4 Stakeholders & the social contract: a broader view of corporate governance

4.1 Introduction

It is becoming increasingly common to take a very wide view of what corporate governance is all about. In this chapter we consider it in the context of all stakeholders to the business. We show the evidence of this approach by firms and the limits of the approach.

4.2 The Social Contract

In 1762 Jean-Jacques Rousseau produced his book on the Social Contract which was designed to explain – and therefore legitimate – the relationship between an individual and society and its government. In it he argued that individuals voluntarily give up certain rights in order for the government of the state to be able to manage for the greater good of all citizens. This was the idea of the Social Contract which has been generally accepted.

More recently the Social Contract has gained a new prominence as it has been used to explain the relationship between a company and society. In this view the company (or other organisation) has obligations towards other parts of society in return for its place in society.

This can be depicted thus:

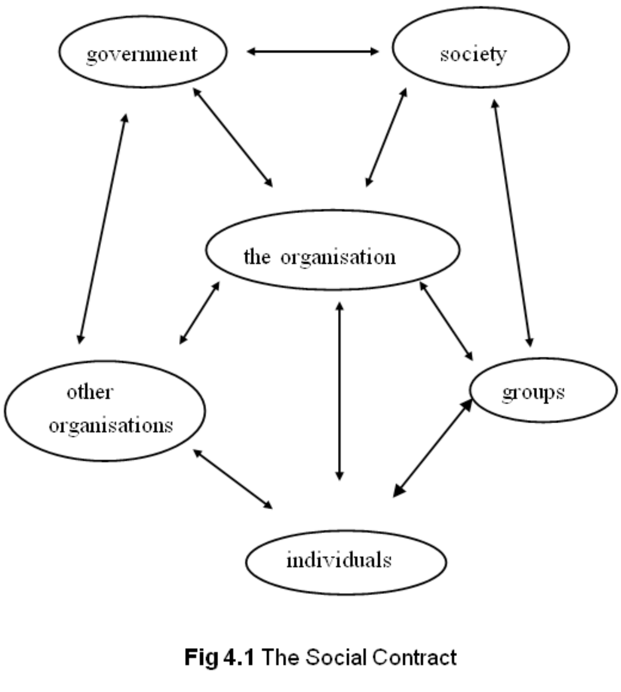

Fig 4.1 The Social Contract

This in turn led to the development of Stakeholder Theory, which we will consider in the next section.

4.3 What is a stakeholder?

There are several definitions. The most common ones are:

- Those groups without whose support the organization would cease to exist
- Any group or individual who can affect or is affected by the achievement of the organization's objectives

We can see from these definitions that a lot of people can be a stakeholder to an organisation. The most common groups who we consider to be stakeholders include:

- Managers
- Employees
- Customers
- Investors
- Shareholders
- Suppliers

Then there are some more generic groups who are often included:

- Government
- Society at large
- The local community

Many people consider that only people can be stakeholders to an organisation. Some people extend this and say that the environment can be affected by organisational activity. These effects of the organisation's activities can take many forms, such as:

- the utilisation of natural resources as a part of its production processes
- the effects of competition between itself and other organisations in the same market
- the enrichment of a local community through the creation of employment opportunities
- transformation of the landscape due to raw material extraction or waste product storage
- the distribution of wealth created within the firm to the owners of that firm (via dividends) and the workers of that firm (through wages) and the effect of this upon the welfare of individuals
- pollution caused by increased volumes of traffic and increased journey times because of those increased volumes of traffic

Thus many people also consider that there is an additional stakeholder to an organisation, namely:

- The environment

As we will see in the next chapter the actions of an organisation have a big effect upon future possibilities. It is for this reason that we also add one extra stakeholder:

- The future

It should be noted however that others do not generally include the future as a stakeholder.

4.4 Multiple stakeholdings

It is normal to consider all of these stakeholder groups separately. It should be noted however that each person will belong to several stakeholder groups at the same time. For example a single person might be a customer of an organisation and also an employee and a member of the local community and of society at large. He or she may also be a shareholder and a member of a local environmental association and therefore concerned about the environment. Most probably that person will also be concerned about the future also, on their own behalf or on behalf of their children.

