Stakeholder Theory, Corporate Responsibility and the Ethics of Managerial Conduct

NICETO S POBLADOR

Introduction

Easily one of the hottest and most contentious topics in the business world today is corporate responsibility and the related issues of corporate governance and business ethics. Debates on these issues have taken on a more serious turn as a result of corporate scandals in the United States, and more recently in Europe. Because of these highly publicized corporate scandals, corporate names such as Enron, Tyco, and Arthur Andersen have become synonymous with corporate malfeasance and managerial venality. These events have shaken to its core the corporation as an important institution of capitalism, and serious questions are now being asked about its *raison d'etre* in contemporary society.

While there remains widespread agreement with the Friedmanesque doctrine that profit making is "...the one and only social responsibility of business," (Friedman, 1962) many are beginning to be highly critical of the high-handed manner in which professional managers pursue that goal. These critics contend that managers must practice their profession with a modicum of concern for the interests of those who will be affected in one way or another by their choices.[1]

There is little debate about what constitutes "good" corporate behavior. However, the usual basis for the acceptability of business practice are long-established and universal ethical norms that are embodied in the holy scriptures and about which there can be no quarrel. Who is to argue against fairness or honesty in business dealings, or against concern for the welfare of the community? There is much less consensus, however, as to what these norms of conduct imply for corporate strategy and for operational decisions made by corporate managers[2] in today's rough-and-tumble world of business. When it comes to the nuts and bolts of managerial decision making, lofty statements of corporate "core values" are of little help.

Meaningful debates on these issues have been hampered by the lack of a generally acceptable theoretical framework for the analysis of firm behavior, one that can provide managers in today's increasingly complex business environment with practical guidelines for making strategic choices that are at once rational and ethical.[3]

This paper evaluates a number of alternative approaches in dealing with this problem and attempts to identify among these an acceptable framework— one which we think allows business managers to address the interests of all stakeholders in the corporation, and yet does no violence to the classical concept of the firm as a profit-seeking entity.

The Subsidiary Issue of Corporate Governance

The corporate scandals that involved such well-entrenched corporate names as Enron, WorldCom, Citigroup and Arthur Andersen, among many others, have to do largely with the acts of self-interested board members, corporate managers and external auditors that were intended to benefit themselves or favored groups of shareholders. These brazen acts of corporate misbehavior include the use of inside corporate information for personal gain, or by providing this to special clients, the manipulation of stock prices through various forms of accounting legerdemain, and the concealment of potentially damning corporate data. The immediate response to these widely publicized and highly damaging scandals was a heightened interest in corporate governance, the internal control mechanisms by which decisions are made by corporate managers on behalf of their employers.

In addressing the issue of corporate responsibility, many progressive companies the world over have started to take a serious look at their system of management oversight. They are reworking their administrative control mechanisms that are intended to ensure that the interests of the various groups that have a stake in the organization – investors, customers, creditors, employees, and the community at large - are taken into account in the running of corporate affairs. If for no other reasons, these steps are being taken to enhance corporate image and thus ensure long-run profitability.

The reform of corporate governance in the Philippines is being actively pursued by the Securities and Exchange Commission (SEC). For the purpose of providing a set of guidelines for redesigning corporate governance mechanisms, the SEC has recently come up with a "Code of Corporate Governance" (SEC Memorandum Circular No. 2, Series 2002). It prescribes, among other things, the size, composition and qualifications of members of boards of directors, and provides for mechanisms for disclosure and transparency.

It is worthwhile noting, however, that the Code, by and large, is concerned primarily, if not indeed exclusively, with the interests of shareholders. While the Code provides for the inclusion of independent directors in the boards of directors of publicly held corporations, these are still to be elected by shareholders to whom they are ultimately responsible and perforce beholden. Moreover, nowhere does the Code specify what constituencies these independent directors are supposed to represent. There is no explicit provision in the Code for board representation of the other stakeholders in the company such as its employees and customers. The Code's silence on the environment and other concerns of the community is equally disconcerting.

The growing awareness among corporate managers of the need for reforming corporate governance, and the active involvement of the SEC in this endeavor, is of course to be applauded. However, current debates on the matter are mostly about corporate policies, procedures and other administrative matters. Little has been done to address the *substantive* issues that underlie these mechanisms.

