is generally handled by only a few individuals at the top of the organizational chart, thus minimizing the amount of information flowing into, and out of, the system. System theorists have long recognized the importance of effective “feedback loops” for the survival of the system (Miller, 1955) and for maintaining equilibrium or “homeostasis” in the organization (Katz and Kahn, 1966). The more “scanners” that are involved in interpreting the environment, the greater potential there is for a healthy system.

The more turbulent the environment, the more organizational structures need to be aligned with environmental realities. A traditional, closed system simply cannot adequately respond to environmental uncertainties as, in this particular case, in the highly complex and volatile world of coffee production. Katz and Kahn (1966) stated that the very efforts of an organization, large or small, to maintain equilibrium in the environment require changes in traditional, hierarchical organizational structure. Scott (1987) argued that organizational structure and resultant goals and objectives are driven by environmental uncertainties. The more fluctuations in the environment, the more open a system needs to be in order to survive. A closed, hierarchical, autocratic, and historicist organization simply cannot respond effectively to market uncertainties. “Organic” businesses are better able to sustain themselves in a fast-changing, turbulent environment (Burns and Stalker, 1961). The more dynamic and complex the environment, the more organic a system must become, if it is to survive (Mintzberg, 1979). Becker and Neuhauser (1975) stated that organizations with complex environmental interactions develop complex organizational structures.

SYSTEMS THEORY IN MARKETING COMMUNICATIONS AND PUBLIC RELATIONS

Effective marketing and public relations functions are considered key predictors of overall “excellence” in businesses, both large and small (J. Grunig, 1992). Open systems theory has therefore become a key concept in both of these persuasion disciplines. J. Grunig (1984, 1992) was interested for some time in understanding both the “how” and “why” regarding the focus, scope and structure of marketing and public relations in various organizations. J. Grunig and Hunt (1984) differentiated between two primary communication models, finding that a more close-systems oriented, asymmetric organization engages primarily in one-way communication, conducts virtually no research, and does not seek input from the environment. In contrast, the more open-systems, symmetric organization engages in two-way communication, utilizes research and evaluation, and actively seeks input from the environment.

The key difference between closed/asymmetrical and open/symmetrical models of communication is one primarily of philosophy and of corporate culture: While the closed/asymmetric model is largely manipulative and often authoritarian in nature, the open/symmetrical model is generally more open, holistic and innovative in nature. The difference in the two models is related in large part to the corporate culture as dictated and modeled by the dominant coalition or “power elite” (J. Grunig, 1992). Top management, therefore, dictates the culture of an organization and the resultant practice of an open or closed systems mentality.

Regarding the effectiveness of a symmetric system, Dozier and L. Grunig (1992) wrote that:

... the symmetrical model is inherently more efficacious because it assumes that the knowledge, attitudes, and behavior of both top management and publics are subject to change. Communication managers are more successful moving two parties closer together than converting one party (publics) over wholly to the other party’s (dominant coalition) perspective. Application of game theory to communication management suggests that public relations is a

mixed-motive game when played by rules of symmetry. Asymmetrical public relations is a zero-sum game where one party wins only when the other party loses. (p. 178)

J. Grunig (1989a; 1992) argued that asymmetrical communication programs essentially mirror the organizations they represent. For example, J. Grunig (1992) maintained that asymmetrical programs assume:

. . . that organizations and opposing groups use communication to persuade or manipulate publics, governments, or organizations for the benefit of the organization sponsoring the communication program and not for the benefit of the other group or of both. In the language of game theory, public relations based on asymmetrical presuppositions is a zero-sum game: one organization, group, or public gains and the other loses. (p. 9)

As an alternative to the asymmetrical worldview of some organizations, J. Grunig (1992) proposed a set of symmetrical presuppositions that view marketing communications and public relations as “a nonzero sum game in which competing organizations or groups both gain if they play the game right.” (p. 9). Symmetrical communication is designed to resolve conflict and promote understanding. It is not manipulative in nature.

J. Grunig’s asymmetrical/symmetrical presuppositions provide a useful way to analyze not only the way marketing communication units operate in society, but in analyzing the way organizations and institutions themselves operate. He wrote (1992):

Although these presuppositions about the social role of organizational communication are couched in the language of external communication and the organization’s macro-level role in society, they are equally applicable to internal communication and social relationships within an organization. Asymmetrical communication systems inside an organization are generally found in highly centralized organizations with authoritarian cultures and systems of management. Symmetrical communication systems are found in decentralized organizations with participatory systems of management. (p. 9)

The theory that J. Grunig developed regarding marketing communications and public relations cannot be separated from his general belief that organizations, to be effective, should be open systems practicing a symmetrical style of management — serving the public interest, developing mutual understanding, and contributing overall to the good of society. This certainly fits well with the overall mission and goals of the Nich Klum coffee cooperative, as reflected in its organizational/management structure.

SUMMARIZED HISTORY OF TIEMELONA NICH KLUM (TNK)

The Chiapas region is the poorest and yet the most resource rich state in all of México. However, since the early 1980s when the Zapatista movement gained momentum—in large part to demand land reform and an end to abject poverty—the area has suffered economically and socially. In 1994, the Zapatistas held an armed insurrection on the same day the North American Free Trade Agreement (NAFTA) was passed by the United States Congress. Since then, political and social instability has had a tremendous impact on the ability of the indigenous people to expand their markets and gain a foothold in new global markets.

In 1981, Don Samuel, Bishop of San Cristóbal de las Casas in Southern Chiapas, asked the Superiors of the Sisters of Charity of the Incarnate Word to send Sisters to attend to the indigenous communities of the Salto de Agua Parish. It wasn't until 1984 that five Sisters arrived to determine how best they could help this impoverished region. Due to unusual hardships, three of the Sisters left within several years. The two remaining include Sr. Margarita Campos and Sr. Dolores María Di Costanzo who continue to work at the cooperative.

At first, the Sisters were housed in the Arroyo Palenque, an indigenous Ch'ol community. They set out to visit all of the communities that invited them, attending the reunions of various groups and participating in the catechists' assemblies. The Sisters began an in-depth evaluation of the needs of the Ch'ol people. At the same time, the people in the community wrote out a list of their own needs, including:

- To better understand how to grow and market coffee.
- To eliminate the middlemen, or “coyotes” who were paying such low prices for coffee.
- To become better organized as a community in order to take advantage of world markets.
- To improve the health system in the various communities.
- To better understand the Mexican Constitution and the laws of the land.
- To be better able to defend themselves, as needed.
- To improve their nourishment and be able to feed their children, year-round.
- To improve their understanding of the Bible.

Following an initial seven-month review, the Sisters invited all interested persons in their communities to find solutions to these needs to attend a reunion in Arroyo Palenque to discuss their options. Approximately 30 people from different communities attended. From the list above, they selected five priorities: production/global marketing of coffee, health, nourishment, law, and Bible study.

Based on community priorities, the Tiemelonlá Nich K Lum cooperative (“The Flower of Our Land Unites Us”) was begun in 1985. A total of 25 partners from six Ch'ol communities (El Zapote, Actiepá Yochib, El Toro, Suclumpá, Buena Vista y Tronconada) attended the first Assembly. At that time, the first Administrative Board was also named. With a great deal of

difficulty, including a massive flood, the first coffee warehouse was organized; a mere 50 sacks of 140-lb. coffee was harvested in March of 1986.

The next season, a number of communities from Tumbalá, Yajalón and Palenque applied to join the Tiemelónlá cooperative. With the city of Palenque entering the cooperative, the first Tzeltals became members. Increasingly, Palenque was becoming the center of operations as the community offered convenient elements of marketing infrastructure for the commercial distribution of coffee. There was an immediate need to build a warehouse for storage of the coffee, and a no-interest loan was obtained from a bank in Cenami. The Sisters purchased a plot of land on the outskirts of Palenque and built the first warehouse for the cooperative. The building was constructed largely with volunteer labor.

In 1989, the partners of Tiemelónlá joined the Program of Organic Agriculture meaning the cooperative would adhere to strict ecological principles in the growing and harvesting of their coffee. Meanwhile, the number of communities joining the cooperative continued to grow. In 1993, with a loan from “Hearts that Educate Foundation,” the cooperative was able to build offices, dormitories, bathrooms, a dining hall, and a kitchen on the land adjacent to the warehouse. A large meeting room was constructed for the partners’ workshops, reunions, study groups and assemblies.

In 1996, several communities of Chilón y Ocosingo applied to join TNK once they learned its advantages. The number of Tzeltal partners continued to grow, along with their Ch’ol counterparts. By 1997, the cooperative had outgrown the warehouse located on the premises; thus, the two Sisters entered and won a competition to acquire from Conasupo a larger warehouse that they subsequently remodeled. That same year, with credit received from the World of Food Program and with donations of coffee from the partners, a house for the two Sisters as well as a laboratory were constructed. An engineer was hired to run the lab, designed specifically for production of *Beauveria bassiana* for the biological control of the broca responsible for great yearly damage to the coffee beans. Because many coffee producers lived far from Palenque in the Tzeltal zone, and in order to facilitate the storage and distribution of coffee, the organization acquired land in Chilón, Chiapas, and built yet another warehouse.

In 2001, the Mexican Council of Coffee and the National Indigenous Institute supported the TNK with another zero-interest loan. The money was used to further expand warehouse space and to implement a quality control program to protect the freshness of the coffee. TNK began an association with other six coffee producers from Los Altos de Chiapas and also formed a commercial firm called Más café, SA de CV through which they started exporting coffee with a large number of other producers in order to reduce costs and achieve a common image with the buyers.

In 2002, the TNK organization grew to a total of 592 partners from 41 communities in six municipalities, all representing the indigenous Ch’ol and Tzeltal. This year the cooperative stored 7,000 140-lb. sacks of parchment coffee, exporting it to five countries in Europe (Germany, Denmark, Holland, England, and Austria). Presently, there are 670 partners from 48 communities of small coffee producers belonging to three indigenous ethnic groups: Ch’ol, Tzeltal and Tzotzil. In 2003, the cooperative received the Organic Certificate from the European

Union (UE). The cooperative also received the National Organic Program Certificate (NOP) which allows TNK to sell coffee to the United States; however, this benefit has been limited following the September 11 terrorist attack in New York City.

The cooperative recently joined the commerce institution Compras (a large Mexican trader of agro-ecological products) which unites 5,000 coffee producers. With Compras' experience in global marketing, TNK has greater ability to interact with national and foreign buyers in México, the United States and Europe.

