

Giving value to stakeholders

Often credited with being the father of 'stakeholder theory' – a title he says is undeserved – Ed Freeman of The Darden School, University of Virginia believes that business should be about creating value for stakeholders. In his Egon lecture in Brussels, he argued that the current way that we look at business must be thoroughly reformed.

By Jon Eldridge

"Where are we in the world today?" – Freeman began his lecture by asking this question. Recognising that the financial crisis has brought confidence in business to an "all-time low", he referred to a 'technical' term used by Russell Ackoff, one of his mentors, and one of what he calls the fathers of systems theory: "it's a mess!"

Freeman's assessment is brutal: "We do have a crisis, but it's actually a conceptual crisis. A conceptual occurs when we simply don't know what to think about something anymore, when the map of the epicycles gets complicated. We need to think about it differently; we need to make sense of it differently. Let me be clear: I think we have an outmoded, shop-worn, dated, no longer useful, flat-out wrong model about business."

Reforming corporate governance is not the solution. "It's like moving the deck chairs on the Titanic. It's not going to help; it's actually going to make things worse. The extent to which you change some of the governance requirements and make directors dependent or independent etc. gives people the idea that the problem has been fixed, and I believe it hasn't."



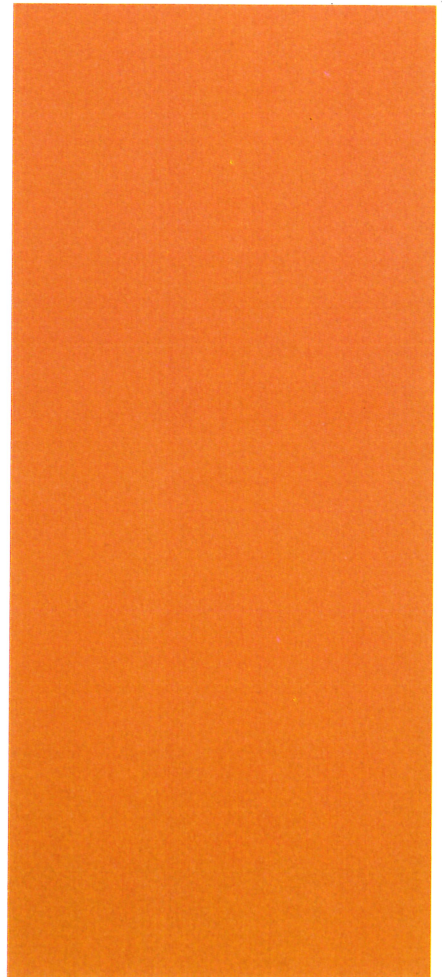
There are many examples – Enron, AIG, Lehman's, Bear Stearns, General Motors and Chrysler – of why corporate governance is a "broken idea", he said. "Reforms help, but they miss the point. The story just doesn't work anymore."

For Freeman this "old story" is that business is primarily about making money. The only constituency that matters is shareholders; capitalism works because people are self-interested, they need to be motivated, not inspired. They only act for others if they have the proper incentives, and given the opportunity, business people will cut corners. The old story says that "business works because people are competitive and greedy, and, as if by an invisible hand, the greater good emerges."

"Even if we add a concern for civil society, usually it's bolted-on as an idea about corporate social responsibility or philanthropy or something like

that," he said. "We need a thorough reform of the way that we think about business."

"I'm actually a real-life libertarian, who thinks that human freedom is what lights up the world. But [it] comes with responsibility and not many libertarians believe that."



Freeman believes that we must correct the misconception that capitalism is first and foremost a story about competition and the distribution of resources. The old story says that "what makes a business successful is that you create products that customers want; you create suppliers who are going to make you better; you have some employees who are engaged and show up every day; and you're a good citizen in the community. If you do that, you are going to make money," he said.

But Freeman believes that business should be about adding value to stakeholders. It should ask how you can make employees better off as well as customers, and "when you make your employees better off, how does that make suppliers better off? When you make customers, suppliers and employees better off, how is that going to make communities better off? When you do all those things, how do you make money for the people with the money?"

Nobel economist Milton Friedman once said: "The only role of an executive is to create as much profit as possible". But Freeman says that "the only role of an executive is to create as much value for the stakeholders as possible."

Such a role should be achieved without resorting to trade-offs, he says. According to Freeman, much of stakeholder theory over the last 30 years has concerned trade-offs between the profitability of a company and its social and environmental responsibilities.

However, he says that if companies search for ways of creating value instead of looking for trade-offs, then there may not be any need for a trade off, as was demonstrated by a chemicals company that remained profitable while introducing tougher controls on pollution. "Conflicts among stakeholders and critics from the outside, as well as conflicts among values on the inside, are the fuel of innovation," he added.

