THEORIES OF CORPORATE GOVERNANCE

By

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2016
What is Corporate Governance?

The relationship among various participants in determining the direction and performance of corporations.

Corporate Governance Theory: Introduction

• Market, hierarchy, and the limits to the scope of the firm. => Transaction Costs Theory.
  (Williamson, 1975, 1985)

• Principals, agents, and the limits of the control mechanisms. => Agency Theory.
  (Fama and Jensen, 1983)

• Stakeholders, Stewards, and the limits of transaction and agency theories.
  (Carroll, 1979, 2003; Davis, Schoorman & Donaldson, 1997; Ghoshal, 2006)
Reputed literature on the agency costs associated with the separation of ownership and management in corporate governance has been reviewed in this study. A model has been developed that determines the optimal level of monitoring of CEOs by directors, which is considered a crucial function in determining the financial performance of the Firm.

The above-mentioned optimal level monitoring model also incorporates the premise that it is important for the board to evaluate CEO’s performance by defining the final achievement as well as setting the executive limitations and point of accountability of the CEO. Such a monitoring needs to be conducted on a regular basis to maintain an optimal level of expected CEO performance.

Even though corporate law outlines that shareholders choose the board of directors, in practice, shareholders almost always vote for the slate proposed by management. Moreover, this slate is approved by, if not chosen by, the very CEO these directors are supposed to monitor. The resulting governance system has been criticized as ineffective in controlling management.

Consistent with the continuing research in agency theory, the finding of this study contributes to resolve the agency problem, in essence that the board Agency theory and corporate governance monitoring of CEO will improve the performance of the CEO and avoid possible conflict of interests.

(Agency Theory and Corporate Governance A study of the effectiveness of board in their monitoring of the CEO, Livia Bonazzi & Sardar M.N. Islam, 2007)
An agency relationship exists when:

Shareholders (Principals)
Firm Owners

Agency Relationship
Risk Bearing Specialist (Principal)
Managerial Decision-Making Specialist (Agent)

Hire

Managers (Agents)
Decision Makers

which creates

Source: adapted from Fama and Jensen (1983)
Manager & Shareholder Risk & Diversification

Shareholder (Business) Risk Profile

Managerial (Employment) Risk Profile

Dominant Business

Related Constrained

Unrelated Businesses

Related Linked

Level of Diversification
Agency Theory

- Agency theory is the influential theory in Corporate Governance.
- Basic assumptions of agency theory, particularly concerning the human nature, can be questioned on the basis of psychology, sociology and other alternative perspectives.
- The cost of agency problems plus the cost of actions taken to minimize agency problems are collectively termed agency costs.
- Executives are often free to pursue their own interests because of the disproportionate access they have to company information. This is the moral hazard problem.
- Adverse selection is an agency problem caused by the limited ability of stockholders to determine the competencies and priorities of executives at hire.
- Agency theory is a set of ideas on organizational control based on the belief that the separation of the ownership from management creates the potential for the wishes of owners to be ignored.
Corporate managers and directors are agents
Shareholders are the principal
Construct rules and incentives to align the behavior of agents with the desires of the principals.
Directors and Managers need to be monitored as their motives differ from that of shareholders
Agency Theory

- Principals may engage in monitoring behaviour to assess the activities and decisions of managers
  - However, dispersed shareholding makes it difficult and inefficient to monitor management’s behaviour
  - Boards of directors have a fiduciary duty to their shareholders to monitor management
  - However, boards of directors are often accused of being lax in performing this function.

The Solution:
- Incentive-based performance contracts
- Monitoring mechanisms such as the board of directors
- Enforcement mechanisms such as the managerial labour market
Principal-Agent Relationships

- An agent has decision-making authority that affects the well-being of the principal.

Examples of agents:
- Money managers
- Lawyers
- Corporate managers

Examples of principals:
- Investors in a money market fund
- Clients of lawyers
- Stockholders of the firm
Problems Resulting from Agency

- Executives pursue growth in company size rather than earnings
- Executives attempt to diversify their corporate risk
- Executives avoid healthy risk
- Managers act to optimize their personal payoffs
- Executives protect their status
Overcoming Agency Problem

- Executive compensation
- Controlling management through Board of Directors’ actions
- Accounting system as a monitoring device
  - Internal control
  - Disclosure
- Audited financial statements
- Stewardship Theory and other theories
An agency problem arises when there is a conflict of interest between the agents and the principals.

- It can also arise due to asymmetric information:
  - The principal cannot monitor the agent’s behavior perfectly.