THE ORGANIZATIONAL STRUCTURE OF TIEMELONA NICH KLUM

The TNK coffee cooperative has created a relatively sophisticated business plan (plan de negocios) each of its 19 years. The plan gives a brief history of the cooperative, overall objectives, responsibilities of each division as listed on the organizational chart, past-year production levels in each community, and anticipated production levels and pricing objectives for the current year. For example, in 2002 production capacity was 175 tons of unprocessed beans. The goal was to export 80 percent of total production to Europe, including Germany, Austria, England, Holland, and Denmark. About 20 percent of total production remains in México. "Asking" price for unprocessed ("Oro Verde") beans was \$146.00 USD per 100 pounds. The price for processed ("Tostado y Molido") ground and/or whole bean roasted coffee was \$8.00 USD for 2.2 pounds.

TNK attempts to receive "fair trade" prices for its coffee, which guarantees about \$1.46 per pound for organic coffee such as grown by TNK. For this higher price, growers guarantee certain environmental practices. Fair trade coffee currently represents only about 2 percent of the global coffee market; however in the United States (the world's largest importer of coffee) that grew to a remarkable 36 percent that same year. Without fair trade guarantees, farmers in developing regions, such as Chiapas, are paid roughly 24 cents a pound for unprocessed beans, while the four transnational corporations that buy nearly half of the world's supply of coffee—Sara Lee, Kraft, Proctor & Gamble, and Nestlé—sell those same beans at an average price of \$3.60 a pound. In their attempt to gain fair trade prices, TNK is constantly seeking new global markets, with the number-one goal of selling a majority of its coffee to the United States.

The TNK coffee cooperative has a traditional organizational chart (Organigrama de Tiemelona Nich Klum) that reflects administrative and operational duties. At the top of the chart are listed administrators and executives (ejecutivos) responsible for "strategies" (estrategias). Toward the middle and bottom of the chart, individuals are listed who are responsible for the day-to-day operations (operativos) of the cooperative.

In an interview with Sister Dolores Maria de Constanzo (personal communication, October 29, 2011) she was quite emphatic in pointing out that just such a "traditional" organizational chart does not adequately reflect the interdependent, holistic nature of the Tiemelónlá Nich Klum cooperative. She stated that "a flat piece of paper does nothing to reflect what we are all about" and that "the person at the top of this organizational chart is no more important in any way whatsoever than the person at the bottom. We don't like to refer to "top" or "bottom" in this organization. We are all equals. We are all partners in our success." In fact, at a meeting of the

Asamblea General de Socios (50 “delegates” representing the approximately 700 partners from 48 Ch’ol and Tzeltal indigenous communities) on the afternoon of October 22, 2011, everyone referred to each as “partner” and there was no apparent organizational or hierarchical stratification among the men who attended.

To reflect this operational philosophy, the organizational chart favored by Sr. Dolores is a circular diagram that she said “truly reflects the equal representation of all elements in the cooperative” (October 23, 2011). This organizational chart hangs on a wall in one of the warehouses where organizational and operational meetings are held once a month. The quite-beautiful circular organizational diagram has been meticulously painted on a large piece of canvas. It is, indeed, a work of art in and of itself—a series of circles and arrows and colorful drawings indicating the “wheel of life” of the TNK cooperative.

According to Sr. Dolores, the purpose of the circular organizational diagram is to more equally represent all elements of the cooperative without overemphasizing the importance of any one group. At the center of the diagram is the “GA” or “General Assembly (Asamblea General de Socios) comprised of 50 men representing the 48 communities. The Assembly is coordinated by one Administrative Board, constituted by the president, the secretary, the treasurer, and the vigilance committee which monitors growing practices and environmental controls. This group gathers in Palenque once a month for strategy sessions related to crop management, ecological issues, acceptance or rejection of new applicants to the cooperative and, importantly, for worship and prayer.

A critical function of TNK is the “GAR” or “Group of Analysis and Reflection” which is the heart and soul of the cooperative. This group of eight men meets the day prior to each monthly Assembly in order to plan the agenda for the next day’s meeting.

AN OPEN SYSTEMS APPROACH

Throughout the year, the GAR makes both long-range plans and also immediate decisions reflecting the best interests of the organization. What guides their discussion is a total commitment to “sustainability” and its dual meaning, representing an “open systems” approach to management and organization:

- 1) sustainability of the Earth through organic farming processes and total lack of pesticides; and
- 2) sustainability of the Tiemelonlá Nich Klum cooperative—emphasizing the health, education and overall spiritual well-being of 700 indigenous families in 48 communities—in light of the two founding Sisters’ impending retirement.

In addition to the circular representation of the organization, another diagram represents the overall mission of the cooperative. In this highly illustrative drawing, the coffee producers/growers (productores and productoras) are the real “roots” of the organization while their spiritual and theological beliefs (teologia) are represented by the air and sky. The “branches” of the mission include “love” (amor), “truth” (verdad), “fraternity” among partners (fraternidad), “unity” (unidad), “justice” (justicia), and “peace” (paz). Traditional coffee

productions/operations such as transportation (transporte), laboratory (laboratorio), roasting (tostado y molido), and human resources and community relations (relaciones con otras organizaciones) are represented as are less “traditional” management practices as “freedom from the Coyotes” (notorious middlemen who absorb most of the profits). This colorful diagram is included not only in the yearly business plan, but also painted on a large canvas and hung in one of the main warehouses. Truly representing and open systems approach to management and organization, this unique diagram is a guiding force throughout TNK.

According to Sr. Dolores (October 23, 2011):

It began with the coffee, together with God’s plan: to live the way God wants us to live. There was not a moment when faith was out of sight. Some would say ‘Yes we can solve this problem, if we only get organized’ while others would say: ‘We are foolish, we cannot get organized; there are many dangers on the road.’ We did not know a thing about selling coffee, but together with the ones that wanted to get organized, we figured we could learn and fight to find the right road to take from there.

CONCLUSIONS AND SUGGESTIONS FOR FUTURE RESEARCH

Mulnix (1996) related open-systems, symmetrical theory to public relations, fund raising, and marketing and argued that organizations and institutions characterized as being socially responsible, collaborative, ethical, and holistic were far more likely to succeed and, thus, survive. We argue here that small business owners and managers in developing regions of the world that hold a symmetrical worldview (holistic, socially responsible, collaborative, caring) are far more likely to adopt elements of an open system. On the other hand, those who operate their businesses in a more traditional, autocratic, authoritarian and asymmetric fashion would be less likely to utilize such principles, leaning instead toward a closed-system orientation. Mulnix and López (2002) designed a “Symmetric Model of Education” that is easily related to an open-systems model in business. Specifically with TNK in mind, the authors categorize two models as follows:

Symmetric Model of Business

Open-systems orientation
Innovative
Interdependent
Truth Constructing
Interpretive
Decentralized
Organic
Participative
Collaborative
Flexible

Asymmetric Model of Business

Closed-systems orientation
Traditional
Independent
Truth Imparting
Deductive
Centralized
Bureaucratic
Exclusionary
Individualistic
Rigid

At this point in time, these models are theoretical and will need to be validated through both qualitative and quantitative methodologies. If, indeed, such models can be further refined,

then practical implications would necessarily follow. Future researchers may find it illuminating to examine whether a symmetric/open systems organizational model allows indigenous, small business owners such as the Nich Klum cooperative to compete more successfully in limited global markets. On the other hand, researchers may want to validate if asymmetrical/closed systems are too restrictive and bureaucratic to allow small business owners in developing nations to both develop and nurture close working relationships among “partners” that would ensure the long-term survival and well-being of the organization. If we understand the basics of open vs. closed systems theory, it may help us—as business faculty and general consultants—to advise how best to organize fledgling businesses in developing regions. The main use of our model is, therefore, organizational in nature and requires validation by other business scholars.

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Performance Appraisals: Demotivation vs. Motivation

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ABSTRACT

Organizations, as part of their own competitive strategy, need motivated employees producing at the highest level to outsell their competition and become industry leaders. Performance Appraisals can accomplish this goal.

INTRODUCTION

Motivation is the force, internal or external, that creates enthusiasm and persistence to pursue a certain course of action. (Daft, 2005, p. 294). One of the key functions of manager is to motivate employees to increase their individual and organizational production and performance. At the same time, properly designed performance appraisal tools can satisfy employee needs. A highly motivated employee may also be a top performer within an organization. Because there are many ways to motivate people, however, managers must learn to adapt their approach to the individual.

Herzberg

According to behavioral scientist, Frederick Herzberg, “the best way to motivate the work force is to create opportunities for challenge and achievement into their jobs through job” (Dessler, 2005, p. 138). Job enrichment is achieved by adding motivators to it to make it more rewarding and encourages a desire for self-improvement. Generally, it means making a job more humanized by addressing both basic needs and higher level needs of employees. To increase the chances that employee’s find their work intrinsically rewarding, organizations can enrich their jobs by giving them the opportunity to acquire a new skills or demonstrate a new competency. Affording employees the chance to manage a project from start to finish and at the end of the project be able to show the successful results they have achieved gives them a sense of pride in their work. Also allowing employees to work on a project that has a high impact on the organization provides intrinsic rewards. In attempting to enrich jobs, organizations must be careful not to simply add routine job duties to an employee’s current responsibilities, add to the level of productivity expected just because they meet current expectations, and don’t use job rotation to move someone into a job that does not provide some kind of challenge (Deeprise, 2007, p.94).

Herzberg developed his two factor model in the 1950's. He argued that motivation is divided into two factors. Hygiene factors are elements such as pay, status, job security, benefits, working conditions, and policies and practices. Provided by managers or individuals higher up in the organization, Herzberg contended these external or extrinsic factors might improve short-term job satisfaction but they do not necessarily motivate. If hygiene factors are inadequate, almost certainly, employees have low job satisfaction. Regardless of whether managers have the ability to change hygiene issues concerning employees, they should be acknowledged. Empathy toward others goes a long way in understanding what motivates employees.

The other factor Herzberg suggested, called motivators, are within the employee's control. He proposed hygiene factors alone are only a part of motivation and believed creating a motivated workforce depended more on intrinsic rewards. Internal factors such as the fulfillment one receives from completing a challenging assignment, achievement, meaningfulness, and a sense of accomplishment are some examples of what he believed truly motivated people long term.

Maslow

Scientist Abraham Maslow offered a needs-based theory of motivation which says lower level needs must be met before the higher level needs will motivate another behavior in employees. Maslow's five levels of need included physiological needs, safety needs, belonging needs, esteem needs and self actualization needs. He believed the first three needs were lower level and must be met before the employee would be concerned with the higher level needs. For example, if a person does not have food or water, they will focus their attention on those basic life sustaining necessities before they will be able to concern themselves with esteem needs such as their recognition from their supervisor. "Essentially, employees are more enthusiastically motivated by what they are seeking than by what they already have, but they move forward with enthusiasm only when they are seeking something else" (Davis & Newstrom, 1989, p. 109).