We can therefore see that it is often not helpful to consider each stakeholder group in isolation and to separate their objectives. Reality is more complex.

4.5 The classification of stakeholders

There are two main ways to classify stakeholders:

Internal v external

Internal stakeholders are those included within the organisation such as employees or managers whereas external stakeholders are such groups as suppliers or customers who are not generally considered to be a part of the organisation. Although this classification is fine it becomes increasingly difficult in a modern organisation to distinguish the two types when employees might be subcontractors and suppliers might be another organisation within the same group.

Voluntary v involuntary

Voluntary stakeholders can choose whether or not to be a stakeholder to an organisation whereas involuntary stakeholders cannot. For example a supplier can choose to not deal with the organisation and therefore is a voluntary stakeholder. The local society or the environment are not able to make this choice and must therefore be considered to be involuntary stakeholders.

4.6 Stakeholder Theory

The argument for Stakeholder Theory is based upon the assertion that maximising wealth for shareholders fails to maximise wealth for society and all its members and that only a concern with managing all stakeholder interests achieves this.

Stakeholder theory states that all stakeholders must be considered in the decision making process of the organisation. The theory states that there are 3 reasons why this should happen:

It is the morally and ethically correct way to behaveDoing so actually also benefits the shareholders

- It reflects what actually happens in an organisation

As far as this third point is concerned then this is supported by research from Cooper at al (2001) into large firms. This research shows that the majority of firms are concerned with a range of stakeholders in their decision making process:

	Concerned with	**Very concerned with**
Stakeholder	%	%
Customers	89	57
Employees	89	51
Shareholders	100	78
Suppliers	70	3
The environment	62	5
Society	73	3

Fig 4.2 Stakeholder inclusion in decision making

According to this theory, stakeholder management, or corporate social responsibility, is not an end in itself but is simply seen as a means for improving economic performance. This assumption is often implicit although it is clearly stated by Atkinson, Waterhouse and Wells (1997) and is actually inconsistent with the ethical reasons for adopting stakeholder theory. Instead of stakeholder management improving economic, or financial, performance therefore it is argued that a broader aim of corporate social performance should be used (Jones and Wicks, 1999).

4.6.1 Details of Stakeholder Theory

A fundamental aspect of stakeholder theory, in any of its aspects, is that it attempts to identify numerous different factions within a society to whom an organisation may have some responsibility. It has been criticised for failing to identify these factions (Argenti, 1993) although some attempts have been made. Indeed Sternberg (1997) suggests that the second of Freeman's (1984) definitions of stakeholder, which is now the more commonly used, has increased the number of stakeholders to be considered by management adopting a stakeholder approach to; in fact this definition includes virtually everything whether alive or not.

However attempts have been made by stakeholder theorists to provide frameworks by which the relevant stakeholders of an organisation can be identified. Clarkson (1995) suggests that a stakeholder is relevant if they have invested something in the organisation and are therefore subject to some risk from that organisation's activities. He separated these into two groups: the voluntary stakeholders, who choose to deal with an organisation, and the involuntary stakeholders, who do not choose to enter into – nor can they withdraw from – a relationship with the organisation. Mitchell, Agle and Wood (1997) develop a framework for identifying and ranking stakeholders in terms of their power, legitimacy and urgency. If a stakeholder is powerful, legitimate and urgent then its needs will require immediate attention and given primacy.

Irrespective of which model is used, it is not controversial to suggest that there are some generic stakeholder groups that will be relevant to all organisations. Clarkson (1995) suggests that the voluntary stakeholders include shareholders, investors, employees, managers, customers and suppliers and they will require some value added, or otherwise they can withdraw their stake and choose not to invest in that organisation again. It is argued that involuntary stakeholders such as individuals, communities, ecological environments, or future generations do not choose to deal with the organisation and therefore may need some form of protection maybe through government legislation or regulation. Other more specific interest groups may be relevant for certain industries due to the nature of the industry or the specific activities of the organisation.