To be sure, these governance mechanisms provide a set of potentially effective constraints on managerial abuse. But given the area of latitude within which managers are free to operate, these same mechanisms do not provide any meaningful guidelines for action. From a given set of feasible strategic options, which one should management choose? More importantly, why? These fundamental questions remain to be addressed.

To answer these questions in any meaningful way, it is necessary to specify in no uncertain terms what the goals of the organization are and how these goals are to be achieved. Unless these are made known to all concerned, these debates will remain largely unsettled.

The Dominant Short-Run, Bottom Line Perspective

The generally accepted goal of the firm is to maximize profits, or, putting it in another way, to maximize shareholder value. In practice, this objective of the firm is commonly interpreted to mean maximizing *immediate* profits or other measures of financial success. Managers typically are driven by the goal of meeting annual profit targets and other short-term financial goals such as minimum target rates of return on capital employed (ROCE) and earnings before income taxes, depreciation, and amortization (EBITDA). This short-run orientation invariably favors decisions that have an immediate effect on the bottom line because management's performance is typically assessed by corporate boards and by financial markets on the basis of *actual* financial results. As a consequence, the firm's long-run profitability tends to be compromised.

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From this short-run perspective, the firm is a zero-sum game.[4] Current profits are typically enhanced at the expense of financial benefits to the other claimants to the firm's resources and, by extension, at the expense of profits over the life of the firm. In effect, certain resource costs incurred in production are either postponed or passed on to others rather than borne by the firm. These costs are mainly in the form of benefits foregone and are largely overlooked, and therefore not reflected in the firm's Profit-and-Loss statement.[5] The following are typical examples:

- The employment of child labor. This practice degrades the young workers' health and prevents them from enhancing their productive capabilities through schooling and other forms of skills development. As a result, their future income-earning capability suffers.

- Efforts at seeking protection from imports. Many firms seek to preserve their markets by asking the government to impose tariff protection from cheaper imports. As a result of this very common form of rent-seeking behavior, consumers are forced to pay more for the products which they could have otherwise acquired at lower prices.
- Destroying the environment with toxic wastes and effluents. By causing harm to the environment, society's future productive capability is diminished. In effect, society pays for part of the firm's cost of production.
- Short-changing the customer by offering products of lesser quality than expected.

From this short-run perspective, the optimum solution is one where the usual marginal conditions for maximum profits are achieved. Here, any choice that enhances profits are, in a rather perverted sense, "rational." However, from a purely utilitarian point of view,[6] these acts are patently unethical because the decision-makers create value for their shareholders – and indirectly, for themselves – at the expense of other stakeholders. Their gain is somebody else's loss.[7]

Deception and opportunism on the part of decision-makers pose special moral problems. Due to information asymmetries and our natural inclination to take undue advantage of others, any party to a transaction may, through devious and deliberate means, exaggerate the value received by the other party. In most cases, the value of the product or service is overstated either by providing false information about the product, or by concealing the dangers and costs associated with its consumption. The production and sale of cigarettes and dangerous drugs are cases in point. In transactions of this nature, both the buyer and the seller perceives enhanced value for herself, the magnitude of which depending on the agreed price. Even while these transactions are voluntary in nature, they are no less reprehensible because one party ultimately gains at the expense of the other.

Among the more gruesome examples of unethical behavior are those perpetrated against society. These are especially prevalent in countries where social institutions intended to protect public property rights are either absent or relatively undeveloped. Damage done now to the environment reduces society's ability to sustain itself and to produce value for future generations. These are true economic costs that industrial polluters, urban developers, illegal loggers, and dynamite fishers fail to factor into their cost calculations. These miscreants ply their trade with full knowledge of the damage done to society, and their acts are patently unethical by our definition.[8]

Deliberate attempts at artificially inflating the value of corporate stocks by overstating revenues or understating costs through various accounting sleight of hands are yet another example of corporate mischief.[9]

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In transactions that involve deception or misrepresentation, the use of reasonably efficient contracts, explicit or otherwise, serve to minimize – if not totally eliminate – the potential damage to the aggrieved parties. Moreover, in repeated transactions, learning will insure that any damage suffered by either party will ultimately disappear.