McClelland

David McClelland, who studied motivational theories for over twenty years, developed the acquired needs theory, emphasizing the belief that some needs are acquired during one's lifetime, specifically the need for achievement, affiliation, and power. His research showed that people's motivational drives reflect elements of the culture in which they grew up, like family/friends, school, church and media (Davis & Newstrom, 1989, p. 103). Achievement addresses one's need to attain success or a higher level of success than others. The need for affiliation means the desire to develop personal relationships, to bring together people and different groups within an organization. Finally, the need for power often describes someone who seeks to move upward and make an impact on an organization throughout their career.

The theories discussed above identify specific needs that motivate people. If managers can identify the needs of their employees and successfully meet them, employees will very likely demonstrate desired behaviors in the work place bringing about increased productivity and profit.

OVERVIEW OF EXTRINSIC AND INTRINSIC REWARDS

Money

The list of rewards and recognition used to motivate workers is long and many have argued the effectiveness of each method. Money is often the first type of reward that comes to mind when thinking about motivation. But can money really motivate a person to perform at their peak? Deeprose (2007) suggests it “depends on how money is used as to whether it can motivate. Most would agree salaries are not motivators; they are an employee’s expectation for doing their job. Furthermore, not receiving a raise or getting a raise lower than what was expected, has a negative effect on a person’s level of motivation” (p. 20).

When employees are eligible to receive a financial reward for meeting established criteria, they are more likely to perform at a higher level than those that are not. The key is to provide them with clear, specific information and review it periodically so they understand their progress in reaching the goal. Spot bonuses can also be used as a way to show appreciation for an employee’s exceptional performance. “These bonuses do not have to be big but should be presented for specific behaviors or achievements, immediately following the noteworthy performance” (Deeprose, 2007, p. 21). There is less of an impact if the reward is given too far from the time of the behavior.

That being said, money as a long term motivator has its proponents and detractors. According to social critic Alfie Kohn (cited in Kriegel and Brandt, 1996), “while rewards are effective at producing temporary compliance, they are strikingly ineffective at producing lasting change in attitudes or behavior” (p. 261). As introduced by Frederick Herzberg, people are more motivated by intrinsic factors such as meaningful work, flexibility, recognition for a job well done, and belonging and acceptance. They are less motivated by extrinsic factors like money and material things. According to Herzberg, “compensation will, at best, prevent employees from being dissatisfied with their environment. Recognition, however, motivates” (cited in Jensen & McMillen & Stark, 2007, p. 215).

Is money a demotivator?

For example, rewards are not always positive motivators but sometimes actually become demotivators. When a worker is recognized for a particular contribution, they see themselves as recognized. Herrera (2002) proposes “if the level of recognition is not at least equal to the person’s perception of the effort they exerted toward the action, the reward becomes a negative motivator” (p. 44).

Employee development

Employee development, an intrinsic motivator, gives employees an opportunity to grow both personally and professionally. Employee development also benefits the company who gains an even more educated and prepare workforce. Hopkins (1995) offers five categories of development activities that will assist managers in effectively motivating employees and increasing their morale.

1. Social gatherings such as company picnics, family days, or philanthropic work gives employees a sense of belonging and through this, employees will take ownership of their jobs which leads to higher morals.
2. Recognizing employee contributions, no matter how small, is an important motivator. Also, nothing is more motivating than to recognize someone's accomplishments in front of the entire company. It helps motivate others to strive to achieve similar results so they too can be rewarded for their efforts.
3. Providing opportunities for employees to continue their education improve both their knowledge base and their work performance. Employees become more self-confident and in essence become more motivated about their work and responsibilities.
4. Employee meetings show support for employee's ideas and concerns as they relate to the company's needs. They are a good way to promote upward communication within the company.
5. Though not a specific activity, empowerment increases motivation. It is important to allow employees to participate in the decision making process (p.26-27).

Empowerment

Another approach used to motivate employees is empowerment. "The need for empowerment is a direct consequence of the attempts by organizations, through de-layering and right-sizing, to increase efficiency, effectiveness and meet the needs of increased competition" (Smith, 1997, p. 120). Empowerment, which satisfies intrinsic needs, is a concept or a way of distributing power down to lower levels of the organization. It can be difficult to implement because it means less power and more trust from top management. It also refocuses efforts away from traditional extrinsic reward programs and emphasizes intrinsic satisfaction employees get from doing a job well. Empowerment allows employees to flourish and find meaning in their jobs. It also brings the organization different ideas and new approaches to problem solving from a larger, more diverse group of people.

To expand on the concept of empowerment, Independent Consultant and Editor Bryan Smith (1997) suggests that "by giving employees more control over how to do their job, comes immense potential for improving productivity. Empowerment supports and promotes learning from experiences and personal growth" (p. 120). Often, additional responsibility, decision making power and autonomy bring increased motivation and a decrease in employee absenteeism and turnover. It allows employees to satisfy intrinsic needs through their work.

Daft (2000) suggests there are several factors that must be present in order for empowerment to be effective. (1) Information about company performance must be shared with the employees. (2) Companies must provide employees with the training and knowledge necessary to contribute to the company's goals. (3) Employees are able to influence company direction and make substantive decisions through self-directed work teams. (4) Employees understand the impact their work has on all parties involved and consider what they do to be important. (5) Company performance determines how employees are rewarded. Many times this means profit sharing and employee stock ownership (p. 317-318).

There are a considerable number of benefits that come from empowering people to use their expertise and skills to get their jobs done without constant direction from management. Being given the freedom to use their creativity to problem solve or draw on their knowledge to complete a complex task satisfies an individual's need for self-efficacy. From a higher level, some leaders believe giving up some control will encourage speed, flexibility and decisiveness in the workforce, leading to a smooth running, efficient organization.

Inspiration and Recognition

Creating meaning within an organization gets people excited about their work and inspires them to perform at a high level. When employees can relate to the organization's identity, it gives them a sense of belonging purpose in their work. Without inspiration, workers lack the drive necessary for top performance. Stallard (2007) suggests there are several ways managers can help employees find meaning in their work, regardless of the product or service they are producing. Demonstrate how the product brings something innovative and new to the industry. Challenge employees to reach a stretch goal or be the best in the industry. This brings about good competition and motivates. It is especially effective if data from competitors is available for comparison. Get employees connected to the organization right from the start. New hire orientation is a great place to convey the organization's mission and culture and help them understand their role in it. Find ways to continuously share the vision and identity. It is important to gain employee commitment and maintain an organization where people work together to achieve common goals. Finally, in addition to verbal communication, managers can use written communication as a tool to encourage people and influence behavior (p. 51-56). Regardless of the approach, providing meaning and inspiring people in the workplace is critical to the success and longevity of any organization.

Some argue, recognition above all else, is the most powerful and effective tool used to motivate employees. One key point regarding recognition programs is that they can be much less costly than traditional monetary reward programs and can be more effective too. Organizations have found that behaviors and efforts that get recognized get repeated. Different from performance management, which will be discussed later, recognition programs acknowledge specific behavior and not sustained peak performance. "Recognition is not a replacement for performance management, but rather a process for improving performance through people. Recognizing events, activities, and efforts after the fact may not drive improved performance, but it will reinforce it" (Jenson & McMullen & Stark 2007, p. 217).

There are several elements that make up effective recognition programs to celebrate successes. People love seeing others being recognized for achieving a goal, accomplishing a daunting task, or for providing great customer service in a flashy awards event or ceremony. So it makes sense that recognition, and lots of it, should involve many employees. It not only motivates those receiving the recognition, but those applauding the recipient.

According to Levesque (2008), employee motivation and customer satisfaction are always mirror-images of each other. He suggests "where employees are cynical and demoralized, no amount of customer service training, no amount of disciplinary action, no amount of managerial pressure is going to get them consistently delivering a delightful customer

experience”. On the other hand, when employees are enthusiastic about doing their jobs, customer satisfaction is almost always a given (p. 130). In his book, Levesque also declares positive customer feedback is one of the most powerful employee motivators of all. If this is true, acknowledgement based on this feedback is a critical element of the recognition process.

Just as continuous recognition and celebration is important, the quality aspect is another factor to consider. There are four attributes of motivational celebration. First is the effort quotient. The amount of effort put forth to recognize someone for a job well done determines the level of effectiveness. “It tends to be directly proportional to the motivational effect the recognition will have on the recipient” (Levesque, 2008, p. 135). High effort recognition and one that has meaning increases the level of impact on the employee.

The second attribute is the internal/external meld. Levesque (2008) describes these recognition events as internally funded, externally triggered which enhances cultural alignment (p. 139). So even though the event is hosted management, it is in celebration of customer feedback. The key to these events is that the effort factor must also be present.

Called the hero story, the third attribute focuses on stories of employee’s specific action to help one or more specific customers in a profound way. Often they tell of employees helping customers in an unprompted, unplanned manner. Usually they are stories customers tell management after the fact, delaying the motivational effect until the internal recognition takes place. These stories are then celebrated in big, elaborate fashion. “When a business empowers its workers to look like heroes in customers’ eyes, the mere loyal return of these customers becomes a motivational form of recognition and validation in and of itself” (Levesque, 2008, p. 142).

The last attribute of motivational celebration is a large audience. The level of motivational impact a celebration has on a person is determined, in part, by the number of people participating in the festivities. Clearly, an audience of five people applauding has less of an impact than an audience of 200. Another positive outcome of this type of celebration is that it creates a connection among the audience participants, giving them a sense of unity. Motivational celebrations, according to Levesque (2008) “awaken the spirit of volunteerism that may be lying dormant within many employees-their basic human need to feel useful and necessary in the world” (p. 147). They also drive other employees to provide the same type of remarkable customer service within their own jobs so they too can be recognized.

A LEADER’S ROLE IN MOTIVATION

Providing the right environment for employees to perform and be successful is an important function of any leader. “True motivation lifts the level of performance and produces a more valuable, committed employee” (Stettner, 2000, p. 70). Trusting employees, providing them with the right tools, and giving them freedom to get the job done are powerful motivators that contribute to their success and that of a manager. But before a manager can respond to the needs of his staff, he must develop trusting, mutually beneficial relationships.

Establishing these relationships are key to building rapport among employees. It encourages collaboration and team work and without it, employees will lack the motivation to reach their highest potential. Showing genuine interest in one's employees also demonstrates a leader's concern and empathy for their well being. In turn, subordinates will be more dedicated and willing to go the extra mile for their supervisor. "Without rapport, managers will get the minimum required from their people, but never anything more, and they will never take the team to new, important heights" (Snair, 2007, p. 143).