- Moral hazard can occur when agents take actions in their own best interest that are unobservable by and detrimental to the principal.

- Desires and goals of agents and principals may not be in accord.

- Objectives of owners & agents in conflict

- Difficult or expensive for the principal (owner) to verify the activities of the agents (agents performance).

Example: Over-diversification that occurs because increased product diversification leads to lower employment risk for managers and greater compensation
Solution to Agency Problem

- Owners pay executives a premium for their service to increase loyalty
- Executives receive back-loaded compensation.
- Creating teams of executives across different units of a corporation can help to focus performance measures on organizational rather than personal goals.

Risk Sharing Problem:

- Owners & agents risk assessment in conflict
The Role of Monitoring

- The principal can monitor the agent’s actions, but not perfectly.
- Costs are incurred in monitoring the agent’s behavior.
- Perfect monitoring of all actions of the agent can eliminate the agency problem.
  - This can be prohibitively costly.
- There is a trade-off between resources spent on monitoring and the possibility of agent misbehavior.
Alternatives to Monitoring

- Alternatives to monitoring include:
  - **Constraints** on agent’s behavior.
  - **Incentives** to align agent’s interests with the principal’s interests.
  - **Punishments** for agent misbehavior.
- **Principal-agent contracts that eliminate all agency problems cannot be designed.**
  - Thus, a residual agency problems remains.
Agency Costs

- Agents likely to place personal goals ahead of corporate goals
- Results in conflict of interests between agents and principals
- Consistent with egoism
- Information asymmetry
- Occurs if BOD fails to exercise due care in oversight.
- The sum of incentive, monitoring, and enforcement costs as well as any residual losses incurred by principals because it is not possible for principals to guarantee 100% compliance through monitoring arrangements.
Agency Costs

- These are costs incurred in an attempt to push agents to act in the principal’s best interest.
- They are the *incremental costs* of working through others.
- They consist of 3 (three) types:
  1. Direct contracting costs.
  2. Monitoring costs
  3. Loss of principal’s wealth due to residual, unresolved agency problems.
Direct Contracting Costs

- **Transaction cost** of setting up a contract.
  - *e.g.* Legal fees

- **Opportunity costs** imposed by constraints that preclude otherwise optimal decisions.
  - *e.g.* Inability to take positive NPV projects due to restrictive bond covenants.

- **Incentive fees** paid to agents to encourage behavior consistent with the principal’s goals.
  - *e.g.* Employee bonuses.
Role of Financial Contracting

- To design financial contracts between agents and principals that minimize total agency costs.
- Perfect contracts that eliminate all agency problems are not feasible.
  - Periodic misbehavior may be less costly than the cost of eliminating it.
- The optimal contract transfers decision-making authority from the principal to the agent in the most efficient manner.
Agency Theory versus Stewardship Theory

Agency Theory

Physiological
Safety
Socialization
Esteem
Self Actualization
Stewardship
### COMPARISON OF AGENCY THEORY & STEWARDSHIP THEORY

<table>
<thead>
<tr>
<th>View of the individual</th>
<th>Agency Theory</th>
<th>Stewardship Theory</th>
</tr>
</thead>
<tbody>
<tr>
<td>Economic agent</td>
<td>Complex &amp; modern</td>
<td>Holistic &amp; rounded view of human nature</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Behavioral assumptions</th>
<th>Agency Theory</th>
<th>Stewardship Theory</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opportunistic wealth maximizer</td>
<td>• want to contribute</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Behavioral characteristics</th>
<th>Agency Theory</th>
<th>Stewardship Theory</th>
</tr>
</thead>
<tbody>
<tr>
<td>• self-serving – employees will choose the options that are in their own best interests</td>
<td>• will choose to do right</td>
<td></td>
</tr>
<tr>
<td>• risk-averse – there is an increasing disutility for wealth</td>
<td>• strive to achieve</td>
<td></td>
</tr>
<tr>
<td>• effort-averse – employees will shirk</td>
<td>• like to innovate</td>
<td></td>
</tr>
<tr>
<td>• want to contribute</td>
<td>• want to do competent work</td>
<td></td>
</tr>
<tr>
<td>• will choose to do right</td>
<td>• interested in a work-life balance</td>
<td></td>
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<tr>
<td>• strive to achieve</td>
<td></td>
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<tr>
<td>• like to innovate</td>
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<tr>
<td>• interested in a work-life balance</td>
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</tbody>
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<table>
<thead>
<tr>
<th>Management philosophy</th>
<th>Agency Theory</th>
<th>Stewardship Theory</th>
</tr>
</thead>
<tbody>
<tr>
<td>Control-oriented</td>
<td>Involvement-oriented</td>
<td></td>
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</table>