The Long-Run, Strategic Perspective

An alternative interpretation of the profit-maximization objective takes a long-run, strategic view. Here, addressing the concerns of *all* stakeholders in the firm is deemed to be good for the business, and shareholder value is maximized by creating value for others. This interpretation of the profit-maximization goal is frequently referred to as the "Stakeholder Theory of the Firm."

As currently articulated and interpreted, stakeholder theory prescribes that managers should be concerned with the economic interests of all groups that have a legitimate claim on the firm's resources and output.[10] This alternative framework has been gaining more and more adherents in recent years. Indeed, it serves as the main rationale for current thinking on corporate governance.

From this long-run perspective, shareholder value V_s is made to depend on the value created for all other stakeholders, V_i. Symbolically, we have

$$V_s = f(V_i), \quad i = 1,2,3, \ldots n$$

The value of V_i that maximizes shareholder value is that which satisfies the condition

$$\partial V_s / \partial V_i = 0 \text{ for all i}$$

This implies that the firm will provide additional economic value for any stakeholder i for as long as this will result in a net increase in shareholder value. Under the usual concavity assumption, this further implies that at optimum, the economic value enjoyed by each stakeholder other than the owners of the firm, and certainly that of all stakeholders taken together, is less than maximized.

In practice, there are a number of typical corporate strategies that are in keeping with this doctrine[11]:

- So-called customer-focused corporate strategies. These include wide-ranging options such as product/service quality improvement and post-sale customer care. These measures are intended to develop and retain a steadily increasing pool of loyal customers. In this way, certain types of transaction costs are averted, such as those relating to market development, credit collection, and the handling of customer complaints.
- Measures intended to enhance worker productivity through efforts at improving working conditions and various types of profit-sharing arrangements. In addition to enhancing productivity, these policies develop

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in the workers a stronger sense of responsibility and loyalty to the organization and thus reduce certain types of agency costs, notably those associated with monitoring and control.

- Environment-friendly policies and various forms of corporate philanthropy. Far from being truly altruistic acts, these measure are intended to enhance the firm's corporate image and ultimately to reduce influence costs in its dealings with government regulators, cause-oriented groups and other concerned elements in the community.[12] These measures also catch the attention of customers who increasingly favor establishments with a positive public image.

From this stakeholder perspective, corporate strategies create value for shareholders by creating value for all other stakeholders, and not at their expense.

It bears stressing that this model of the firm is not a *stakeholder* value maximization model but a *shareholder* value maximization model. Its ultimate aim is profit maximization, but it takes a long run, strategic view of enterprise management. Nonetheless, it serves the useful purpose of providing corporate managers with a practical set of guidelines for making choices that are rational and at the same time – at least in a limited sense – ethical.

Enlightened Value Maximization

Yet another version of stakeholder theory is one that posits that the firm should maximize value for *all* stakeholders taken together. Here, the firm is perceived as seeking to maximize - or at least enhance - its total economic value added (EVA).

On closer examination, however, this interpretation of stakeholder theory as currently articulated may turn out to be more of a catchy phraseology than a true theory. To begin with, it has no concept of equilibrium. But more seriously for the practicing manager, *it provides no rational basis for choice.*

As currently expounded, stakeholder theory is flawed for a number of reasons.[13] By not specifying the objective function of the firm in terms of a single maximand, stakeholder theory fails to provide a basis for rational choice. While the concern for the total economic wellbeing of all stakeholders in the enterprise is well taken, the theory fails to give any meaningful criterion for establishing tradeoffs among potentially conflicting stakeholder interests. Thus, corporate decision-makers are unable to determine whether one acceptable course of action is to be preferred over another.

As a consequence, managers have to be empowered to exercise discretion, subject only to *incompletely specified* constraints. Managers are therefore able to maneuver within their specified areas of accountability and can divert corporate resources in pursuit of their own interests and those of preferred others (Jensen and Meckling 1976; Hoenack 1983). This situation enhances the firm's agency costs— those that are intended to put such resource diversion in check.

In addition, stakeholder theory as formulated in this manner unnecessarily politicizes the corporation by sharply drawing the boundaries between the interests of one group of stakeholders against those of another. Thus, a zero-sum situation re-emerges and the various stakeholders are put in a confrontational relationship vis-à-vis one another. Lost is the idea that their interests are mutually interrelated.

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To move out of this dilemma, we have to push the level of analysis one step further. This, however, would require a quantum theoretical leap: It requires a complete reformulation of the decision-maker's utility function.

