Stakeholders: the Case in Favour

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John Argenti and I decided to write down our views on stakeholder ‘theory’ because of an exchange of memos between us. The tone of these memos was “I read your explanation, but think you are incorrect in both theory and practice”. We therefore decided to expose our thinking for broader examination.

I support stakeholder ‘theory’ not for some left wing reason of equity, but because I believe it to be fundamental to understanding how to make money in business. At Harvard Business School I had a professor who greatly influenced his students with the advice ‘Buy low, sell high’. These pearls of wisdom appeared to capture the essence of many cases we discussed. Yet, I now see them to be entirely misleading. Business is not about squeezing the last drop out of suppliers and charging as high as possible a price to customers. This is the trader’s mentality. This is short termism. This is not what business is about.

Argenti argues that the stakeholder approach has weaknesses. It is hard to decide who is a stakeholder and who is not. It is not clear what stakeholders should expect to receive. It is unrealistic to expect management to make a trade-off between stakeholders. Stakeholder thinking interferes with performance measurement. He, therefore, proposes a ‘shareholder return’ theory as a more appropriate ‘philosophical foundation stone’ for ‘companies’. Shareholders are the ‘intended beneficiaries’. All other stakeholders are the ‘collateral beneficiaries’.

I will deal with Argenti’s arguments in a moment. But I would first like to compare stakeholder thinking with shareholder return thinking.

Companies compete for space in an economic jungle. To survive in this jungle a company must win the loyalty of important groups. It must get loyalty from customers, employees, suppliers and financiers. Some members of these groups must prefer doing some business transactions with this company rather than with any other. Without this loyalty, the company’s space will gradually erode until it disappears. The maxim ‘Buy low, sell high’ is in essence different from the maxim ‘Give a good deal to your suppliers and to your customers’. I believe the second of these two maxims is more useful to ambitious businessmen, and it is for this reason that I believe the stakeholder point of view is a vital starting point for thinking about business. Unless you ‘give a good deal’ to all of your stakeholders you will not be in business for long.

The ‘Buy low, sell high’ maxim is not, however, wrong. What is right about it is its focus on value creation and profitability. A successful business is based on adding value in such a way that there is a surplus after deducting from the selling price the costs of all the inputs (capital, labour and materials). The maxim ‘Buy low, sell high’ is a useful reminder of this requirement, as are the shareholder value or economic value criteria.

The reason why I am a believer in stakeholder thinking is because it is a counter balance to ‘Buy low, sell high’ thinking. It helps managers think of the full range of communities from whom they need loyalty. To place all the emphasis on shareholders is to misunderstand the human dynamic of business by unbalancing the manager’s thinking. It also flies in the face of common sense. If you ask a room full of MBAs who are completing their course, fully educated in discounted cash flow techniques and versed in shareholder value thinking, “How many of you are excited about leaving this school to go out and make money for shareholders?”, they will look at you with embarrassment. Making money for shareholders is not one of their life’s ambitions. They recognize that they have to do this to achieve their ambitions, but enriching shareholders is not a purpose.

This is where Argenti’s thinking is flawed. He argues that companies must have intended beneficiaries and collateral beneficiaries. Since this thought forces him to choose only one stakeholder as the intended beneficiary, he chooses shareholders for ‘companies’ and ‘patients’ for hospitals etc. This is to misunderstand completely the concept of purpose in an organization.

By insisting that an organization should only have
one set of intended beneficiaries, and then insisting that the delivery of value to these beneficiaries is the sole purpose of the company, Argenti misleadingly oversimplifies. Purpose is a much more complex combination of desires.

The purpose of the Ashridge Strategic Management Centre is to "improve the strategic management of multibusiness companies". I find it hard to unpick the beneficiaries to fit Argenti’s model. One of the purposes of the Body Shop is to make cosmetics without hurting animals. Are the animals intended or collateral beneficiaries?

I agree that the formulation of purpose is an important part of providing leadership to an organization. I also agree that the statement of purpose should include explicitly or implicitly an explanation of the nature of the ‘deal’ each stakeholder might expect from its relationship with the organization. But I do not agree that all ‘companies’ should have the same purpose, ‘make money for shareholders’, or that all other stakeholders should always take second place to shareholders when the surplus is divided.