<table>
<thead>
<tr>
<th>Motivation</th>
<th>Agency Theory</th>
<th>Stewardship Theory</th>
</tr>
</thead>
<tbody>
<tr>
<td>Extrinsic rewards</td>
<td>More intrinsic than extrinsic rewards</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Organizational identification</th>
<th>Agency Theory</th>
<th>Stewardship Theory</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low value commitment</td>
<td>High Commitment</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Trust</th>
<th>Agency Theory</th>
<th>Stewardship Theory</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low – employees are work averse and so they will shirk</td>
<td>High – stewards have an inherent preference for honesty</td>
<td></td>
</tr>
</tbody>
</table>

# Stewardship Theory

**TABLE 1**

Comparison of Agency Theory and Stewardship Theory

<table>
<thead>
<tr>
<th></th>
<th>Agency Theory</th>
<th>Stewardship Theory</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Model of Man Behavior</strong></td>
<td>Economic man</td>
<td>Self-actualizing man</td>
</tr>
<tr>
<td></td>
<td>Self-serving</td>
<td>Collective serving</td>
</tr>
<tr>
<td><strong>Psychological Mechanisms</strong></td>
<td><strong>Motivation</strong></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Lower order/economic needs</td>
<td>Higher order needs (growth,</td>
</tr>
<tr>
<td></td>
<td>(physiological, security,</td>
<td>achievement, self-actualization)</td>
</tr>
<tr>
<td></td>
<td>economic)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Extrinsic</td>
<td>Intrinsic</td>
</tr>
<tr>
<td></td>
<td>Other managers</td>
<td>Principal</td>
</tr>
<tr>
<td><strong>Social Comparison</strong></td>
<td>Low value commitment</td>
<td>High value commitment</td>
</tr>
<tr>
<td><strong>Identification</strong></td>
<td>Institutional (legitimate,</td>
<td>Personal (expert, referent)</td>
</tr>
<tr>
<td></td>
<td>coercive, reward)</td>
<td></td>
</tr>
<tr>
<td><strong>Situational Mechanisms</strong></td>
<td><strong>Management Philosophy</strong></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Control oriented</td>
<td>Involvement oriented</td>
</tr>
<tr>
<td></td>
<td>Control mechanisms</td>
<td>Trust</td>
</tr>
<tr>
<td></td>
<td>Short term</td>
<td>Long Term</td>
</tr>
<tr>
<td></td>
<td>Cost control</td>
<td>Performance Enhancement</td>
</tr>
<tr>
<td></td>
<td>Individualism</td>
<td>Collectivism</td>
</tr>
<tr>
<td></td>
<td>High power distance</td>
<td>Low power distance</td>
</tr>
</tbody>
</table>

Reference: Davis, Schoorman & Donaldson, 1997
# Stewardship Theory

**FIGURE 1**  
Principal-Manager Choice Model

<table>
<thead>
<tr>
<th>Principal's Choice</th>
<th>Agent</th>
<th>Steward</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Minimize Potential Costs</td>
<td>Agent Acts Opportunistically</td>
</tr>
<tr>
<td>Agent</td>
<td>Mutual Agency Relationship</td>
<td>Principal Is Angry</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Principal Is Betrayed</td>
</tr>
<tr>
<td>Manager's Choice 1</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>Steward</td>
<td></td>
<td>Maximize Potential Performance</td>
</tr>
<tr>
<td></td>
<td>Principal Acts Opportunistically</td>
<td>Mutual Stewardship Relationship</td>
</tr>
<tr>
<td></td>
<td>Manager Is Frustrated</td>
<td>Manager Is Betrayed</td>
</tr>
<tr>
<td></td>
<td>3</td>
<td>4</td>
</tr>
</tbody>
</table>
Stewardship Theory

Assumptions –

- Steward is a person who manages other’s property and financial affairs and is entrusted with the responsibility of proper utilization and development of organization’s resources.

*Executives more motivated to act in best interest of the corporation than their own self-interests.*

*Theory that over time, senior executives tend to view corporation as extension of selves.*
Stakeholder Theory

- The purpose of the firm is to create wealth or value for its stakeholders by covering their stakes into goods and services.

