

# **STAKEHOLDER MANAGEMENT**

# **BUSINESS AND SOCIETY 360**

Series Editors: David M. Wasieleski and James Weber

# STAKEHOLDER MANAGEMENT

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United Kingdom – North America – Japan – India – Malaysia – China

Emerald Publishing Limited  
Howard House, Wagon Lane, Bingley BD16 1WA, UK

First edition 2017

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**British Library Cataloguing in Publication Data**

A catalogue record for this book is available from the British Library

ISBN: 978-1-78714-408-8 (Print)

ISBN: 978-1-78714-407-1 (Online)

ISBN: 978-1-78714-925-0 (Epub)

ISSN: 2514-1759 (Series)



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# Preface

## Introducing the *Business and Society 360* Book Series — An Overview

### *Where Are We? How Did We Get Here? Which Way Should We Go Now?*

Sounds familiar? Have you ever considered the answers to these questions related to the work you do? Existential moments are common in the maturation of any academic discipline. They are the product of a passionate, caring constituency that is careful about making meaningful contributions that can propel future research and provide illusory discoveries that are conceptually powerful, empirically sound, and practically useful.

It is in this spirit for academic progress that we proudly present the *Business and Society 360 (BAS 360)* annual book series. It is our view that there has never been a more opportune time to introduce a comprehensive book series on the most important theories, concepts, and constructs that drive our field. Taking advantage of this moment of reflection that seems to creep into many of our academic discussions at IABS, the Academy of Management (primarily in the Social Issues in Management Division), and our scholarship, as evidenced by a recent Special Issue in *Business and Society* on “Stakeholder Theory at the Crossroads,” as well as an editor reflection piece on how to define the scope of work that appears in the journal.

We also see debates about the field’s status through groups like The Aspen Institute, that hosts an annual forum on topical CSR issues with the purpose of determining the most promising future research.

We envision *BAS 360* as an annual book series targeting cutting-edge developments in the broad business and society field (stakeholder management, corporate social responsibility and citizenship, business ethics, corporate governance, sustainability, and others). Each volume features a comprehensive 360-degree discussion and review of the current state of the research and theoretical developments in the specific area of business and society scholarship. The goal of this series is to shape future work in the field around our many disciplines and topics of interest and to enlighten scholars in the area about the most productive roads forward. Essentially, at this crossroad, which way do we proceed?

The 360-degree view is intended to reflect on a theory's cross-discipline research, empirical explorations, cross-cultural studies, literature critiques, and meta-analysis projects. Given our multi-disciplinary identity, each volume draws from work in areas both inside and outside of business and management.

## **Introduction to Inaugural Volume on *Stakeholder Management***

The theme of the 2016 International Association for Business and Society (IABS) annual conference was, "Business and Society at the Crossroad." This somewhat daunting leitmotif was meant to motivate scholars in the Business and Society field to reflect on the current state of our discipline, review the dominant research questions that are being asked, and come to some consensus on the direction we should take. It is not so much an identity crisis, but rather, a responsible exercise to audit what the field means and how it can grow and continue to offer valuable insights. We feel it is healthy for an academic field to contemplate its origins and assemble the most significant research in order to determine what questions still need to be asked and what paths are the most worthwhile to pursue.

The business and society field is multi-disciplinary in nature. Inherently, we borrow from and build upon insights from many informing disciplines, such as sociology, psychology, strategic management, political science, international business, behavioral economics, moral philosophy, and the natural sciences, among others. We would argue that our field can more accurately be portrayed as "trans-disciplinary." It is through scholars' knowledge of these various base literatures that we understand the complexities of business, and its collaboration with society is revealed. Conceptual blending among disciplines allows the research in the field to accurately revise discipline-specific approaches and to broaden our knowledge of how this interaction between business and society actually transpires. The field's dominant approach to conducting research and applying the findings to management has led to many important implications for business and for deeper, more meaningful theory building. It is the field's strength that our scope and relevance is broadly based and spans nearly all sub-disciplines within the academy.