For example in the UK utility industries have been regulated by a regulator since privatisation and thus the regulator is a stakeholder of these organisations. Similarly certain industries are more environmentally, politically or socially sensitive than others and therefore attract more attention from these stakeholder groups, and again the water or nuclear industries provide examples here.

4.6.2 Informational needs

Stakeholder management has significant informational needs. It is extremely difficult to manage for a variety of stakeholders if there is no measurement of how the organisation has performed for those stakeholders. Thus for each stakeholder identified it is necessary to have a performance measure by which the stakeholder performance can be considered. Due to the nature of the stakeholders and their relationship with the organisation this will not necessarily be easy nor will it necessarily be possible in monetary terms.

Therefore non-financial measures will be of great importance but this information is often considered more subjective than financial information. Therefore measures of customer satisfaction are sometimes based on surveys and sometimes on statistical performance measures such as numbers of complaints or returns, or market share or customer retention. Recently there have been a number of multi-dimensional performance measurement frameworks that can be argued to have some level of stakeholder orientation.

Probably the best known of the multi-dimensional performance measurement frameworks is the "balanced scorecard" (Kaplan and Norton 1992, 1993, 1996a, 1996b). Another example is the service profit chain (Heskett et al. 1994) that specifically considers three stakeholders; namely employees, customers and shareholders. Again this model specifically considers the first two stakeholders as means to achieving superior financial results.

Thus they argue that satisfied and motivated employees are essential if service quality is to be of a high standard and hence customers are to be satisfied. Further it is then argued that satisfied customers provide the base for superior financial results. Both of these models acknowledge the needs of stakeholder groups and thus deem it necessary to measure performance for these groups but still target financial performance as the ultimate goal.

A stakeholder managed organisation therefore attempts to consider the diverse and conflicting interests of its stakeholders and balance these interests equitably. The motivations for organisations to use stakeholder management maybe in order to improve financial performance or social or ethical performance howsoever these may be measured. In order to be able to adequately manage stakeholder interests it is necessary to measure the organisation's performance for these stakeholders and this can prove complicated and time-consuming.

Recently the Centre for Business Performance, Cranfield University, has set up a "Catalogue of measures" related to their Performance Prism that contains measures of each of the "dimensions of performance" – stakeholder satisfaction; strategies; processes; capabilities; and stakeholder contributions. The stakeholders identified were customer, employee, investor, regulator & community, and suppliers and in total the catalogue includes over 200 relevant measures.

This shows the vast number of stakeholder measures that could be used to any organisation although it is not expected that all of these will be relevant for an individual organisation. This again highlights the potential complexity of measuring performance for stakeholders as these numerous measures will provide conflicting evidence on performance that somehow must be reconciled. In comparison Value Based Management techniques that propose the use of a single metric to measure performance as well as set objectives and reward executives appear far simpler.

4.6.3 Research findings

In its Global Investor Opinion Survey of over 200 institutional investors first undertaken in 2000 (and subsequently updated), McKinsey found that 80% of the respondents would pay a premium for well-governed companies. They defined a well-governed company as one that had mostly outside directors, who had no management ties, undertook formal evaluation of its directors, and was responsive to investors' requests (and requests from other stakeholders) for information on governance issues. The size of the premium varied by market, from 11% for Canadian companies to around 40% for companies where the regulatory backdrop was least certain (eg those in Morocco, Egypt or Russia). Other studies have similarly linked broad perceptions of the quality of companies to superior share price performance. On the other hand, research into the relationship between specific corporate governance controls and the financial performance of companies has had very mixed results.