In his seminal paper on the topic, Jensen introduces the concept of Enlightened Value Maximization (EVM) and develops a model of the firm that evolves around this concept (Jensen 2001). The model is essentially identical to the wealth-maximization framework, except that here, the decision-maker *endogenizes* the economic interests of all stakeholders and factors these into her utility function.[14] In this way, tradeoffs (marginal rates of substitution) between the economic interests of the different stakeholders in the firm are established, and it becomes theoretically possible to find a unique solution to the value-maximization problem.[15]

However, because we are all "boundedly rational[16], optimality in practice is a will-o'-the-wisp, and one can only hope to move heuristically from the current position to a preferred one. Here, decision making is viewed as an adaptive process rather than as a calculative one. Instead of viewing the firm as a value maximizer (i.e., seeking the optimal position), it may be viewed as a value enhancer. By this guideline, a decision is rational if it is expected to yield a net increase in economic value, regardless of who benefits from it. The issue we raised earlier is one of how this added value is to be allocated among the firm's various stakeholders.

In this version of the value-maximization model, the firm is not a zero-sum game, and organizational choices may yield either win-win or win-lose results. Here, a rational act may be ethical, by our definition, even if one stakeholder gains at the expense of another.

In handling issues of this nature, the enlightened manager must weigh the benefits enjoyed by one stakeholder against the loss experienced by another, should there be any. A couple of hypothetical examples will serve to illustrate our point. Take a firm that is forced to retrench operations by reducing its workforce as part of a cost-cutting exercise. The resulting additional short-term profits (or decline in short-term losses) experienced by the firm must be weighed against the decline in economic value that the laid off workers will endure. If it can be shown that the benefits to the firm and to other stakeholders exceed the losses suffered by the workers who will lose their jobs, then the act is both rational and, ironically, ethical as well. In practice, many progressive firms go out of their way to extend various forms of financial assistance to laid off workers in order to lessen their anguish from losing their jobs. To continue employing these workers even at a net loss in economic value would lead to even greater suffering on the part of all stakeholders.

Investments that result in severe damage to the environment are, by their very nature, reprehensible. However, if the decision to engage in an activity that degrades the environment can be shown to yield benefits to the firm and to its other stakeholders that outweigh the resulting decline in society's future economic output, the decision is acceptable on both rational and ethical grounds.

By this criterion, even the gruesome act of employing child labor, under certain circumstances, may both be rational and ethical at the same time.

The same principles apply in dealing with the conflicting interests among individuals within a particular stakeholder group. For example, decisions made by executives of publicly held corporations typically favor certain investor groups more than others. This is especially true in countries with relatively undeveloped capital markets and where prominent families and the government are the dominant investor groups.[17] Company officials tend to curry favor on these dominant investors who, through whose elected boards of directors, are the ones responsible for recruiting and rewarding them.

Implications of EVM on the Capital and Goods Markets

The EVM framework runs counter to the dynamics of capital markets and the process by which firms – and by extension, corporate managers – are evaluated.

The market value of an enterprise and its shares of stock are typically determined by the market's assessment of the firm's net cash flows over the relevant time horizon. Quite typically, the market places great weight on the results of current operations. Moreover, what is evaluated by the market is the net returns accruing to the firm's shareholders. The capital market is indifferent to the value that the firm creates (or destroys) for its many other stakeholders.

Considering that managers are motivated mainly by how their efforts are rewarded by their employers, it is only to be expected that corporate managers will direct their energies towards satisfying their employers' interests. This serves as a severely restricting constraint even on the most enlightened of managers who genuinely seek to create value for all stakeholders.

Then again, by failing to address the economic interests of all stakeholders, some firms stand to lose the patronage of consumers and investors who are concerned with social, ethical and environmental issues. Due to increasing consumer and investor activism, errant business firms are bound to lose their competitiveness and may therefore suffer financial setbacks that will adversely affect the capital market's assessment of their market value.

It is clear that alongside the need to develop enlightened, value-maximizing managers, EVM also requires investors and customers who favor enterprises that look after the concerns of their workers, their customers, and the communities in which they operate. Enlightened managers, enlightened investors, and enlightened customers are a requisite for economic value maximization to become the basis for corporate decision making and governance.