- The conception of the company is a set of relationship rather than a serious of transactions, in which managers adopt an inclusive concern for all stakeholders.
Property Right Theory

- Property rights are a set of rules and guidelines that help people (investors) from reasonable expectations about control over assets.
- These can be law, administrative arrangement, social norms etc.
- How will it help –
  - To understand the type of firm
  - Specific CG mechanisms available to the firm
# Models of Corporate Governance

<table>
<thead>
<tr>
<th>Anglo American</th>
<th>German</th>
<th>Japanese</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share holders</td>
<td>Shareholders and employees/unions</td>
<td>Shareholders and banks</td>
</tr>
<tr>
<td>Elects</td>
<td>Elects</td>
<td>Elects</td>
</tr>
<tr>
<td>Board of Directors</td>
<td>Supervisory Board</td>
<td>Supervisory Board appoints President And President</td>
</tr>
<tr>
<td>Appoints</td>
<td>Appoints</td>
<td>Appoints</td>
</tr>
<tr>
<td>Officers/Executive</td>
<td>Management Board</td>
<td>Executive Board</td>
</tr>
<tr>
<td>Manage</td>
<td>Manage</td>
<td>Manage</td>
</tr>
<tr>
<td>Company</td>
<td>Company</td>
<td>Company</td>
</tr>
</tbody>
</table>

Indian Model = Anglo American Model + German Model
Anglo American Model

- Wide spread shareholding
- Separation of ownership and management
- Professional managers
- Single board structure
- Focus on mainly on Shareholders
The right to share in residual income means that shareholders must accept the risk that no residual profits will remain if the firm’s expenses exceed its income.

Reduce risk efficiently by holding diversified portfolios

In small firms, managers and owners are often one in the same, so there is no separation of ownership and control.

As firms grow larger, individual owners generally do not have access to sufficient capital to fund the growth of the business and seek other investors with which to share residual profits (and risk).
Separation of Ownership & Managerial Control

- **Shareholders**
  - Purchase stock, becoming Residual Claimants
  - Reduce risk efficiently by holding diversified portfolios

- **Professional managers contract to provide decision-making**

- **Leads to efficient specialisation of tasks, such as:**
  - Risk bearing by shareholders
  - Strategy development and decision-making by managers
Owners

- Concentrated versus Diffused ownership
  - Concentrated: Founders start up and control firms
  - Diffused: Numerous small shareholders, none with complete control
- Family ownership - Founding family and descendants maintain controlling interest
- State ownership - Means of production owned by the government. Managers employed by the state; firm governed by the state
Managers

- Principal-Agent conflicts: The relationship between shareholders and professional managers is a relationship between principals and agents.
- Principal-Principal conflicts: Such conflicts are between two classes of principals: controlling shareholders and minority shareholders.
Principal-Agent Conflicts

- **Principal-Agent Relationship**
  - One example: The relationship between shareholders and professional managers

- **Agency Theory**
  - Because the interests of principals and agents do not completely overlap, there will *inherently* be principal-agent conflicts, which result in agency costs
  - Conflicts persist because of *information asymmetries* between principals and agents (agents always know more about their tasks than principals).

- **Reducing Agency Problems**
  - While it is possible to reduce information asymmetries and minimize agency problems, it probably is not realistic to expect to completely eliminate such problems
Managers’ Self-Interest

- Maximizing Growth, Not Earnings
- Diversifying Risk
- Managerial Risk Aversion
- Managerial Self-Preservation (managerial entrenchment)
- Managerial Enrichment
Principal-Principal Conflicts

- Expropriation of Minority Shareholders
  - Family managers, who represent (or are) controlling shareholders, may engage in activities that enrich the controlling shareholders at the expense of minority shareholders
  - Illegal activity: “tunneling”
  - Legal activity: related transactions
Principal- Agent Conflicts & Principal-Principal Conflicts

**FIGURE 16.2**
PRINCIPAL-AGENT CONFLICTS AND PRINCIPAL-PRINCIPAL CONFLICTS

- Minority shareholders
  - Principal-Agent conflicts
  - Professional managers

- Minority shareholders
  - Principal-Principal conflicts
  - Controlling shareholders
  - Family managers
    - Family managers are appointed by controlling shareholders

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## Principal-Agent VS Principal-Principal Conflicts