Well-informed employees are good and productive employees. Open, honest communication and sharing of information is another element in facilitating employee motivation and creativity. "Communication is the transfer of information and understanding from one person to another person. Without communication, employees cannot know what their coworkers are doing, management cannot receive information inputs, and supervisors cannot give instructions. Coordination of work is impossible, and the organization will collapse for the lack of it" (Davis & Newstrom, 1989, p. 70-71).

According to Stallard (2007), "knowledge flow communicates people with less power in an organization that they appreciated and respected enough to be informed and heard and that their ideas can make a difference. It energizes and engages them" (p. 83). Another benefit of knowledge flow is an organization's ability to leverage ideas and experience from anywhere in the organization in order to make better decisions. Increased creativity and innovation is another positive outcome of knowledge flow. "When knowledge flows up and down and across the organization, it empowers people and makes them more effective in their jobs" (Stallard, 2007, p. 92). These are just a few of the clear benefits to keeping the lines of communication open and letting employee's know management values their input.

Conversely, communication can create unwanted difficulties and barriers among people. It can highlight differences of opinion between employees or work groups. This can create an unwanted barrier that can hinder creativity or productivity. Another negative outcome that can arise is cognitive dissonance. Defined as "an internal conflict and anxiety that occurs when people receive information incompatible with their value systems, prior decisions, or other information they may have", it makes people uncomfortable and want to reduce or eliminate it all together. Consequently, one must proceed with caution because communication reveals something about the sender while at the same time, judges others (Davis & Newstrom, 1989, p. 75).

Effective leaders understand the importance and benefits of delegating work. Whether it is delegating daily tasks or the management of a major project within the organization, it demonstrates a leader's trust in their employees and establishes credibility within the team. Entrusting employees shows you have the confidence in them to get the job done. It also builds trust among team members.

Once a leader has established these important relationships, it is their responsibility to identify what motivates his or her staff and then work to provide them with opportunities to be successful. "Leaders are responsible for going beyond removing dissatisfiers to using motivators to meet higher-level needs and propel employees toward greater achievement and satisfaction"

(Daft, 2005, p. 300). Since Herzberg didn't believe hygiene factors were motivators, addressing factors such as achievement, responsibility, and meaningfulness becomes important.

In order to satisfy these needs, Ellis (2005) offers five motivators that leaders can institute within their organization.

1. Monitor and provide ongoing feedback regarding goal achievement.
2. Provide proper training taking into account the learning curve.
3. Give staff opportunities to manage and direct an activity.
4. Offer staff the chance to cross-train in other departments.
5. Provide training and learning opportunities on a subject staff wants to learn more about (p.89-90).

While the above suggestions by Ellis focus primarily on training and development, Stettner (2000) argues "most people are motivated by six needs: attainment, power, belonging, independence, respect, and equity". Again, these intrinsic needs, as Herzberg argued, were much more effective in motivating employees than financial rewards.

Employees that are motivated by challenging work and enjoy diving into a project to achieve success are motivated by attainment. These people want to develop their skills sets in order to advance within the company. Being the center of attention is a characteristic of people that are motivated by power. They strive for positions of leadership and the opportunity to influence others. Those who value social events and become engaged through their relationships with their co-workers are motivated by a sense of belonging. Team meetings also satisfy their need for belonging. Being given the freedom to work independently and the flexibility to problem solve the way they choose motivates those that are motivated by independence. The biggest demotivator for these people would be working on a project and being told exactly how to complete it and strict timelines for them to follow. These employees want the autonomy to establish their own set of rules. Some employees want to be heard and given full attention by their leaders. They want to be appreciated and given feedback on their performance. They are motivated by respect. While the goal of most leaders is to be fair to all their employees across the board, this becomes more important for employees that are motivated by equality. Leaders must make this a top priority and engage this group of employees by going out of their way to demonstrate they are indeed unbiased to any particular employees (p. 74).

Setting challenging goals encourages employees put forth extra effort resulting in higher performance. The key to encouraging peak performance from everyone, including top performers, average employees and even those that managers seem unable to motivate, is that the approach should be different. Deeprose (2007) recommends presenting top performers with these challenges to increase the level of motivation:

1. Allow employees to choose their own projects.
2. Give them the time and resources to work on projects they create and do not relate to their usual jobs.
3. Make these employees project managers, heading up cross functional teams, where promotional opportunities are few.

4. Provide them with opportunities to learn new skills, both in and outside of work and ensure they use the new skills at work.
5. Arrange for them to attend conferences or meetings normally reserved for top ranking personnel.

For the group of employees that produces satisfactory work but falls short of turning out exceptional results, leaders should work with them to create goals that push them but are still achievable. No matter the type of employee a leader is trying to motivate the goal is the same; to reinforce the behavior so it will be repeated in all aspects of the employee's day-to-day responsibilities (p. 24-28.)

Poor performers and employees that nothing seems to raise their level of motivation require yet another approach. They fail to respond to promises of advancement, more money and more responsibility. Stettner (2000) advises managers to work with these employees individually to modify their job duties to include more challenging projects that focus on their areas of expertise. Allowing them the time to teach and train others in these areas can encourage them to become more engaged and interested in their work (p. 82,84). Deeprose (2007) offers a different method to engaging this group of individuals. She suggests rewarding a behavior instead of waiting to reward an outcome. If a particular behavior is not rewarded, the employee may not sustain it long enough to improve their performance (p. 63). Bottom line, reward even the smallest win for this group and eventually they will add up to something to rejoice over.

INCREASING PRODUCTIVITY THROUGH PERFORMANCE MANAGEMENT

Performance goals and measures provide employees with direction and expectations which motivate them to work toward achieving those outcomes. It is management's responsibility to set effective goals that inspire peak performance from their employees. Employee goals should be focused on helping achieve the company's strategic goals. Goals must be clear and identify what is important to the company. It gives employees the opportunity to contribute its success.

It is worth noting the distinction between performance appraisals and performance management. An appraisal is assessing one's performance against specific performance standards. Performance management combines goal setting, training, the appraisal, and rewards into a total package. It means having ongoing interaction with employees to review goal progress, ensure continuous performance improvement and providing training as necessary for the employee to carry out his or her job responsibilities successfully. A total performance management system also helps an organization's attempts at continuous improvement.

Involving employees in establishing goals can encourage their commitment to them. Jensen, McMullen, and Stark (2007) argue that "whether employees participate in the goal setting process, they should always be involved in discussions as to why the goals are important and why meeting deadlines is critical" (p. 47). Employee goal attainment depends on their understanding of exactly what the goals are, how they will be measured and what the rewards are if they meet them. In the end, a high level of employee performance results in happy, satisfied customers which increases company profits and growth over a period of time.

Because effective goal setting is so essential in determining whether an employee is able to achieve them, it is important to review the process. Goals should help employees focus their actions and help them to create strategies to achieve the set goals. Giving employees specific goals often results in a higher level of performance than those who are not. Leaders must ensure goals are attainable in order for them to have a positive influence on the employee's performance. If an employee feels they are unreasonable, it can actually have a negative effect on performance. The effectiveness of goals also depends on their ability to be measured. This can be done either by using quantitative terms or even providing achievable milestones throughout the project. Providing deadlines also clarifies and leaves less room for confusion among employees.

Appraising employee performance is important for several reasons. "Performance appraisal is a fundamental requirement for improving the productivity of an organization's human resources because it is through an appraisal that each individual's productivity is evaluated." (Latham & Wexley, 1994, p. 6). Appraisals aid in development of employees which will encourage continuous improvement. It does little good to set employee goals based on those of the organization and provide training if periodic review of the performance is not a part of the process. The appraisal provides an opportunity for the supervisor and the employee to take action to correct any deficiencies identified in the appraisal. It allows time to review the employee's career goals based on his or her strengths and weaknesses. Organizations don't have control over the rising costs of materials and energy in today's poor economy, but they can control employee performance and productivity, and must. Finally, the performance appraisal is most likely to directly affect an employer's decision regarding promotional opportunities and salary raises for employees (Dessler, 2005, p. 313).

Providing employees with regular feedback gives them a sense of where they stand and suggestions for areas of development that will help them reach the desired outcomes. Deeprose (2007) proposes "managers need to keep up with employees' progress toward goals, facilitate employees' access to resources and guide them toward solutions to problems that block their progress" (p. 43). The performance appraisal is one tool used to facilitate this feedback. "Performance appraisals are crucial to the effective management of an organization's human resources, and the proper management of human resources is a critical variable affecting an employee's productivity" (Latham & Wexley, 1994, p. 2).

Many organizations have implemented an appraisal system that includes feedback from a variety of sources, not just that of the immediate supervisor. This might include one's peers, subordinates, and even a self-appraisal. To be qualified to assess one's performance, Latham & Wexley (1994) argue that an individual "must be aware of the aims and objectives of the person's job, frequently observe the employee on the job, and be capable of determining whether the observed behavior is satisfactory" (p. 111). Peer appraisals, for example, are highly reliable and valid. This is because peers observe each other interacting with one another, with subordinates and managers. They have a wide-ranging view of their performance.

Appraisals given by subordinates are used most infrequently. It is thought these appraisals could weaken managerial power. There are however, benefits to conducting subordinate appraisals. Bernardin and Beatty (cited in Latham & Wexley, 1994) suggested

subordinates have a different vantage point regarding managerial performance than managers. They also help eliminate one-rater-only biases. Surprisingly, they also found that most managers said the feedback would be extremely valuable to them (p.120). Nevertheless, there are problems that can arise from this type of appraisal. Some subordinates may find this process intimidating because their supervisor may punish them for their honest, sometimes negative, feedback.

Many studies have been conducted to assess the validity of self-assessments. Though some of the outcomes have differed, many have actually found a high correlation between self-appraisals and that of the manager's assessments. In any case, most would agree there are both advantages and disadvantages to self-appraisals. One positive is the potential to increase self-motivation and ultimately, productivity. It can also improve one's self-respect and improve their understanding of the need for goals. On the other hand, a problem with this form of appraisal as noted by Harris & Schaubroeck (cited in Latham & Wexley, 1994) "is their lack of agreement with other sources of appraisal, especially supervisors". This is prevalent in jobs that are poorly defined. The key is to remove the aspects of the job that are unclear, so the evaluation criterion is obvious (p. 126).

Performance appraisals should be used to measure performance against established measures and reward the individual accordingly. Latham & Wexley (1994) believe "that the use of multiple sources of appraisal increases the probability of obtaining a comprehensive picture of an employee's total contribution to the organization" (p.136). Finally, performance management is one of the best tools available to organizations in which to measure performance and set a plan to increase performance and productivity of the long term.