However, for as long as the values and motivations of economic actors remain as they are, we must continue to rely on theories of the firm premised on self-seeking behavior as the basis for rational managerial choice. The only important qualification that we make is that managers focus on the attainment of long-run strategic goals rather than on immediate financial gratification. This implies that the interests of workers, customers and of the community must be addressed by business managers if they are to maximize the wealth of their employers.

Endnotes

1 This is another way of saying that externalities should be factored into the firm's private cost and benefit calculations. Traditionally, externalities have been considered to be the responsibility of government. However, public-sector institutions have serious governance problems of their own and have proven themselves to be highly unreliable in carrying out their mandated tasks. See Poblador (2003).

2 Soule (2002) has noted ruefully that current discussions on business ethics "have not translated into ... successes in terms of influence on managerial practice."

3 Clarkson (1995) makes a distinction between ethical issues relating to a particular firm and its primary stakeholders and those pertaining to the relationship between the business community and society as a whole. Our position is that this distinction is at best tenuous since the underlying economic concepts are essentially the same. We hold that the wellbeing of society and of "secondary" stakeholders should be as much the concern of firms, individually and collectively, as the interests of primary stakeholders. These diverse interests are, after all, intimately interrelated.

4 Here, the various stakeholders in the firm are in a confrontational relationship vis-à-vis one another, and the likely result is known as a Nash equilibrium.

5 These economic costs (and benefits) are largely in the form of external diseconomies (economies) and are therefore not factored into the firm's internal cost/benefit calculations.

6 A strictly utilitarian or materialistic view is taken here as it vastly simplifies the problem of ethics in managerial decision making. Questions of human compassion, truth, equity and fairness in all forms of human interaction, while certainly not unimportant, only serve to unnecessarily becloud what we consider to be the basic issues.

7 Unethical behavior among managers includes the diversion of the firm's resources for their own personal use and benefit. See Jensen and Meckling (1976) and Hoenack (1983).

8 We must qualify our definition of unethical acts. Choices that are harmful to others are not unethical if done unintentionally or without the knowledge of their harmful consequences.

9 For an account of how AOL Time Warner created "revenue" out of thin air, see Loomis (2003).

10 For a discussion of alternative perspectives on stakeholder theory, see Donaldson and Preston (1995).

11 These strategies create intangible assets for the firm. These assets include the firm's network of dependable suppliers, its loyal customers, and highly satisfied and productive workers. These assets are typically not reflected in the firm's balance sheet, but nonetheless enhance the firm's competitiveness and long-run sustainability. See Kaplan and Norton (2001).

12 Corporate involvement in social issues and corporate philanthropy are especially prevalent among corporations with very high ownership concentration, such as family-owned companies that are dominant in the Philippines. Georgen and Renneboog (2002) point out that the major reason for this is that such shareholders are highly visible and may easily become targets of activists if they do not actively pursue socially responsible policies.

13 See Jensen (2001). This view stands in stark contrast with the dominant profit-maximization concept of the firm. For alternative perspectives of value maximization, see Moran (1999) and McCann (2000).

14 For an interesting discussion of the need to reformulate the objective functions of firms and individuals, see Ben-Ner and Putterman (2000).

15 In our simplified version of the EVM model, the total value created by the firm is a function of decision variables x_i:

$V = f(x_i), \quad i = 1, 2, 3, \ldots, n \qquad (1)$

V is distributed in its entirety among the firms stakeholders,

$V = \Sigma v_j \quad = 1, 2, 3, \ldots, m \qquad (2)$

The firm's decision maker seeks to maximize V by setting $\partial V/\partial x_i = 0$, and allocates this among the firm's stakeholders in such a way as to maximize his/her utility function

$U = U(v_j) \qquad (3)$

In the simplest case where $j = 2$, optimality is achieved where

$\partial U/\partial v_1 = \partial U/\partial v_2 \qquad (4)$

In our interpretation of the EVM model, enlightenment is a matter of degree, and the relevant stakeholders may include, at one extreme, only those select few with whom the decision maker has a close affinity, or, at the other extreme, the countless, faceless individuals whom he or she has chosen to empathize with. At the limit, the enlightened decision-maker's concern may extend to the whole of humanity and for all time!

16 The notion of bounded rationality is attributed to Herbert Simon (1957).

17 See Saldana (2001)

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