CEOs are beginning to appreciate the value of such an approach. Successful businesses have reinvented what customers, suppliers and employees want, according to Freeman. It is crucial, he argues, that companies are aware of their business models when considering people governance. "What we need is lots of what we call 'stakeholder-orientated companies' trying things out to see what works," he said.

Another common idea that must be revised is the notion that human beings are self-interested 'maximisers', said

Freeman. "It's not that it's wrong; it's not that we aren't sometimes self-interested – it's just that it's not the whole story. Sometimes we're 'other regarding.'" Another idea that needs adjusting is the perception that business is rational and people can be motivated in a simple stick-and-carrot manner.

Citing US psychologist Stanley Milgram's famous experiments of the 1960s that showed the shocking extent to which people often obey authority, Freeman said that "we need continuous inquiry and discovery of what it is to be a human being. We share a lot of values around the world, but getting beneath words to their interpretation and the actions that we take is a lot harder."

The third area of business that Freeman covered was leadership. He quoted Howard Gardner of Harvard University and his idea of 'leadership by choice' – a scenario where people choose to follow the leader. Other ideas of leadership that Freeman quoted included Jim Collins' 'level-5 leadership', which is characterised by humility and determination; the type of leadership that seeks to make the world a better place; and the leadership typified by Will Miller of the bank, Irwin Financial, who first strives

Rewriting business theory

According to Freeman, problems arise in the way business models commonly view four areas:

- **Business** : they are successful simply because they make money for their owners.
- **People** : human beings are treated as resources.
- **Leadership** : it works because of the charisma, brilliance or gender of the leader (usually male).
- **Capitalism** : the interaction of the above.

to meet ethical obligations and then figures out a way to make it profitable. "If you have a compelling vision about the future, it causes the present. I really believe that leadership works when we see people as complex and fully moral... with rights and duties, and hopes and dreams," he said. "The Milgram experiments taught us that many crises occur because people don't push back – they don't speak up," Freeman said, "and that has to be a core process in thinking about leadership."

Leadership that allows employees to speak up will generate extra value. It is a worthwhile exercise for a company executive to ask him or herself to define his or her model of leadership, he added.

Responsible capitalism

Freeman concluded his lecture by summing up his idea of 'responsible capitalism'. "It's business for human beings. It's when we see capitalism as an institution that allows us to bring 100% of our humanity to the task of creating value and trading with each other. It becomes the most powerful force on this earth and it's up to us to enact the story."

"A CEO in an energy company who was hammered in the wake of Enron said: 'You know, it was tough going into the office, because I had consultants, accountants, lawyers and my own inside people telling me I was stupid not to do all the stuff that Enron was doing. But we just didn't see how it added any value to our customers.' Imagine if that had been the question of the day on Wall Street; imagine if that had been the question of the day in every financial institution."

"Capitalism works, because human beings are complicated – we have self-interest, we have that 'other-regarding' interest, we have emotion, we have sexuality, we are not one-dimensional creatures. And most people, most of the time, are responsible and capable of governing themselves. Good leaders understand that they need to enable others to act and I really believe that if free people make voluntary decisions in a responsible way, society flourishes. There's much in the world that needs to be changed. And, we have an unprecedented opportunity to be the generation that leaves capitalism better than we found it."

According to Freeman this responsible capitalism will come about if we apply four principles of people governance:

the principle of stakeholder values; the complexity principle that acknowledges the many facets of human nature; the leadership principle that recognises that people can be inspired to better things and the responsibility principle. "People are and want to be responsible, at least partially, for the effects of their actions and their company's actions on others. They are capable of governing themselves. A manager's job is to enable people to govern themselves, and to figure out how to work together," he said.

A conversation about value is always a difficult one to have, Freeman acknowledged, before leaving attendees with a final thought: "If we're not trying to make our corporations places for our children to live in, then we have set the bar too low. I believe that's what people governance, responsible capitalism, business for human beings is about."

The old story says that "business works because people are competitive and greedy, and, as if by an invisible hand, the greater good emerges."

The New Story ...

- Business is primarily about creating value for customers, suppliers, employees, communities and financiers (and maybe others).
- Capitalism works because human beings are complicated. Sometimes we act in our self-interest, sometimes for others, sometimes we just don't know. Most people are responsible most of the time, and they are capable of governing themselves.
- Good Leaders understand their role in the process of value creation as enabling others to do great things.
- When free people make voluntary decisions to collaborate responsibly, society flourishes.