RETURN ON INVESTMENT

Employee motivation, high organizational performance and profits all go together. A survey completed by the Gallup organization found that when all of an organization's employees are highly motivated and performing at their peak, customers are 70 percent more loyal, turnover drops by 70 percent and profits go up by 70 percent (cited in Daft, 2005).

If this is true, then why don't most organizations measure their return on investments? The answer is different for any organization but there may be factors some have in common. According to Jensen & McMillen & Stark (2007) measuring ROI may be up to finance or operations and not the compensation function of human resources. It may be too costly and difficult if financial and HR measurement and reporting systems are not in place. Another possible reason is that departments within HR operate as separate functional entities which can hinder communication between departments. Thus, each of these functional areas tend to focus only on the costs and returns for their particular areas. Additionally, HR as a whole has historically focused their efforts on measuring and monitoring the investments in compensation programs instead of their returns (p. 13).

An organization's compensation programs, investments, should not only include to monetary rewards. When workers are choosing which employers to work for or deciding to stay with a particular employer, it is often the intangible rewards that play a significant role in their decision. Indeed, they are a major factor in an organization's ability to recruit, retain and

motivate employees. For example, training and development, intrinsic motivators, are highly valued among today's workforce. People understand their future employability depends on their ongoing efforts to improve their skills. Another factor important to employees is the understanding of the company's direction and trust in top management. They want to know where are headed to ensure their skills will continue to benefit the organization long term.

From a management perspective, the good news is that supervisors have the greatest control over the intangible benefits like working conditions and development opportunities. According to author Jac Fitz-enz (cited in Jensen & McMillen & Stark, 2007), the "principle driver of human performance and retention was the immediate supervisor or manager." He suggested seven items employees valued on the job.

1. Receive job-related training.
2. Receive career-development support.
3. Have advancement opportunity.
4. Be treated as a contributing adult.
5. Have personal knowledge and experience put to use.
6. Be kept informed about company matters and changes.
7. Be compensated fairly and equitably (p.19-20).

Noticeably, compensation is the lowest in order of importance. This reinforces the idea that monetary rewards are of lower value than intrinsic rewards and therefore should not be considered a primary factor in employee reward programs. That being said, a manager's ability to make a connection between rewards and performance proves critical to improving employee performance and therefore, contributions to the organization. The message is that to be able to effectively leverage them to increase motivation and ultimately ROI, managers must have a complete understanding of their value and how they relate to the overall business results.

As stated by Jensen & McMillen & Stark (2007), an example of an investment used to improve performance that is easy to quantify is measuring the costs training. The direct costs are the costs of developing and delivering training and the pay for employees while attending the training. In order for the training to have an ROI, employee performance must be higher after the training than before. There needs to be a clear increase in productivity, quality or some other performance metrics following training (p.21).

Regardless of whether organizations make the effort to actually calculate ROI they can benefit from identifying and implementing a reward system, made up of both intrinsic and extrinsic rewards that will likely produce the desired outcomes. "Managers who use all of the rewards elements available to them and who clearly link rewards to performance, ensure that they get an appropriate ROI from their people" Jensen & McMillen & Stark, 2007, P.28).

CONCLUSION

Winning organizations understand the significance of motivating employees and maintaining that motivation over the life of the business. Motivation effects productivity, employee morale, customer satisfaction, and profits, to name just a few. Its success depends on

their ability to identify and meet the needs of their employees. It is important for managers to build trusting relationships that facilitate open communication and cooperation within departments and up and down the organizational chart.

The majority of the literature concluded financial rewards can be effective in demonstrating appreciation but falls short as a lasting motivator. Intrinsic rewards have, however, been determined to be most satisfying and motivating over the long term. Intrinsic motivators such as development, empowerment, organizational identity and meaning, recognition, and performance management were all discussed in order to illustrate the variety of tools organizations can implement for the purpose of increasing motivation.

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The Role of Marketing Mix in Successful Independent Restaurants

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Abstract

The restaurant industry has a failure rate of over sixty percent within the first three years of a restaurant's opening, with independent restaurants failing in greater numbers than multi-unit (chain) restaurants. This qualitative study of 25 successful Chicago-area independent restaurants (successful defined as profitable and in operation at the same location for a minimum of five years) was undertaken to ascertain the role of specific marketing mix methods in the success of an independent restaurant.

The findings of this study suggest that, in addition to sufficient investment and capitalization of the start-up restaurant operation, five elements were found to be crucial to the success of an independent restaurant: (1) having a good location; (2) pricing food (menu items) appropriately for the market; (3) maintaining the quality of food items (even in times of scarcity of an item in the featured menu, or if costs should spike suddenly); (4) utilizing promotional tactics to encourage repeat customers and to encourage new business; and (5) having an ongoing commitment to service in developing relationships with existing and new customers.

The implication from the data obtained in this study is that the combination of marketing mix methods (location, price, quality, targeted promotions, service) are collectively needed by the independent restaurant to achieve and maintain success. Finally, the study reported that independent restaurant operators believe that the consistent commitment to these marketing mix methods is necessary to create the foundation for positive customer relationships, which in turn generate repeat business and the crucial of word mouth advertising to sustain their operations.

Key words: restaurant success, independent restaurant, restaurant promotion, menu pricing, restaurant location, food quality.

INTRODUCTION

Previous research on restaurant success has been conducted on singular factors contributing to a restaurant's success such as product quality, location (Holaday, 2007), promotional execution, and pricing. Additional research has focused on restaurant failure (Parsa, Self, Njite and King, 2005) by examining restaurant turnover and conducting qualitative interviews with successful and failed restaurant operators. This study explored successful independent restaurants and the relationship of product, promotion, place, and price to their success. In contrast to previously conducted studies that concluded that food is what has made the industry what it is (Filipan and Kleiner, 2000) or that chains are growing at the expense of independents because of their marketing efforts (Bradley, 2007), this study indicated that it is the unique balance of all factors (product, promotion, place, and price) that resulted in success for the independent restaurant. A qualitative analysis of specific factors for success identified five critical elements for an independent restaurant to achieve success: having a good location, pricing their food appropriately for the market, maintaining the quality of their food, using promotional tactics to encourage new and continued visits, and developing relationships.

“I think our concept is very appealing to a broad market of people. We try to be the neighborhood restaurant and pub for all ages, so we try to target everybody. We care about everything. We have to care about everything. Whatever the customer feels like, whatever the customer wants. The food that we make is cooked fresh, so if the customer wants to substitute something, we will do it for them.”

- *Successful operator commenting on why they think their restaurant is successful.*

Restaurant associations and research companies continually publish data on the size of the industry and its importance to the United States Economy. Numerous state, regional, and national restaurant associations hold annual tradeshow, offer training classes, and provide research and information for restaurant operators regarding new products, hiring staff, profitability and sustainable practices. Now knowing that approximately 60% of all restaurant startups fail within the first three years (Parsa, et. al, 2005), we think it is vital for current and prospective restaurant operators to understand why restaurants are successful.

Most research studies on restaurants considered one of the marketing mix variables for their analysis. Such research focused on the relationships of promotional activities, such as loyalty clubs, or the strategies behind food and its importance to a restaurant's success. With the exception of the research study, *Why Restaurants Fail* (Parsa, et. al) we could not find any qualitative research that was conducted with successful restaurant operators. Furthermore, we could not find any research that specifically studied each of the marketing mix variables in depth with successful operators.

The focus of this investigation was twofold: (1) to identify marketing strategies (marketing mix methods that have been employed in successful independent restaurants) and (2) to disseminate within the restaurant industry results of this seminal marketing research that may be of benefit to current and future independent restaurant operators. We think that sharing the information in this article will provide current and prospective operators with valuable insight relative to their operation, thus reducing the number of restaurants to fail each year in the United States.

MARKETING MIX VARIABLES APPLIED TO THE RESTAURANT INDUSTRY

The marketing mix variables: product, promotion, place, and price each have been studied by researchers in the restaurant industry. We found that the majority of research conducted on reasons for restaurant success focused on the product offered and the promotional activity.

Product

Product is the food offered on the menu. This includes the variety of food on the menu, the presentation of the food to the customer, the quality of the food in terms of flavor, consistency, and freshness, the uniqueness of the menu items relative to those offered in the immediate trade area and the consistency or rotation on and off of items on the menu.

Promotion

Promotion or promotional activity is internal and external to the restaurant. External promotional activity includes advertising through the traditional mediums of newspaper, television, radio and outdoor billboards and signage. It also includes more recent methods of promoting on the restaurant's websites and other websites related to restaurants. Coupons and are also considered promotional activity outside of the restaurant. Internal advertising is table tents, signage, suggestive selling, chalkboards/wall signs, menu cards, special menus specifically for children, food and drink specials, loyalty club cards, and special occasion activities (i.e., holiday promotions, live performances, and birthdays).

Place

Place is specific to the location of the restaurant. Place is related to the number of or lack of competitors in the immediate area, the demographics of the immediate area, and if the physical structure of the housing the restaurant existed or not and whether a physical structure was inhabited previously by another restaurant or not.

Price

Price is the amount of money that is exchanged for the menu item(s). Price is correlated to customer value. Specifically is the food a good value for the money received in exchange for it. Determination of price relative to competition, food costs, and desired profit also affect price.

STUDYING SUCCESS

The qualitative research consisted of opened and closed ended questions. A series of personal interviews were conducted to gather the data for the study. The one-on-one interviews first asked a series of direct questions regarding their full-service restaurant's success, followed by closed ended questions concerning their use of marketing mix methods. The interviews were conducted with study participants over the course of six weeks during Winter and Spring 2008.

The desire to study the subject of restaurant success was derived from the researcher's personal experience in the restaurant industry (over twenty years as a supplier to restaurants). The researchers previously conducted a modified version of the research with five independent restaurant entrepreneurs and decided to expand the study to further explore the topic. Upon completion of extensive research on the topic of restaurant success and failure, the researchers decided to expand the research into a study that included twenty-five restaurants in the Chicago area.

STUDY DESIGN

The research protocol used was a questionnaire that combined open- and close-ended questions. Open-ended questions were read to the participant and the responses were audio-taped. For the close-ended questions, the questions were read to the participant and then the responses were recorded on the questionnaire. For some of the close-ended questions, respondents were shown a card listing a series of optimal answers to the question; respondents were asked to select the best answer from those listed. We analyzed and coded the qualitative data.

