

Sustainability, Stakeholder Perspective and Corporate Success: A Paradigm Shift

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Executive Summary

The recurring financial crises and market failures call for a new paradigm in corporate management and the reexamination of capitalism and the market economy. It has long been argued that the major objective of the corporation is to maximize shareholders' wealth. The idea of shareholder wealth maximization demands short-term profit maximization. In order to maximize profit, American corporations tend to take a short-term planning horizon and the short-term results. These opportunistic behaviors results in unethical behaviors, illegal actions and numerous corporate failures including Enron, Arthur Anderson, and Global Crossing.

Recent theories on corporations argues for the stakeholder's perspective and emphasizes long run sustainability over the shareholder's perspective and short run profit maximization. The stakeholder perspective argues that the corporation exists not only for the benefit of shareholders but also for that of employees, suppliers, customers, and to some extent, for the benefits of society.

In this paper, I argue that the corporation can 'do well by doing good' in the long run if they take the stakeholder perspective. Corporations narrowly focused on short-term profits, can make business decisions that could be detrimental to long-run sustainability. For example, firms might not be making enough investments in Research and Development, producing potentially harmful products, and might not pay enough attention to their corporate image. The stakeholder perspective promotes ethical business decision-making and focuses on long-run sustainability by emphasizing a stable customer base, employee well-being, a better corporate image, and corporate social responsibility. Ethical decision-making includes a fair and equitable distribution of corporate profits, empowering business decisions and stabilizing employment. In a new and contemporary economy, the stakeholder perspective provides a better view of managing corporations by promoting long run focused, ethical decision-making and by paying attention to "common good". This will ultimately help in improving profitability and long-run sustainability.

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"It was about creating value, about treating your employees and customers well, and respecting your vendors-and ultimately rewarding your shareholders in the process. (Paul Latham)" (Brad Stone, 2013, *Bloomberg Business week*)

"... even stronger current economic recovery, in which rising earnings have done little to offset high unemployment, local business stress, and severe pressure on community service. ..." (Porter & Kramer, 2011, *Harvard Business Review*)

Recurring Financial Crises and Market Failures

Since 1990, the US and World economies have experienced a number of recurring economic crises and market failures: In early 1990, the Savings & Loans Crisis, with 747 failed institutions; In 1997-8, the Asian & Russian Currency Crisis; Early 2000, the Internet (Dot-com) Bubble Crisis, resulted in many corporate failures including Arthur Andersen, Enron, WaMu, Bear Sterns, Lehman Brothers, MCI WorldCom, pets.com, and open.com. After the Internet bubble crisis, the US Congress passed the Sarbanes Oxley Act (SOX) in 2002 in order to regain investor confidence and reduce corporate fraud. The SOX Act is viewed as the major financial regulation in US history. Despite the 2002 SOX Act, the US economy was again pummeled by the Sub-prime Mortgage (Real Estate) Crisis of 2008.

The sub-prime mortgage crisis resulted in \$8 trillion in losses in the US economy; bring the economy down from \$20 trillion to \$12 trillion. These recurring financial crises and market failures including Internet Bubble crisis of 2001 call for a new paradigm in corporate governance and the reexamination of capitalism and the market economy. Classic economics and management have long been argued that the major objective of corporation is to maximize shareholders' wealth. Shareholders' wealth can be maximized by increasing stock price. Because corporate profits are one of the most important determinants of stock price, shareholder wealth maximization calls for profit maximization. Profits are normally measured and reported on a short-term base. In order to maximize profit, American corporations tend to take a short-term perspective with a short-term planning horizon and tend to focus on short-term profits and results. This short-term oriented decision-making might have encouraged unethical behaviors, illegal actions and numerous corporate failures, including Enron, Arthur Anderson, and Global Crossing.

Should the corporation pursue profitability without concern for long-run sustainability?