Let me give an example. Let us assume I have a passion to improve the way multibusiness companies are managed. Let us assume I think I can achieve my purpose by running seminars for managers, writing books and publishing books, and producing TV and radio programmes. Let us assume I am successful and my books sell well, my seminars are well attended and my TV ideas are accepted. I become more ambitious. I now want to expand my purpose outside the UK, to Europe, to the USA and to Asia. With a proven track record of success behind me, I can now raise money from financiers to finance this purpose. So I put together a prospectus for the creation of a global management education business and place shares privately, retaining overall control.

My business continues to be successful and the private shareholders do very well. I decide to expand further and launch the company on a stock market to raise further equity. I am blunt about the purpose of the business, and the prospectus states clearly that 10% of profits will be given to universities that have centres devoted to researching the strategic management of multibusiness companies. My placing is a success: the shares sell at a premium and in the process my holding falls to less than 50%. I am confident, however, of controlling the company since I have carefully selected the board to include people who are equally committed to the business’s purpose.

My challenge to Argenti is to explain at what point did this company’s purpose change from being about the strategic management of multibusiness companies to being about making money? In the same vein, is the purpose of a hospital owned by shareholders different from one owned by employees or set up as a trust? Does a school’s purpose change when it is privately owned?

My thesis, therefore, is that purpose is something independent of shareholder value thinking or stakeholder thinking. It comes first. Once a purpose has been chosen, it then has implications for each stakeholder. If there are shareholders, their returns will be affected by the purpose chosen.

In my experience many companies have a weak purpose. By default they find themselves focusing on making money for shareholders. And this is often the biggest weakness in the company. It is my contention that it is harder to gain the loyalty of customers, employees and suppliers if the company’s purpose is unequivocally dedicated to shareholders. As a customer, I would be well advised to focus on companies that were unequivocally customer-focused. As an employee I would be advised to dedicate my career to a company that was committed to a purpose I approved of and had a special focus on employee development and well-being, etc. In other words, in the economic jungle loyalty will drift towards whichever organization offers the most current value and commitment to future value for that stakeholder. The competition is not just for shareholder loyalty. It is for the loyalty of all the ‘active’ stakeholders—shareholders, customers, employees and suppliers.

A clear purpose helps a company through this minefield. If my purpose is to improve the way multibusiness companies are managed, the shareholders in my company will know they are taking a punt on how good I will be. If the purpose is making steel, the shareholders know they are betting on the future of the steel industry and how good their company will be relative to others. If purpose is clear, the stakeholders have a clearer idea of what to expect from a relationship with the company. If the purpose is ‘to make money for shareholders’, the other stakeholders should rightly be suspicious of what this will mean for them.*

At this point I need to address the legal problem.

*There is much debate about what classes of stakeholders should be considered. Some writers have argued for eight or ten classes of stakeholders and Argenti suggests potentially an infinite number of classes. I have also been intrigued by the argument that stakeholders are those who would suffer (or benefit) if the business ceased trading. This helps distinguish between transient customers and committed customers, for example. The definition I use of four 'active' stakeholders approaches the subject from a slightly different direction. The active stakeholders are stakeholders who can affect the performance of the company and whose demands are unquantifiable. These stakeholders are infinitely greedy. They always want more dividends, higher wages, better terms of trade and lower prices. Their loyalty can, therefore, only be won by offering more than others. The 'passive' stakeholders are all the other stakeholders. They have less active influence on the company because they do not have daily transactions with the company and their needs are definable. As long as the company performs at an acceptable level (i.e. pays its taxes, does not pollute or disrupt the community, does not employ unfair competitive tactics etc.) these stakeholders have very little influence on the company. The active stakeholders have a continuous, infinitely demanding, daily influence on the company.
Argenti’s position has one great strength. He is right in legal terms. The shareholders do own the company. They are the only stakeholder who can intervene in the management of the company to extract more value for themselves. They have legal rights other stakeholders do not have. (Regulators have similar rights to extract value but do so through a different mechanism.)

A company that is making a huge surplus of economic value and continuously chooses to distribute this to customers and employees in the form of excessive rebates and bonuses is likely to be interfered with by its shareholders. The shareholders will want to try to get a larger slice of the cake.

This, in my view, places a constraint on management to ensure that shareholders get a fair slice of the cake. It does not mean that management should lay down all other purposes and worship only at the altar of shareholder value. It means that management should be continually viewing the business from a shareholder perspective and assessing whether the shareholder might have a grievance. It also places on management a great responsibility for making the company’s purpose clear to shareholders before they invest in the business. They can then judge how much to pay for the slice of the future they are being offered.