4.7 Governance and stakeholders

A company's structure is nowadays more complex than before and there are other people, in addition to owners, directly or indirectly implied in the company's operations – known as stakeholders. Multinational corporations have sometimes even more power than governments in their influence, and stakeholders have gained more power through the media and public opinion in order to require some kind of specific behaviour from companies. Within this new environment, although explained in a very simple way, the primary objective of the company has become wider. Although generally speaking, the assumption may be that the first goal is to get financial performance in the company, after that the next step will be to comply with other socially responsible policies.

This is because to pay attention to social objectives, or to show an orientation to multiple stakeholders group, could be considered a luxury, because it must have meant that the other basic company's goal had been met. This argument is the basis of the first hypothesis about the relationship between CSR, linked to pay attention to stakeholders, and business success: "Better performance results in greater attention to multiple stakeholders" (Greenley and Foxall, 1997: 264). While the other hypothesis about this relationship will run in the opposite direction: "that orientation to multiple stakeholder groups influences performance" (Greenley and Foxall, 1997: 264), which means to "attend" to social policies in a better way.

This double-side relationship increases the difficulty to try to empirically prove it. Intuitively it seems as if there is a clear relationship between CSR and business success, but although the measurement of business success may be easy, through different economic and financial tools, such as ratios: the measurement of the degree of compliance of a company with social policies is really difficult. We can have in mind some kind of indicators such as funds donated to charitable objectives, but a company can spend immeasurable quantities of money on charitable questions and have problems in the relationship with labour unions because of bad working conditions, or low wages, for example.

In this sense there have been for many years some companies whose objectives include philanthropic aims. We can cite examples of the Quaker companies – such as Cadburys[13] and Rowntrees – which emerged in the UK Industrial Revolution or the Spanish saving banks, which emerged with the peculiar distinction of including in their aims charitable purposes. But finally, if they want to survive in the competitive market they have to bear in mind the conventional objective of profit maximisation. It may be considered that the initial values of the company are ones promoting concern, and then the market and the capitalism forces the firm to change them in order to survive in this maelstrom. Although at the same time the double sided relationship operates, because people socially concerned bear in mind these basic aims and the image of such a company is improved, which provides a direct relationship with economic performance.

In this attempt to satisfy the necessities of the stakeholders there can appear other conflicts between the interests of the different groups included in the wider concept of stakeholders. Sometimes due to this conflict of interests and to the specific features of the company it tries to establish different levels between the stakeholders, paying more attention to those ones that are most powerful, but are there some goals more socially responsible than others? In the end the hierarchy will depend on the other goals of the company; it will give an answer to those stakeholders that can threaten the performance of the economic goals.

4.8 Relating corporate governance and corporate social responsibility

It is of course no longer questioned that the activities of a corporation impact upon the external environment and that therefore such an organisation should be accountable to a wider audience than simply its shareholders. This is a central tenet of both the concept of corporate governance and the concept of corporate social responsibility. Implicit in this is a concern with the effects of the actions of an organisation on its external environment and there is a recognition that it is not just the owners of the organisation who have a concern with the activities of that organisation. Additionally there are a wide variety of other stakeholders who justifiably have a concern with those activities, and are affected by those activities. Those other stakeholders have not just an interest in the activities of the firm but also a degree of influence over the shaping of those activities. This influence is so significant that it can be argued that the power and influence of these stakeholders is such that it amounts to quasi-ownership of the organisation.

One view of good corporate performance is that of stewardship and thus just as the management of an organisation is concerned with the stewardship of the financial resources of the organisation so too would management of the organisation be concerned with the stewardship of environmental resources (Aras & Crowther 2009). The difference however is that environmental resources are mostly located externally to the organisation. Stewardship in this context therefore is concerned with the resources of society as well as the resources of the organisation. As far as stewardship of external environmental resources is concerned then the central tenet of such stewardship is that of ensuring sustainability. Sustainability is focused on the future and is concerned with ensuring that the choices of resource utilisation in the future are not constrained by decisions taken in the present. This necessarily implies such concepts as generating and utilising renewable resources, minimising pollution and using new techniques of manufacture and distribution. It also implies the acceptance of any costs involved in the present as an investment for the future.