<table>
<thead>
<tr>
<th></th>
<th>Principal–Agent Conflicts</th>
<th>Principal–Principal Conflicts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ownership pattern</td>
<td>Dispersed—shareholders holding 5% of equity are regarded as “blockholders”</td>
<td>Dominant—often greater than 50% of equity is controlled by the largest shareholders</td>
</tr>
<tr>
<td>Manifestations</td>
<td>Strategies that benefit entrenched managers at the expense of shareholders (such as shirking, excessive compensation, and empire building)</td>
<td>Strategies that benefit controlling shareholders at the expense of minority shareholders (such as minority shareholder expropriation and cronyism)</td>
</tr>
<tr>
<td>Institutional protection of minority shareholders</td>
<td>Formal constraints (such as courts) are more protective of shareholder rights; informal norms adhere to shareholder wealth maximization</td>
<td>Formal institutional protection is often lacking; informal norms are typically in favor of controlling shareholders</td>
</tr>
<tr>
<td>Market for corporate control</td>
<td>Active, at least in principle, as the “governance mechanism of last resort”</td>
<td>Inactive, even in principle; concentrated ownership thwarts notions of takeover</td>
</tr>
</tbody>
</table>

Principal-agent theory

The principal-agent relationship: private v public sector
Stockholder-Manager Conflicts

- Created by the separation of ownership and control of the corporation.
- Stockholders elect the Board of Directors, who in turn appoint managers.
- The self-interested behavior of managers may be at conflict with the interest of stockholders.
- Managers may favor growth and larger size of the firm:
  - Greater job security
  - Larger compensation
  - Greater prestige
  - Larger discretionary expense accounts
Stockholder-Manager Conflicts

- Consumption of excessive perquisites.
  - Direct benefits: use of company car, expense accounts.
  - Indirect benefits: up-to-date office decor.

- Shirking
  - They may not put forth their best efforts.

- Non-Diversifiability of Human Capital
  - Managers’ expertise is closely tied to the firm.
  - This leads to a divergence of goals.
Non-Diversifiability of Human Capital

- **Capital Investment Choices**
  - Preference for low-risk projects even though their NPV may be lower than other riskier projects.
  - If the firm ceases to operate as a result of “bad” outcomes of risky projects, managers lose their jobs.

- **Asset Uniqueness**
  - The more a manager’s human capital is closely tied to the firm, the more unique the assets of the firm are.
Debtholder-Stockholder Conflicts

- When a firm issues risky debt, stockholders have an option against the debtholders.
  - The option to default on debt.
- Now, stockholders are the agents and the debtholders are the principals.
  - Debtholders want to protect themselves against adverse decisions taken by stockholders.
- This conflict can manifest in three ways:
  - Asset substitution
  - Underinvestment
  - Claim Dilution
Two Models of Corporate Governance:

The outsider (shareholders) model:

- A priority to market regulation
- The owners of firms tend to have a transitory interest in the firm
- The absence of close relationships between shareholders and management
- The existence of an active “market for corporate control” - takeovers, particularly hostile ones
- The primacy of shareholder rights over those of other organisational groups
The priority to stakeholders control

The owners of firms tend to have an enduring interest in the company

They often hold positions on the board of directors or other senior managerial positions

The relationships between management and shareholders are close and stable

There is little by way of a market for corporate control

the existence of formal rights for employees to influence key managerial decisions
Making sense of corporate governance and the role of boards

Main theories (often developed wrt the private sector):

- Managerial hegemony theory
- Agency theory
- Stewardship theory
- Stakeholder theory
- Resource dependency theory

(all have their advocates, detractors and variants)
<table>
<thead>
<tr>
<th>THEORY</th>
<th>Assumptions</th>
<th>Board member role</th>
<th>Main board function</th>
<th>Key issues</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principal-Agent theory</td>
<td>Owners’ interests may differ from managers’ interests</td>
<td>Supervisor (Chosen to represent owners interests, and be independent of management)</td>
<td>Conformance: - Safeguard owners resources and interests - Supervise management/staff</td>
<td>Emphasis on control may stifle innovation and risk taking, and reduce staff motivation</td>
</tr>
<tr>
<td>Stewardship theory</td>
<td>Owners and managers have similar interests</td>
<td>Partner (Chosen for expertise)</td>
<td>Improving Performance: - add value to top decisions/strategy - partner management</td>
<td>Management proposals and systems may not be given adequate scrutiny.</td>
</tr>
<tr>
<td>Stakeholder theory</td>
<td>Different stakeholder have legitimate but different interests in the organisation.</td>
<td>‘Represent’ different stakeholder views</td>
<td>Political: - represent and balance different stakeholder interests - make policy - control executive</td>
<td>Board members may promote stakeholder interests rather than the organisation’s. May be difficult to agree objectives.</td>
</tr>
<tr>
<td>Resource dependency theory</td>
<td>Organisational survival depends on maintaining coalition of support to obtain resources and legitimacy</td>
<td>Supporter (Chosen for influence or resources they may bring.)</td>
<td>External influence: - secure resources - improve stakeholder relations - bring external perspective</td>
<td>External focus of board members may mean internal supervision is neglected. Board members may lack expertise.</td>
</tr>
<tr>
<td>Managerial hegemony theory</td>
<td>Owners and managers have different interests, but managers control main levers of power.</td>
<td>Symbolic</td>
<td>Legitimacy: -ratify decisions -support management -give legitimacy</td>
<td>Management may pursue own interests at expense of ‘owners’, managers gain little of value from board.</td>
</tr>
</tbody>
</table>
Milton Friedman: The Purpose of Business is to make money for the owner or stockholders.