Argenti is also right in pointing out that this shareholder pressure is one of the strengths of capitalism. It helps to ensure that resources are used for their most beneficial purposes. But shareholder pressure is no more important to capitalism than customer or employee pressure. The markets for labour and for goods are as critical as the markets for capital in helping to make best use of resources. Moreover neither of these markets would operate effectively if there was no market for goods and services. Rather than emphasize the capital market as the most important one, as Argenti does, I prefer the balanced guidance offered by stakeholder thinking, which argues the importance of all three markets, and hence the primacy of the four ‘active’ stakeholders who operate in these markets—shareholders, employees, suppliers and customers.

Let me now turn to some of the specifics in Argenti’s argument.

Argenti argues that stakeholder thinking does not define who the stakeholders are. He is right, and it should not. The stakeholders depend on the purpose. Most companies have the four ‘active’ stakeholders because they operate in the three market places. But many privately owned companies have no distinguishable shareholders; regulated companies have a regulator as stakeholder; and Marks & Spencer, with its buy British policy, had Britain as a stakeholder for a long period.

Argenti complains that stakeholder thinking does not define what stakeholders can expect. He is right, and it should not. It is the duty of the board to define what it intends to deliver to each stakeholder. Stakeholder thinking does not lay down what value should pass between the company and its stakeholders. It simply states that management should make this clear so that the stakeholders can judge whether they want to commit to a relationship with the company. In most situations the expectation is that the company will deliver fair value: a return at or above the cost of capital; market wages to employees; normal terms of trade to suppliers; market value for money to customers. Where these unwritten expectations are not part of the purpose, management needs to explain clearly what the deal is and how it differs from the norm.

Our market economy allows each company to define its own ‘deal’ for each stakeholder group. This in turn encourages creativity. Companies can experiment to find out what stakeholders value and put together a deal that suits the stakeholder and suits the company’s purpose.

Argenti is unhappy that stakeholder theory does not define how the spoils are going to be divided. Again he is right. And again it is management’s task to do this. Argenti is dismissive of management’s ability to affect this division of the spoils without it becoming “the thin end of the wedge of corporate perversion”. Here he is wrong. And he is wrong because of the market economy. He implies that management will have “no objective guidelines whatever” and can “hand it over to whomever they please (including, all too evidently from recent British experience, themselves)”. But he is wrong. The markets for capital, labour and goods provide highly objective and very demanding guidelines. Many companies do not make enough spoils to satisfy these three markets. It is only those who have surpluses, even after satisfying these three markets, who have a choice. If they choose unwisely, by building a new corporate head office, paying high management bonuses or making some wild diversification, they will find themselves unable to meet the demands of their market places next time round. The wonder of the market economy is its self-disciplining nature. Only the naive manager hands out the spoils to ‘whomever he pleases’. The wise one invests surplus spoils in some value-generating activity in the hope of continuing to have surplus spoils in the future.

Argenti’s final concern is about measurement. Here he falls squarely in to the ‘Buy low, sell high’ trap. He evidently believes that a return to shareholder value measure of performance is in some way superior to a balanced score card measure of performance. Here he is clearly driven forward by his own reasoning rather than his common sense.
As we all know, a company that is delivering high shareholder value today may be on the brink of collapse tomorrow. Moreover companies that have not made a profit for years can still have high stock market values. Any attempt to measure performance must take account of a multitude of indicators. Measures of the satisfaction of stakeholders are useful members of a balanced score card; but they are not the only members.

Conclusion
Stakeholder theory is little more than common sense. It recognizes that companies cannot survive unless they deliver value to their chosen stakeholders. Shareholders, like regulators, have some legal rights that distinguish them from other stakeholders, but these legal rights should not allow us to become unbalanced in our thinking or in our understanding of the wonders of our capitalist market system. The markets for capital, labour and goods are unseen hands that help to keep resources flowing towards their best use. These markets are not the masters of business, but the servants of management. Managers use these market places to help them achieve the purposes they have defined.

Defining the purpose of an organization or a company is an important responsibility of the board or governing body. Without a clear purpose an organization will drift, buffeted by the stakeholders in the markets it competes in and by management’s lack of clarity about what to do with surpluses. Argenti’s idea that a company’s purpose should be ‘to make money for shareholders’ is currently popular and may be appropriate for some companies. To suggest that all companies should define their purposes in this way is misconceived and, if adopted, would have “practical consequences to society that are profoundly damaging”!