The Stakeholder Perspective: A Paradigm Shift

Recent theories on corporations agrees for the stakeholder perspective and emphasizes long run sustainability over the shareholder perspective and profit maximization. The stakeholder perspective argues that the corporation exists not only for the benefit of shareholders, but for that of the stakeholders: employees, suppliers, customers and to some extent for the benefits of society. It departs from single-objective optimization centered on the shareholder in favor of multiple-objective optimization for stakeholders. The real important question is "should corporations be maximizing shareholder wealth, maximizing stakeholder wealth or both?" Are the shareholder theory and the stakeholder theory competing or complementary?

Friedman (1970, 1962) argued that "the social responsibility of business is to increase its profits". The profits and fiduciary duties owed by managers are to shareholders only. The underlying premise of the shareholder theory is that the higher the profits, the higher the taxes and the greater the possibility of contributions to the common good. Shareholder maximization theory demands the division of labor between the business entity and government arguing that the government should be responsible for the equitable distribution of wealth but not the business entity. This view objects to the ethical responsibility of corporation for the "common good." Alternatively Freeman (1983, 2010) argues that the corporation has a duty to act for the benefits of all of its stakeholders, including shareholders. The manager should serve the interests of all stakeholders (shareholders, employees, creditors, customers and communities) and should be concerned about all value chain partners. For example, if a manufacturer wants to produce a high quality product, the firm must obtain high quality parts. Unless part suppliers provide these high quality parts, the manufacturer cannot produce high quality finished products. The manufacture should not only minimize suppliers' parts costs but should pay attention to the quality of parts supplied. In 2010, Toyota had to recall 2.4 million cars due to a sticky pedal problem (LA Times, 2010). Though the pedals involved in the recall are confined to one of Toyota's suppliers, CTS, a Canadian supplier, Toyota's losses were estimated to be as much as US \$2 billion from lost output and lost sales worldwide. In addition, between January 25 and 29 in 2010 Toyota's shares fell in value by 15%. Toyota's sticky pedal problem demonstrated how important the quality of part suppliers is to the production of high quality cars.

Freeman, et. al. (2004) argues that the stakeholder theory is consistent with shareholder theory and the goal of maximizing stakeholder value is pro-shareholder. The stakeholder theory gives corporations a better way to think about entrepreneurial management and risks. Corporations should not only pursue profits but also be concerned about food safety, and contributions for the benefits of nature and future generations.

Shareholder Theory vs. Stakeholder Theory

As Table 1 indicates, shareholder theory tries to maximize shareholders' wealth while stakeholder theory attempts create value for all stakeholders including shareholders. The shareholder theory emphasizes economic value and only profit is sought, while the stakeholder theory is concerned about economic, social, political and environmental values. Shareholder theory pursues a short-term stock price when stakeholder theory takes a long term view and pursues the common good. Shareholder theory promotes short-term profitability while stakeholder theory is concerned with long-term sustainability. In order to obtain maximum profits, the shareholder theory tries to minimize short-run production costs while the stakeholder theory attempts to minimize long-run impact costs.

The stakeholder theory attempts to stabilize employment while the shareholder theory advocates “fire & hire” as needed. Enron, WorldCom and Global Crossing pursued short-term profits and failed while Johnson & Johnson, Unilever, among others, demonstrated healthy sustainability by taking the stakeholder perspective.

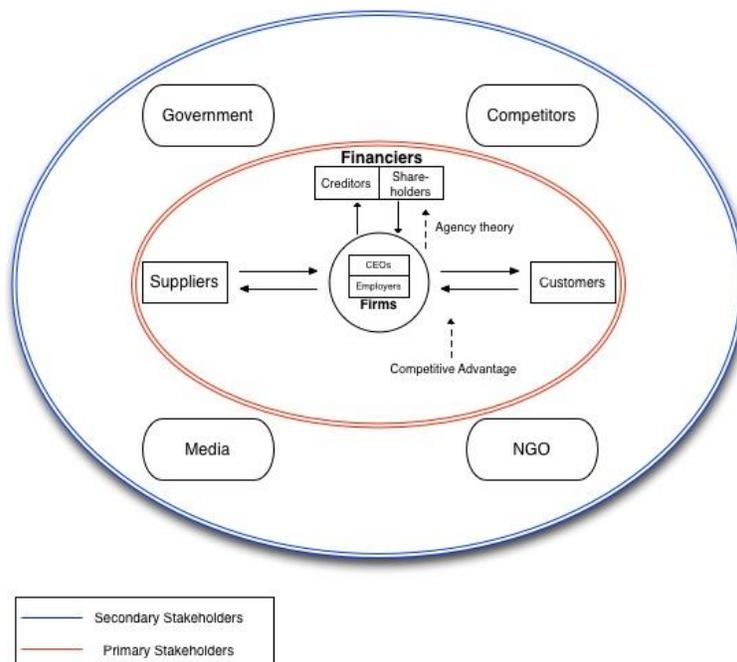
Table 1: Creative Discourse on Shareholder Theory vs. Stakeholder Theory