- **Argument 1**: “The Social Responsibility of Business is to increase its profits”.
  - The Underlying Ethical principle: Manager has *Fiduciary Responsibility* to Owners.
  - Purpose of business is NOT to:
    1. provide employment
    2. eliminate discrimination
    3. avoid pollution
    4. help the community
    5. make life better for workers

- **Business is NOT charity**.

To think business should do anything other than make a profit is to preach *socialism* and undermine *free society*. 
Stockholder Theory

- **Argument 2**: Businesses cannot have responsibility, because only people can have responsibilities.

- **Argument 3**:
  - Executive has obligation to stockholders.
  - “a corporate executive is an employee of the owners of the business. He has a direct responsibility to his employers. That responsibility is to conduct the business in accordance with their desires, which generally will be to make as much money as possible…”

- **Argument 4**: No way for Executive to know how to solve social ills—that’s not his expertise!

- **Argument 5**: Majority speaks through the law. Don’t undermine or circumvent democracy by imposing one’s views on other people’s money-use via subversive private ‘tax’

  Agent to Stockholders:
  - He must act as an agent of the stockholders, not society in general.
  - “But if he does this, he is in effect imposing taxes on the one hand, and deciding how the tax proceeds shall be spent, on the other.”
Assumption #1:
Friedman thinks firms *ought* to maximize their profits (they have social obligation to do so) *Because* “profit really represents the net contribution that the firm makes to the social good and the profits should therefore be made as large as possible.”

Assumption #2:
Friedman also assumes natural constraints of the market will help keep companies in check. *I.E.,* if a company is known to be dishonest or terrible to their employees, then consumers will not buy from that company!
Problem with Friedman

- **Problem #1 with Friedman’s Position:**
  - It assumes that forces of competition are sufficiently vigorous—but they aren’t.
  - Federal regulations are essential to force companies to act in an ethical manner. Such regulations direct the market towards ethical behavior.

- **Problem #2 with Friedman:**
  Distribution of income that results from unrestrained profit maximization is very unequal.

- **Problem #3 with Friedman:**
  Maximizing profits is socially inefficient when costs are not paid
  Examples: pollution, traffic congestion, No taxes– poorly educated workforce

- **Problem #4 with Friedman:**
  Maximizing profits is socially inefficient when seller has great knowledge advantage over buyer
Stakeholder Theory
Evidence of an interrelationship between the concepts of

- stakeholder theory,
- corporate responsibility, and
- business ethics.

The earlier stakeholder model involved corporation being involved in four groups (similar to social responsibility): suppliers, employees, shareholders, customers.

- Most common stakeholder model includes 7 (seven) stakeholders: Shareholders, Customers, Suppliers, Employees, Government, Communities/Civil society & Competitors.
Stakeholder Theory: Freeman Model (continued)

- Freeman reduced stakeholders to internal and external
  - 5 (Five) Internal Stakeholder:
    1. Financiers/ shareholders
    2. Customers
    3. Suppliers
    4. Employees
    5. Communities
  - 6 (Six) external stakeholders
    1. Governments
    2. Environmentalists
    3. NGO’s
    4. Critics
    5. Media
    6. Others
Stakeholder Theory
Stakeholder Theory

Reference: Freeman, 1984
Managing for Stakeholders

- “Managing for stakeholders is about creating as much value as possible for stakeholders, without resorting to tradeoffs.”

- “The basic idea is that businesses, and the executives who manage them, actually do and should create value for customers, suppliers, employees, communities, and financiers (or shareholders). And, that we need to pay careful attention to how these relationships are managed and how value gets created for these stakeholders.”
References