Edwin Epstein, one of the founders of the business and society field of scholarship, provided a useful synopsis of the business and society domain that is still pertinent today:

The field has "... provided venues to examine the complex, dynamic, two-way relation between economic institutions of



our society and the social systems in which they operate. They have blended the normative with the scientific, the speculative with the empirical, and the philosophical with the pragmatic .... Their enduring quest and *raison d'être* is to foster corporate capitalism that is accountable, ethical, and humane." (2000, p. 146)

This volume respects these viewpoints on the business and society field and attempts to make a contribution by analyzing how to build better theory and provide more useful applications to the real world. Scholars known in each highlighted discipline are brought together each year to contribute to a 360-degree evaluation of a dominant theory within business and society. A 360-degree view implies that a concept or theory is critically viewed by the experts of the particular subject holistically and completely, keeping in mind the context in which the theory was originally developed and its applicability to modern-day environments and understandings of global business. Thus, it is both backward-looking and forward-seeking.

This inaugural volume focuses on research drawn from work grounded in examining "stakeholder management." We felt there is no better place to kick off this book series than to focus on stakeholder theory and the stakeholder management literature that has manifested. Stakeholder management fits the profile and scope of our endeavor very nicely given its firm grounding in the background disciplines that guide and inform our greater area of study. As a dominant theory in business and society literature since its inception in 1984 with Edward Freeman's groundbreaking book, *Strategic Management: A Stakeholder Approach*, we see a great opportunity to conduct a 360-degree evaluation of much of the important works within this vast scholarly domain.

Stakeholder theory is used for many purposes in a wide array of disciplines. It was intended to serve as a strategic management tool for business and society relationships in a capitalist system. While it has broad scholarly appeal, it is still somewhat controversial and is considered to be empirically underdeveloped (Laplume, Sonpar, & Litz, 2008). Consensus has also not been reached on the underlying values driving decisions to balance stakeholder interests (Margolis & Walsh, 2003). It continues to challenge management assumptions related to the maximization of profit in organizations (Jensen, 2002). Firms are expected to elevate themselves from conventional economic objectives by considering the needs of multiple stakeholder groups (Verbeke & Tung, 2013). Debates over how to address legitimate interests are ongoing. This first volume seeks to address various components of stakeholder management to ultimately identify clear future directions for research in this area.

This volume offers a series of 10 chapters from well-known, established, and emerging business and society scholars working with stakeholder

theory in its many aspects. *BAS 360* book series is tailored to submissions that report on leading scholars' research explorations on a critical topic or field development through a forum or symposium, emerging theory-building ideas, research papers that critique the current extant literature, work that cuts across multiple disciplines, and scholarly studies that are complex and longer than typically accepted in major academic journals. Each chapter is centered on a different sub-topic related to stakeholder management, written by the actual published experts on that sub-topic. The chapters stand alone as comprehensive pieces of scholarship in themselves, but they are intimately related and interwoven so as to give readers an overall sense of cohesion around the area of stakeholder management. In other words, many major facets of research around stakeholder management are covered and as an ensemble, provide a thorough analysis of the developments and evolution of the field, while identifying the trans-disciplinary research that can direct work in the years to come. We hope this volume becomes a source for both emerging and established business and society scholars to create innovative advances in stakeholder management and design new pathways of knowing.

The chapters in this volume are presented as follows:

Chapter 1 presents an essay authored by R. Edward Freeman, the pre-eminent scholar and founder of stakeholder theory, which provides his reflections on the field since he formally introduced the concept to the academic community, as well as his formulation of the main challenges that face the stakeholder management field in the years to come. This sets the stage for the next chapter on stakeholder classification by Samantha Miles. This chapter seeks to make sense of conceptual irregularities in the literature to resolve these inconsistencies so stakeholder research can be more aligned and working toward a common purpose.

The volume then begins to cover specific areas of stakeholder research that splintered off from the initial theory formulation. The first of these chapters is on normative stakeholder theory (Chapter 3), co-authored by Abe Zakhem and Daniel E. Palmer. The authors review the normative core of stakeholder theory from a variety of perspectives in order to justify the pursuit of ethical standards in stakeholder management strategies. This serves as a perfect transition to Duane Windsor's piece on value creation (Chapter 4). How does this relate to stakeholder theory? The answer lies in understanding how value is generated through stakeholder relationships. Professor Windsor addresses this and also shows how social welfare is enhanced by different value creation approaches. Chapter 5 is written by Timothy J. Rowley on the future of stakeholder network research. He critically examines work on social network analysis and stakeholders to highlight opportunities for motivating a new wave of stakeholder network research. In this chapter, Dr. Rowley discusses stakeholder network power and legitimacy, which is a perfect segue to the next piece.