The qualitative data was collected from the interviews conducted with 25 founding owner-operators of casual dining independent restaurants currently in operation in DuPage, Cook, and Lake Counties, Illinois; that have been in operation for a minimum of five years; that have been profitable for at least three years; that derive the majority of their revenue from food sales, and not liquor (eliminates bars and primary liquor establishments). A minimum of five years in operation was utilized because similar criteria were specified in previous research conducted on restaurant failure (Parsa, et. al, 2005). The participants were limited to founding owner-operators of casual dining establishments. (Casual dining restaurants are establishments that are supported by waitstaff in a sit-down environment, generally provide take-out service, and serve alcohol. Check averages per person generally range from \$15 to \$25). The geographic boundaries were established based on travel and time limitations.

A sample of twenty-five restaurants was selected at random from the independent restaurants listed in the AOL Yellow Pages on-line. Using current U.S. Census data and applying the appropriate percentage of independent restaurants in each county relative to the number of the all restaurants in the three counties chosen for this study (Cook, DuPage, and Lake County in Illinois) yielded the number of restaurants per county. Specifically:

- There are 22,564 restaurants in Illinois (U.S. Census Bureau, 2005), of which approximately 9,025 (40%) are considered independent (not chain/multi-unit).

- There are 4,974 independent restaurants (aggregate) in DuPage, Cook, and Lake Counties, of which 682 (13.7%) are in DuPage County; 3,798 (76.3%) are in Cook County; and 494 (9.9%) are in Lake County.

From this total of independent restaurants, 25 were selected as participants in this study:

- 18 from Cook County.
- 4 from DuPage County.
- 3 from Lake County.

Utilizing the AOL local yellow pages on-line database, we screened restaurants for location (county), type of restaurant (Italian, Mexican, varied, etc.), number of locations (one or two), and dine-in and take-out options. The AOL local yellow pages on-line database typically provided restaurant information including address, type of restaurant, hours of operation, and a direct link to the restaurant's website. (The restaurant's website generally provided the number of locations, menu, and dine-in and take-out options).

Restaurants selected from the AOL local yellow pages on-line that passed the initial screening, were then telephoned in order to determine if the restaurant met the additional screening requirements set forth in the study. Once the restaurant was contacted, the interviewer asked to speak with the owner/operator. Owner/operator were asked a series of questions to determine if the restaurant met the criteria which qualified for the study:

- Original owner who continuously owned the restaurant since its founding.
- Number of locations (one or two locations operating under the same name or brand).
- Year restaurant was opened (has been operating for a minimum of five years).
- Type of restaurant (must be casual dining with waitstaff).
- Number of patrons able to be seated at one time.
- Be currently owned and operated by the person who started the restaurant when it opened for business.

If the owner/operator qualified, the owner/operator, was asked if they would participate in a twenty-minute personal interview.

OPERATOR PERCEPTIONS

Several patterns materialized within the data derived from participants' responses to the open-ended questions. The first common thread in the data is that restaurant entrepreneurs attributed their overall success to a multitude of activities they performed consistently: offering a high quality, consistent product; providing exemplary service; maintaining a clear restaurant concept; creating a clean and inviting atmosphere; and cultivating and sustaining a positive, long-term relationship with their customers.

The second reoccurring theme that became apparent is related to attracting and maintaining customers starting with opening the restaurant. Restaurateurs initially attracted customers through some form of advertising – primarily newspaper, outdoor banners, and product/beverage sampling. They also used their own personal reputation in the industry. To

keep customers coming back in the beginning, restaurateurs thought it was the collective activities of providing high quality food, a friendly atmosphere, and good service. Because of these activities, word of mouth brought the customers back into the restaurant.

A third collection of common activities surfaced: the continual use of marketing mix methods to keep customers. Websites, coupons, newspaper advertising, e-mails, and community involvement such as sponsorships and donations were used by operators. Again, word of mouth was a strong driver for attracting customers to the restaurant today. As in the beginning, restaurant operators thought customers came back today because of all of the things they did: providing high quality products, service, and atmosphere, all of which generated strong word of mouth recommendation among customers.

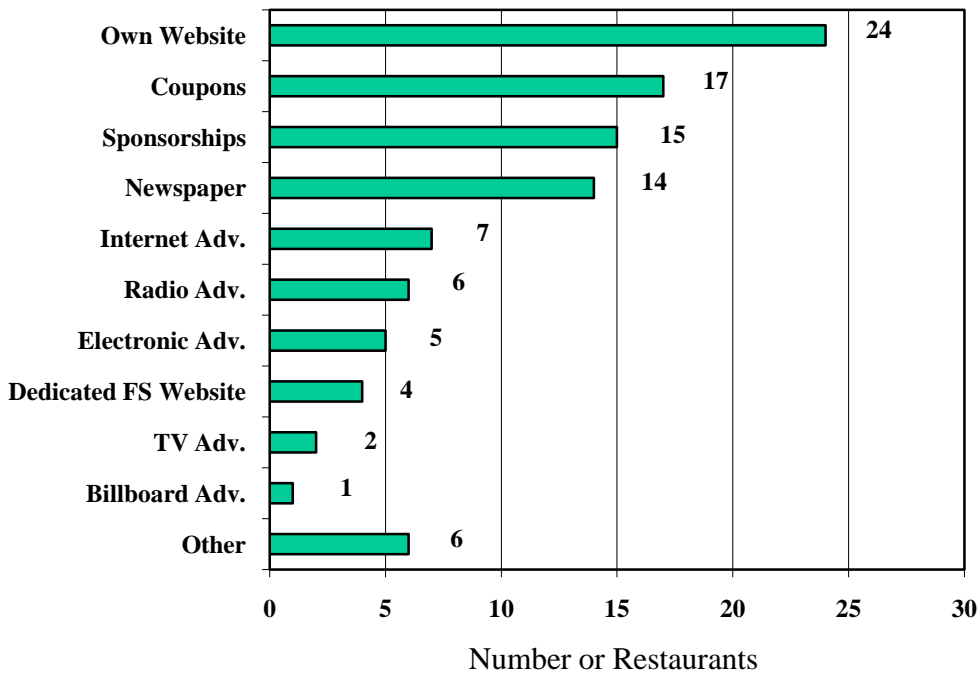


Figure 4.1 Methods Used to Promote Restaurants

A fourth set of similar responses that arose was the selection of the restaurant location and how it correlated with another restaurant. Either the restaurant site had previously housed a different restaurant, or it was located near a restaurant the restaurant operator currently or previously owned. Another pattern that emerged, although not as strong as the four listed previously, was that the operator chose the location because it was vacant and available, and he/she liked it.

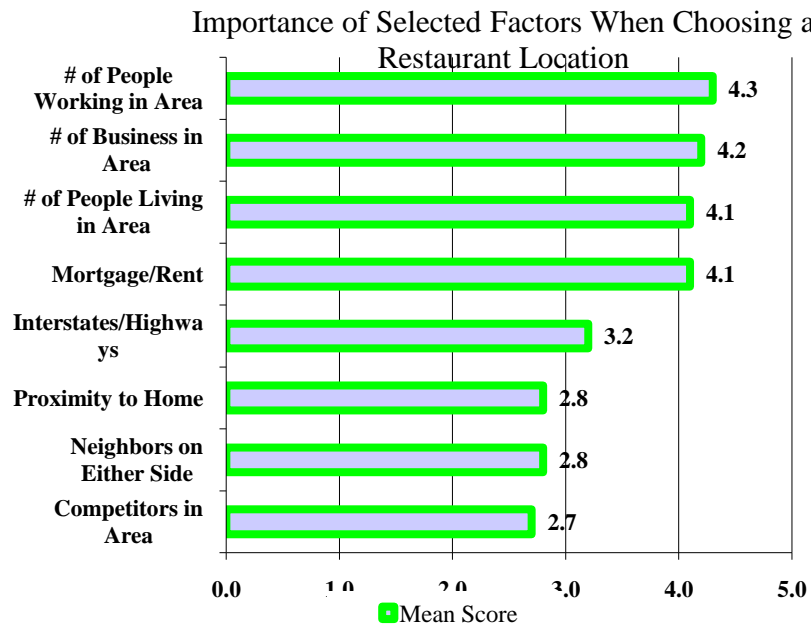


Figure 4.2 Variables' Importance of Location

There were several patterns that formed from the close-ended questions. The first reoccurrence of similar responses that emerged is related to the items on the restaurant's menu and the importance they place on the consistency of the product. Restaurants claimed that they do not change or modify the recipes of their most popular menu items --ever-- and if they do, it is only when they are experimenting with different flavors or ingredients to improve the menu item. They never modify their most popular menu items to save money or use cheaper ingredients; generally if an ingredient is not available to prepare their most popular menu items, they choose not to prepare the item rather than compromise the quality or taste. Regarding the preparation of their menu items, restaurant operators also strive to ensure that items are consistently prepared--regardless of time of day, day of the week, or chef in the kitchen. Restaurant operators also featured a variety of menu items, at least 9 or 10, that they considered house specials.

A second trend to materialize was the use of materials to promote the restaurant and special menu items. All of the restaurants, regardless of size, years open, or extent of advertising budget, used at least one form of marketing within their operation on a consistent basis. Use of their own website was the most common used marketing vehicle by the majority of restaurant operators, followed by wait staff suggestive selling, coupons, table tents, sponsorships/donations, newspaper advertising, and wall signs or chalkboards. Although restaurants had websites, they were generally using them for awareness and informational purposes and not functions such as on-line merchandise sales, on-line reservations, or on-line ordering. Restaurant operators did not use radio or television advertising, nor did they pay to be advertised on foodservice websites.

A third common thread to develop among restaurant operators related to the activities that took place at the restaurant. Restaurant operators and/or their managers made a practice of walking from table to table in the dining room, greeting guests. They also created an ambiance

by playing background music throughout the restaurant. Generally, restaurant operators offered free bread or crackers on the table and provided free drink refills for soft drinks, and/or coffee.

A fourth set of similar responses to appear was the amount of money restaurants spent annually on marketing activities and how it correlated to the size of their operation. Generally, larger restaurants spent \$5,000 or more annually on marketing activities, while smaller operations tended to spend less.

A fifth pattern is related to the factors involved in choosing the restaurant location. Restaurant operators chose the location because of the businesses in the area, and the amount of people working and living in the area. The number of competitors in the area and the neighbors on either side of their establishment played a small to insignificant role in the choice of their restaurant’s location.

A sixth set of repetitious answers that became apparent is related to the restaurant’s menu prices. Larger restaurants and restaurants that spent more than \$5,000 annually on marketing typically changed their menu pricing less often than smaller restaurants or restaurants that spent less than \$5,000 a year on marketing. Larger restaurants also tended to use standard menu pricing --each menu item has price on the menu that does not change, while smaller restaurants or restaurants that spent less than \$5,000 annually on marketing tended to use special of the week pricing --discounting specific menu items depending on the day of the week. Restaurants that had been in business for 17 years or more generally were more likely to conduct a detailed analysis of all of their costs to determine the menu price based on a profitability target than those in business for less than 17 years.