	Shareholder Theory	Stakeholder Theory
Objective	Maximize Shareholders' Wealth	Create value for Stakeholders (Shareholders, Employees, Creditors, Customers, Suppliers, Community)
Pursuit	Stock price	Common Good (Public Good)
Planning Horizon	Short-term	Long-term
Utility	Profitability	Sustainability
Optimization	Single Optimization (Profit)	Multiple Optimization or Single optimization with many constraints
Thesis	Separation (Business vs. Ethics)	Integrated (Business Ethics)
Value	Economic	Economic, Social, Environmental, Political
Policy	Fire & Hire	Stabilization of employment
Minimization	Short-run production cost	Long-run impact costs
Corporate Examples	Enron, WorldCom, Global Crossing	CostCo, 3M, Johnson & Johnson, eBay, Google, Swiss Bank, Nestle

Although managing one objective function, shareholder maximization, appears to be an easy and simple solution, it actually creates more problems and makes corporate governance and managing more difficult. It is easier to make stakeholders out of shareholders but not vice versa. The stakeholder perspective provides remedies that shareholder perspective might not have.

Exhibit 1: Primary Stakeholders and Secondary Stakeholder

Stakeholder Groups



Stakeholders can be divided into primary stakeholders and secondary stakeholders. Primary stakeholders include Shareholders, Employees, Creditors, Suppliers and Customers. The secondary stakeholders include competitors, government, and community.

Changes in Corporate Governance and Corporate Strategies

Corporations choose strategies in order to obtain competitive advantage and to achieve corporate goals. The stakeholder theory provides a better view of managing corporations in the long-run. The corporate board should expect stakeholder maximization from managers. The Board should encourage managers to pursue long-run sustainability in addition to short-term profits. Corporate strategy should include long-run sustainability goals in addition to share price objective. Corporate strategies often include product differentiation, service differentiation, market segmentation, and cost leadership. In order to pursue long-run sustainability, corporations should concern about strategies related to stable employment, a stable customer base, corporate reputations, and corporate social responsibility. Ethical decision-making could be an important part of corporate strategy. Business and ethics are not necessarily oxymoron. Ethical business decision-making improves corporate reputations, promotes sales and, in turn, improves profits.

Can a Corporation ‘do well by doing Good’?

In the long run, sustainability matters more than profitability. Supply chain partners are directly linked with long-term profitability and sustainability. Improved customer and employee loyalty reduce business risks, cut operating costs and increase sales. The stakeholder theory is directly linked to long-term profitability and sustainability and provides a better perspective in managing corporations. Corporations can ‘do well by doing good’ in the long run if they take a stakeholder perspective. Corporations narrowly focused on short-term profits, could make business decisions that could be detrimental to the long-run survival of an organization. For example, in order to increase short-term profits, managers might not be making adequate investments in Research and Development, might not want to support social and civic organizations and might be producing potentially harmful products. The stakeholder theory encourages the fair and equitable distribution of corporate profits, empowering business decisions. In a new and contemporary economy, the stakeholder perspective seems to provide a better view of managing corporations by promoting long run, ethical decision making and by being concerned with the common good which will ultimately help in improving profitability, shareholder’s wealth and long-run sustainability.

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