Co-authored by Ronald K. Mitchell, Jae Hwan Lee, and Bradley R. Agle, Chapter 6 evaluates the role of stakeholder salience on stakeholder research. With a focus on stakeholder prioritization work, the authors work to revise and refresh work on stakeholder salience and suggest several directions for future research in the area. On the same topic, Sofiane Baba and Emmanuel Raufflet challenge stakeholder salience in Chapter 7 and argue for a new conceptualization of stakeholder that incorporates stakeholder dynamics. This chapter addresses long-term stakeholder relations in its analysis. Focusing on a distinct type of stakeholder, Kevin Gibson contends, in Chapter 8, that firms should not always rely on stakeholder salience for determining strategic responses. Rather, Professor Gibson argues that even marginal stakeholders deserve attention by firms, if the definition of stakeholder is to be truly realized.

The last section of the volume focuses primarily on the two-way communication between stakeholders and the firm. In Chapter 9, Sefa Hayibor examines stakeholder responses to firm action, specifically revealing possible precursors of punitive and prosocial behaviors. Professor Hayibor offers several future avenues for research in this area of stakeholder action and reaction. Finally, the last chapter, written by Andrew Wicks and Jeffrey Harrison, closes the volume by looking at the history and interrelationship of stakeholder theory and strategic management in an effort to find convergence themes for future work in strategic stakeholder theory. This piece offers a vast potential research agenda that is integrative in scope and forward-looking in nature.

David M. Wasieleski  
James Weber  
*Editors*

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# Acknowledgments

The *BAS 360* book series is supported by the International Association for Business and Society (IABS). IABS is the premier international professional association of more than 300 educators from over 20 countries researching and teaching on the relationships between business, government and society, sustainability, and business ethics. In addition, there is support from the Palumbo-Donahue School of Business at Duquesne University: recognized as one of the top three American schools of business for its business ethics curriculum; ranked in the top 25 globally for its ethics, social issues and sustainability curriculum; ranked as the #2 business school in the United States and #3 globally for integrating sustainability into the academic experiences; one of the first 100 signatories of the United Nation's Global Compact Principles for Responsible Management Education. Finally, the co-editors of *BAS 360* acknowledge Mr. Gene Beard for his financial support provided through the Eugene P. Beard Faculty Resource Fund in Ethics at Duquesne University.

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## Chapter 1

# Five Challenges to Stakeholder Theory: A Report on Research in Progress

*R. Edward Freeman*

### Abstract

This chapter suggests that there are at least five main challenges to the development of stakeholder theory as it currently stands. We need more research on understanding what counts as the total performance of a business; accounting for stakeholders rather than accounting only for investors; explaining real stakeholder behavior; formulating smart public policy given stakeholder theory; and rethinking the basics of ethical theory. The chapter explains the issues involved in each challenge and suggests ways to meet the challenge. It is a preliminary report of research in progress as well as a blueprint for how others may join the conversation to develop a more useful stakeholder theory.

**Keywords:** Stakeholder management; stakeholder theory; value creation; public policy; stakeholder accounting; total performance

### Introduction

The body of research that has come to be known as “stakeholder theory” has grown enormously over the past 40 years. There are literally hundreds of articles and books devoted to some part of these ideas. In a recent book (Freeman, Harrison, Wicks, Palmer, & de Colle, 2010) that summarized stakeholder theory, my colleagues and I put together a bibliography that was 45 published pages long. A quick perusal of “stakeholder” yields over 47 million results when typed into Google, and over 1 million when Google Scholar is consulted. “Stakeholder management” yields over 4 million and

900,000, respectively, on Google and Google Scholar. “Stakeholder theory” in Google Scholar yields over 500,000 hits. There are many lines of work, some overlapping, some perpendicular, and some that offer novel, even seemingly indefensible, accounts of the main ideas. It is perhaps a fool’s errand to attempt to suggest that there are some overarching challenges to stakeholder theory. Nonetheless, the main point of this essay is to do just that.

Before setting forth these five challenges I want to clarify how I see stakeholder theory, as I have found that I may have a quite different interpretations of the main ideas than many others who write about it (Freeman, 2011; Freeman, Harrison, & Wicks, 2007). Then I will, in turn, and very briefly, set forth the five challenges which are: (1) The Total Performance Challenge; (2) The Stakeholder Accounting Challenge; (3) The Behavioral Stakeholder Theory Challenge; (4) The Public Policy Challenge; and (5) The Ethical Theory Challenge. I am currently engaged with a number of colleagues on joint research projects for each of these challenges. This chapter is a very brief report on this work in progress, and is also a very stylized account of both stakeholder theory and these challenges. In what follows I will do my best to represent their ideas as accurately as possible. Please note their contributions in the Acknowledgements section below. I find that I often get far too much credit for my own rather modest contribution many years ago. Stakeholder theory is alive and well because so many scholars are engaged in research that I believe will foster a generational change in the narrative of business.