The final similar grouping of responses that surfaced is the variables that restaurant operators thought played the most important role in the success of their restaurant. Unanimously, restaurants stated that the quality of the menu items and the relationship operators had established with the customers over the years were the most important reasons for their success. The prices of their menu items, the marketing activities they conducted, and their location were important, but not as important as the two previously stated reasons.

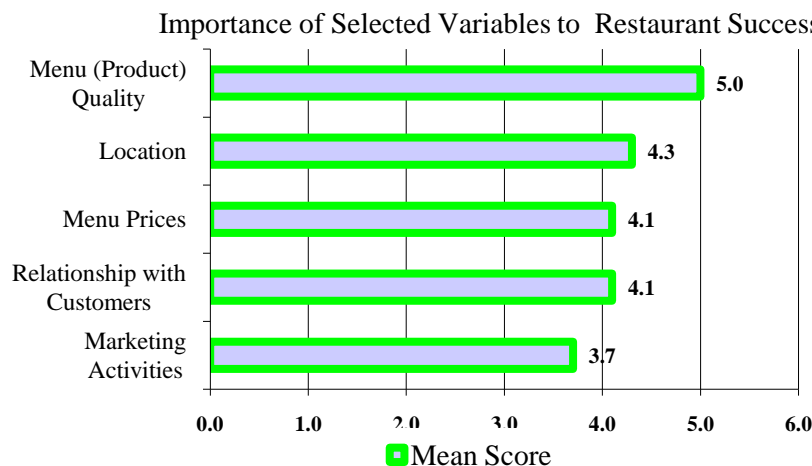


Figure 4.3 Specific Variable’s Importance to Restaurant Success

OVERALL RESULTS

Overall, restaurant operators attributed a significant amount of their success to the quality of the products they provided. Simultaneously, they worked very hard to maintain the quality of those products by not compromising their recipes to save money or use cheaper ingredients; and by ensuring that they were always prepared the same - night after night by every chef or line cook. Restaurant operators also related their success to the word of mouth advertising they received from current customers. This word of mouth advertising was achieved by continually marketing back to customers through the attention they paid to guests when they were at the restaurant, to the information they provided on their menus, to the suggestive selling of their wait staff, and by them personally ensuring that the operation was continually functioning at levels of perfection. Restaurant operators believe that building a relationship with their current customer base is critical to their future success.

Restaurant operators chose their location because another restaurant had previously been on their site, or it was close to another restaurant they already owned. Restaurant operators typically did not consider the competition in the area or their immediate neighbors when they chose a location. They are more interested in the amount of business and people working and living in the immediate area than they are of a location that is close to their home or a major interstate or highway.

With the exception of their own websites, independent restaurant operators do not employ the same marketing and advertising methodologies that large chain restaurants typically do. They do not use radio, television, or billboard advertising to promote their restaurants. They use newspaper advertising and various coupons, but more frequently rely on marketing activities conducted within the restaurant by themselves and their staff. They use table tents and suggestive selling, or they give away desserts and drinks to regulars, or they close the restaurant down for the day and hold a customer appreciation day. Restaurant operators are continually creating a connection with their customers while they are at the restaurant and through the use of the internet when they are not. They use their websites to post photographs of patrons at parties or special events or they send regulars emails advertising specials or upcoming events.

IMPLICATIONS FOR THE RESTAURANT OWNER

The results obtained from the field study presented patterns of responses that lend themselves to informed consensus about independent restaurants in this market. A further analysis of these results, reveals several important aspects about successful independent restaurants. In terms of specific factors for success, five elements are critical: having a good location, pricing their food appropriately for the market, maintaining the quality of their food, using promotional tactics to encourage new and continued visits, and developing relationships.

The correct response to the old maxim “What three things are necessary for success” in any retail or service industry—‘location, location, location’—is borne out in this study. *Where* a restaurant is located is critical to its staying power. Within an area of relative population density—residential or commercial—and along well-traveled routes is fundamental for success. The location chosen was often the result of one or two factors: either the location had been the

site of a previous restaurant that had closed for one of a number of reasons or it was nearby another restaurant that the operator currently or previously owned.

Pricing is also critical to the independent restaurant's success is menu *pricing*. Successful restaurants are reliable touchstones for their customers, which means that they are priced 'right' (affordable) for their clientele. This factor informs customers that ownership is more than sensitive to what the market will bear in terms of price—ownership of successful restaurant is clearly 'in touch' with their client base. Ownership knows the economics not only of their eating establishment, but of the patrons who in fact fuel their ownership economy. The majority of restaurant owners developed menu pricing through a strategic approach of determining all of the factors associated with the cost of the menu item and related it to how much the item needed to sell for to make a profit. Most operators were reluctant to change menu prices because of the perceived negative customer response, and therefore did so infrequently. Hence, it is important for them to calculate a menu price initially that would continue to generate a profit in times of increased economic inflation while still maintaining a positive value perception by the customer.

A third critical factor for success is *quality*. Here, quality refers to the items on the menu, what foods are selected, the care with which each dish of a meal is prepared, the attention to how a dish actually tastes, and the consistency of its preparation over time. Again, consumers appreciate attention to quality, expect it, and will reward quality by return visits to the establishment. Restaurant operators do not compromise on the product quality of their menu items: they would rather not serve a particular dish than to have to use an inferior ingredient when the one specified in the recipe is unavailable or becoming too expensive.

Promotional tactics, be it newspaper advertising, coupons, banners, websites, internet advertising or food and/or drink samplings, were used by all restaurants in one form or another. Traditional forms of advertising typically used by multi-unit chains, such as television, radio, and billboard advertising, were beyond the scope on an independent restaurant operator's budget and were methods, in their opinion, that when tried, were unsuccessful in attracting customers to their restaurant. Communicating with customers via their own website was utilized by twenty-four of the twenty-five operators and the use of the internet for emailing their customers was predominately becoming an effective mode of communication for them.

Finally, the key to success are *relationships*. All successful restaurant owners cite the relationship between the establishment and a focus on the customer as key to a successful restaurant experience. The reason most independent restaurant owners spend so much time in their businesses is to ensure that a proper atmosphere—a proper set of relationships, between employees and customers, among employees, between establishment and vendors—are established and maintained. People are not taken for granted; successful restaurants value this business maxim above all others. They make a point of knowing their customers by name and taking that time to "touch" each table as much as possible. Restaurant operators believed that they further strengthened these relationships through continually *marketing back* to their customers. They cited examples of hosting customer appreciation events, acknowledging customers by way of free desserts, drinks or appetizers, and by sending out promotional information via direct mail or email.

The results of this study suggest an overall factor upon which success is predicated: consistency. Customers expect to be treated well every time they are in the restaurant. They expect a certain quality of product, a level of service, cleanliness. In short, people need to know that an establishment is reliable and can be counted on, especially for something as personal and intimate as feeding oneself and their families, which, after all, is the fundamental transaction that defines the restaurant experience. Instead of concentrating on perfecting or excelling in one area of their business, such as product quality or interior ambience, successful independent restaurant operators strive to be *great* in every aspect of their business: service, quality, ambience, cleanliness, etc.

CONCLUSION

Identifying factors for a restaurant's success, including marketing, is underscored by the initial startup investment. While each restaurant requires different amounts of startup capital, potential restaurant entrepreneurs invest an average of \$100,000 to \$300,000 for opening (Farrell, 2007). With an industry average of a 60% failure rate within three years of opening, the resources (time and capital) required for a restaurant startup--and potential losses--are significant for the typical startup restaurateur. Restaurant entrepreneurs can benefit from the experience and knowledge of successful restaurants--those that have remained profitable for instance, a minimum of five years--and especially of the marketing strategies employed by successful independent restaurants.

This study, first and foremost, underscores the importance of four elements in the success of the independent restaurant: product quality, service, targeted promotions, and customer relationships. Each of these elements was considered to be important by all twenty-five participants throughout the field interviews as indispensable factors contributing to the success of the enterprise. The frequency, with which these factors (in this qualitative field study) are mentioned in the interview, as well as the emphasis of these factors throughout the interview, signaled that the participants believed that these four elements *collectively* contribute to the success of an independent restaurant.

The study results and the significant reporting of these four factors for success by the participants relate, in part, to factors of success noted or postulated in the literature, and support the earlier findings on success as important. Unlike earlier research, however, which reported on the importance of a single factor, the current study emphasizes the *collective* importance of these four factors, in aggregate. Thus, the single strongest implication of the current study is the need to balance all marketing mix methods collectively to *achieve and maintain* success as an independent restaurant. Following from this strongest implication is the further implication that previous research that investigated and/or determined that the potential of only factor, such as product quality, may have strongest significance in an independent restaurant's success may, in fact suggest that such previous efforts could benefit from further review or investigation.

ABOUT THE AUTHOR

Lisa Gallagher has over twenty-two years of experience in the foodservice industry working for several major food manufacturers throughout her career. She is presently employed by one of the

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Improving Stakeholder Value in Corporate Governance

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ABSTRACT

Since the debacle of the financial crisis of 2008, investors have become significantly more skeptical and less confident with the current investment landscape. In many cases the primary concern is the impact that maximizing shareholder wealth has compromised risk management and other stakeholders. There have been some regulatory actions taken that are designed to bring more scrutiny to corporate leaders and boards of directors. These actions are designed to provide more transparency on corporate decisions and to instill confidence in the investment community. There has been additional scrutiny in the boardroom by large pension funds, mutual funds and social responsibility activists. This added level of stakeholder influence is driven by the need to improve the short term perspective that shareholder wealth maximization appears to bring to the corporate decision making process. Additionally, concerns about the environmental impact of maximizing shareholder wealth are resulting in another important stakeholder issue. Ultimately, there appears to be a compelling need to bring more balance between maximizing shareholder wealth and maximizing stakeholder wealth.

INTRODUCTION

As the world emerges from one of the worst lapses in corporate judgment, the role and impact of the traditional corporate mantra of maximizing shareholder wealth is being subjected to significant scrutiny. From the US version of regulatory reaction of Dodd-Frank to the UK Companies Act added attention has been inflicted into the marketplace. When shareholder activism from major pension managers like CalPERS is added to the mix, it would appear that a broader scope is being brought to the traditional corporate mindset (King, 2010).

In addition to the regulators and large block shareholders, there is also momentum impacting corporate governance among other stakeholders. Employees continue to see the fruit of their labor distributed to upper management, the board of directors and the shareholders. Real incomes of employees continue to flat line or decrease while CEO compensation, board of director fees and share prices increase (Liberto, 2011).