Not only does such sustainable activity however impact upon society in the future; it also impacts upon the organisation itself in the future. Thus good environmental performance by an organisation in the present is in reality an investment in the future of the organisation itself. This is achieved through the ensuring of supplies and production techniques which will enable the organisation to operate in the future in a similar way to its operations in the present and so to undertake value creation activity in the future much as it does in the present. Financial management also however is concerned with the management of the organisation's resources in the present so that management will be possible in a value creation way in the future. Thus the internal management of the firm, from a financial perspective, and its external environmental management coincide in this common concern for management for the future. Good performance in the financial dimension leads to good future performance in the environmental dimension and vice versa. Thus there is no dichotomy between environmental performance and financial performance and the two concepts conflate into one concern. This concern is of course the management of the future as far as the firm is concerned.

Similarly the creation of value within the firm is followed by the distribution of value to the stakeholders of that firm, whether these stakeholders are shareholders or others. Value however must be taken in its widest definition to include more than economic value as it is possible that economic value can be created at the expense of other constituent components of welfare such as spiritual or emotional welfare. This creation of value by the firm adds to welfare for society at large, although this welfare is targeted at particular members of society rather than treating all as equals. This has led to arguments concerning the distribution of value created and to whether value is created for one set of stakeholders at the expense of others.

Nevertheless if, when summed, value is created then this adds to welfare for society at large, however distributed. Similarly good environmental performance leads to increased welfare for society at large, although this will tend to be expressed in emotional and community terms rather than being capable of being expressed in quantitative terms. This will be expressed in a feeling of wellbeing, which will of course lead to increased motivation. Such increased motivation will inevitably lead to increased productivity, some of which will benefit the organisations, and also a desire to maintain the pleasant environment which will in turn lead to a further enhanced environment, a further increase in welfare and the reduction of destructive aspects of societal engagement by individuals.

4.9 Relating social responsibility with governance: the evidence

There has been a variety of research over time investigating the relationship between the characteristics of a firm and its disclosure (eg Cowen et al 1987; Gray et al 2001) and equally there is research (eg Burke & Longsdon 1996) showing the benefits of CSR. It is clear that these benefits are also directly related to the sustainability of a firm and that firm's success. It would seem apparent therefore that there should be some attention paid to social responsibility within the corporate governance of a corporation. It is therefore apposite to conduct an investigation as to what exactly is mentioned about CSR within such corporate governance. It is to be expected that good corporate governance will foster social responsibility in general.

There has been much work undertaken which investigates the failures of corporate governance and the ensuing problems which arise and this could be adapted to a consideration of our concern with the relationship between corporate governance and social responsibility. We argue however that this approach is not an appropriate methodology for this kind of research. Rather our starting assumption is that effective corporate governance will be largely unnoticed and that this will be manifest in examples of good practice rather than in the exceptional instances of poor practice.

Although there is a clear link between good corporate governance and all aspects of a firm's performance, which will ultimately affect the sustainability of that firm's activity our research does not show that this is at all clearly understood by many firms. Furthermore, although the majority of firms consider that corporate social responsibility is important, they do not make any connection between this and corporate governance. They clearly do not understand the link between good governance, the management of all stakeholder relations, corporate social responsibility and the longer term economic performance of their company.

4.10 Conclusions

Stakeholder Theory is one approach to the managing of an organisation. It is particularly important for an understanding of CSR and its incorporation into organisational activity. There are various aspects to this which we have considered in this chapter. At the same time we have introduced a variety of other aspects which are related. Our purpose is to show that all of these concepts are inter-related in the management of an organisation and that CSR cannot be considered in isolation from the rest of organisational activity. We will see this more clearly throughout this book.

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4.12 Further Reading

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4.13 Self-test Questions

1. What justification does Stakeholder Theory use for considering stakeholders?
2. How can we classify stakeholders?
3. Name a multi-dimensional performance measurement framework.
4. What are the origins of the Social Contract?
5. What evidence is there of a broader approach to corporate governance by firms?