Pressure is coming from creditors, environmental advocacy and local communities. Creditors, like the federal government and other financial institutions, are adding increasing control over debt obligations or in some cases reducing access to credit as they shift the priority from return

to risk management. Companies like BP have learned the hard way that compromising environmental standards can be quite detrimental to shareholder wealth. Additionally, insurance companies have to reconsider their risk management models as claims costs are shifting from the traditional fire and accident claims to weather-related losses (Auto Owners, 2011). While local communities continue to provide excessive amounts of corporate welfare to secure or retain businesses, they are experiencing the financial pressure of reduced revenues that are likely to lead to decreased funds for corporate subsidy (Scott, 2011).

FINDINGS

While the preponderance of evidence seems to indicate that maximizing shareholder wealth has not been subordinated to maximizing stakeholder wealth, the winds of incremental change cannot be ignored. As companies have worked their way out of the recession, they are spending much more time on managing risk than they have in the past. Adding stakeholders to the corporate governance process is one way to address issues that can be a risk to the shareholder (Sullivan, 2011).

In addition to an increased focus on risk, CEO compensation is creating controversy in the maximizing of shareholder risk. In many situations the CEO is realizing a much greater share of the wealth of the firm than the shareholders. The recent announcement that the new CEO of Apple will receive a million shares as an incentive is an example of adverse effect on shareholder wealth (Cowley, 2011). The issue of executive compensation has been sharply criticized in Europe. At some point, the reality of CEO redistribution of shareholder wealth coupled with basic rationality will bring about change. Some shareholders are seeking greater involvement with management and board members by seeking “say on pay” where executive pay would be subjected to a shareholder advisory vote (Gribbon, 2009).

Another source of influence in the area of pro-stakeholder activism is among many institutional investors who are examining risk more carefully and concluding that environmental, social and governance should be more closely linked. Union pension funds and other major public pension funds along with Tiaa Cref are focused on sustainability as a risk management approach to securing long term returns necessary to properly fund their pension commitments. These funds that account for approximately ten percent of outstanding shares cannot operate effectively with a quarter by quarter approach to maximizing shareholder wealth. The transfer of wealth within the firm to management is also considered a risk factor to be managed (Ho, 2010).

Another group of influential activists in the institutional investment community are mutual funds. When you combine pension investments, mutual fund investments and other institutional investors, their holdings make up approximately sixty six percent of all US equities. This group of shareholders and stakeholders, given their mission, is likely to be the most influential advocacy group for more democracy in corporate governance. There have been studies conducted that indicate investor activism from these investors can reduce funding costs and enhance corporate financial performance. More companies are adding shareholder feedback and internet based communications to their investor relations work units (Ho, 2010).

There is increased momentum in stakeholder rights and advocacy; however that advocacy can also generate potential corporate performance issues. It is possible that defacto “constituency directors” who represent a subset of stakeholders may wield undue and adverse influence in corporate decision making. Since the board of directors holds ultimate accountability for the corporation, a stakeholder group would be immune from accountability (Ho, 2010).

While stakeholders in the US continue to struggle with stakeholder advocacy, the United Kingdom has passed legislation to impact the stakeholder with the Companies Act of 2006. This act introduced an “enlightened shareholder value” proposition of corporate governance that attempts to combine shareholder importance with stakeholder models. The Act requires listed companies to recognize and report on stakeholder issue as part of its disclosures to investors. There are specific requirements for reporting information about the company’s environmental impact, employees, social and community issues and other essential contractual arrangements. The board of directors continues to maintain its control over company decision making and problem solving. The central tenet of the Companies Act “enlightened shareholder value” is an overt focus on long term shareholder value. There has not been movement in the US to follow the “enlightened shareholder value” model (Sullivan, 2011).

Even though the model has not been embraced, there is evidence to suggest that, institutional investors especially, have an interest in the model. With the near meltdown of the financial system, institutional investors have shifted some of their focus from wealth maximization to enhanced risk management. Many fund managers are demanding more information on environmental, social and governance risks that are potentially part of the company’s performance or strategy. Since these issues are not effectively analyzed using standard accounting procedures, they are more qualitative in nature. These issues also tend to be more future oriented and can be helpful in assessing the future risk a company might take on. Some investors are using the United Nations’ Principles of Reasonable Investment as a means of assessing these stakeholder areas of interest. The PRI is particularly interesting because its scope covers the investment industry, the supply chain and broadly across social responsibility issues and stakeholder concerns. The PRI has had limited influence because of a perception that anything that restricts returns cannot maximize wealth (Niklasson, T etal, 2010).

The strongest case for improved stakeholder value is in the portfolio-level risk. This is especially the case for firm specific risk. There appears to be an increase in product risk in both the food and pharmaceutical industries. Additionally, when companies cause harm to the environment that can have an adverse impact on real estate values that impact commerce and the social fabric of the community. As is indicated in this example, it is apparent that one company’s environmental risk could impact the regional macro-economy which could diminish wealth in other companies in the area. The evidence from the financial crisis would seem to indicate that more information about risks associated with a company’s investment could alleviate catastrophe (Ross, 2010).

To increase stakeholder value, there will need to be a concerted effort put forth by large institutional investors and corporations that have seen their shareholder wealth maximized over the long run by utilizing a focus on the environment, social responsibility and active governance. As of 2008, pensions held by California, Connecticut, Maryland and New York required their

fund managers to provide disclosures addressing ESG issues. They are also adding ESG as part of the standards for fund manager evaluation. There are new businesses focusing on providing investment advisory services that address stakeholder evaluation criteria. Furthermore as more individuals use the 401k approach to retirement, it is likely that public opinion will influence stakeholder issues given the sting of the 2008 financial crisis (Ho, 2010).

There has also been some forward movement in enhancing stakeholder value by recent SEC rulings. The SEC reaffirmed in January 2010 the legislative, regulatory, business, market and physical impacts of climate change are increasingly material to public companies and investors and must be included in regular public filings. Additionally, the UK policy does affect US companies that do business in the United Kingdom. For some firms this has resulted in a triple bottom line disclosure, financial, social and environmental. Many analysts view this disclosure as a critical part of their risk analysis (Herrera, 2011).

Enhanced shareholder value can also be achieved through activist shareholders who have the ability to vote on board members and other corporate activity. Recent research indicates that weak support for proposals can often lead to change where activists are voting in opposition. Ultimately board members who share a propensity for enhanced stakeholder value can be voted in by activist shareholders (Ho, 2010).

To move the ball down the field for improved stakeholder value it is important to clarify that improved stakeholder value is not a substitute for maximizing shareholder wealth. It is designed to complement both the board of director function and senior management performance. It provides an opportunity for management to provide some of their focus to potential negative risks that could adversely impact financial performance. Ultimately, improving stakeholder value should lead to an improvement in the firm's long term profitability and risk profile. The company's stakeholders do have a long term impact on the company's financial performance, and they deserve analytical consideration, especially employees and the environment. The primary source of competitive advantage is the collective productivity of the human capital of an organization. At some point, carbon-based energy will no longer be viable. At that point, the first mover company in alternative energy has achieved a source of competitive advantage and has the potential to be a long term participant in economic activity (Thompson Etal, 2010).

Every manager and director understands there will always be competing pressures from multiple constituencies. Employees are prioritizing secure employment, customers are emphasizing frugality, and shareholders are focused on increasing the share price. Oversimplifying this reality by taking a one dimensional focus is inconsistent with the underlying complexity of the situation. Clearly the reality is decision calculus not additive mathematics.

The advocacy for improved stakeholder value is built on a long term vision and impact. Furthermore, the reality that corporate wealth maximization requires the resources of employees, the environment and the community provide a rationale for consideration. This rationale is supported by Blair and Stout's team production model, the enlightened stakeholder model proposed by Michael Jensen, and other approaches that specify long term performance in maximizing value of the firm rather than short term shareholder wealth (Ho, 2010).

The incremental addition of stakeholder value could begin with the notion of decisions made by the company should “do no harm”. While this is a challenge to implement, it could be used as the beginning phase of the decision making process to exclude those alternatives that have the potential to yield harm to external stakeholders (Ho, 2010). This approach would not require a dramatic change in the current approach to governance. It is highly likely the board of directors of Lehman Brothers would have preferred to use this type of model rather than carry the professional embarrassment with them for years.

The role of improved stakeholder value has the potential of substituting for regulation after the fact that is likely to be much more adverse to maximizing the value of the firm than the stakeholder approach. The possibility exists that preventing potential pitfalls from occurring will have a positive impact on society in general. There have been communities that have had to bear the burden of a narrow focus on maximizing shareholder wealth, only to find out later of the damage caused to a community had to occur so further damage to another community would not. The practice of fracking in natural gas exploration has been severely criticized in this context (Fisher, 2010).

There is additional evidence that pure shareholder wealth maximization is not the priority by all investors, especially younger investors. Many activist investors require disclosure of any stakeholder, especially environmental impacts of the firms operations before making or continuing an investment. If this information cannot be discerned, investors will either choose an investment that does provide the stakeholder information or they will demand a risk premium in return for investing in the company that cannot address stakeholder issues (Chenel, 2009).

The most compelling argument for the traditional focus on maximizing shareholder wealth is that it provides a clear focus for management to address share price. This lack of clarity is often used to criticize stakeholder interests. It is more difficult to measure. This mindset provides cover for the self interest of the manager. By focusing on stakeholder value the measurement takes on a more long term focus. This is in the best interests of the investor. For the CEO who realizes a compensation increase of fifty million dollars in one year, the stakeholder value focus will be problematic. Ultimately focusing on stakeholder should minimize two key threats to maximizing shareholder wealth, self interest and collusion. These can occur either inside or outside the company. They can occur with shareholders and stakeholders. Ideally focusing on both vested interests will minimize the negative impact of self interest and collusion (Eiteman, et al. 2004).

CONCLUSION

Between the global financial crisis and the sovereign debt issues being faced, the level of cynicism and skepticism about the power of the free market and capitalism has broken the confidence of people around the globe. It is essential that this confidence be rebuilt in order to provide the greatest economic good. As companies and economies emerge from these crises, we have seen increased regulation. Ultimately, this may result in some short term fix. Since the risk return relationship was largely broken, more investors understand the rational aspects of investing must always be maximized. For many institutional investors this has meant an increased emphasis in stakeholder value as a means of enhancing the risks involved in corporate decision making. For other investors the moral and ethical lapses are catalysts for including the

stakeholders that were largely punished for the behavior of the maximize shareholder wealth advocates. It appears the divide between shareholder and stakeholder interests is becoming slightly narrower. The key challenge for the future of corporate governance is to determine how to best optimize the contributions of shareholders, stakeholders, management and corporate boards to enhance confidence in the system and improve long term financial performance.

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