## **What is Stakeholder Theory?**

The ideas behind the stakeholder concept are as old as business itself. Even though the word “stakeholder” has a fairly recent common usage, from the earliest beginnings, it is difficult to deny that business has been a matter of trade between buyers and sellers so that both were at least perceptually better off because of the exchange, even in times of barter societies. Exchange created value between the partners and led to specialization of labor, more knowledge and innovation, and hence more exchange. Eventually, employees were added, though during ancient times they had relatively little freedom. While the separation of ownership and control may well be rooted in feudal society, the emergence of wealthy merchants who often earned their profits on the backs of others has a long history. While value was often created, it was also sometimes destroyed, especially when trade-offs were made at the expense of one group, say employees, by favoring another, say owners. Business has always affected customers, suppliers, and employees and the owners of the business, even if value was sometimes destroyed for some. Even communities and governments have long been involved in value creation and trade. Fernand



Braudel's (1992) magisterial history of capitalism shows us the fiction that is free floating markets disconnected from the rest of society.

Companies incorporate offshore to minimize tax exposure. Managing the government or community relationship has been a part of value creation and trade from the very beginning.

The basic idea of “managing for stakeholders” or “value creation stakeholder theory”<sup>1</sup> is quite simple. Business can be understood as a set of value-creating relationships among groups that have a stake in the activities that make up the business. Business is about how customers, suppliers, employees, financiers (stockholders, bondholders, banks, etc.), communities, and managers interact and create value. To understand a business is to know how these relationships work. And, the executive's or entrepreneur's job is to manage and shape these relationships, hence the title “managing for stakeholders.”

To say that business is a set of interconnected relationships may well be controversial. Economists and others want to see business as a discrete set of economic transactions, where it is always possible to maximize expected value by taking a “future-forward” approach. “Business as relational” is a much more subtle idea. Relationships are not reducible to transactions. Much more research needs to be done in spelling out such a change in the fundamental vocabulary of business.<sup>2</sup>

The idea of “managing for stakeholders” is usually depicted in a variation of the classic “wheel and spoke” diagram with the corporation at the center (Freeman et al., 2007; Phillips, 2003). However, it is important to note that the stakeholder idea is perfectly general. Corporations are certainly not the center of the universe, and there are many possible pictures. One might put customers in the center to signal that a company puts customers as the key priority. Novo Nordisk, a diabetes drug company, puts “people with diabetes” in the center of its map. Another might put employees in the center and link them to customers and shareholders. Or, one might have no organization in the center to signify that this is an interconnected system of stakeholders. But, there is no larger metaphysical claim here. It depends on the purpose of the picture, or the problem that one is trying to solve.

## **Stakeholders and Stakes**

Owners or financiers (a better term) clearly have a financial stake in the business in the form of stocks, bonds, and so on, and they expect some kind of financial return from them. Of course, the stakes of financiers will

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<sup>1</sup>I use these terms interchangeably.

<sup>2</sup>I have begun this work of spelling out stakeholder theory as relational with Michelle Greenwood and Harry Van Buren in several forthcoming papers.

differ by type of owner, preferences for money, moral preferences, and so on, as well as by type of firm. The shareholders of Google may well want returns as well as be supportive of Google's articulated purpose of "Do No Evil." To the extent that it makes sense to talk about the financiers "owning the firm," they have a concomitant responsibility for the uses of their property. Stout (2012) has argued that depicting "shareholders" as "owners" is at best misleading, and from a legal point of view, simply incorrect. And, it is equally a mistake to believe that financiers' interests can be considered solely in their own right. As with every stakeholder, financiers are connected to customers', employees', suppliers', and communities' interests as well. Stakeholders are interconnected. They have joint interests.

Employees have their jobs and usually their livelihood at stake; they often have specialized skills for which there is usually no perfectly elastic market. In return for their labor, they expect security, wages, benefits, and meaningful work. Employees often want to find meaning at work, and to participate in the decision-making. In today's world, employees who are engaged in the business are much more likely to produce good results for themselves and the other stakeholders. And, employees are sometimes financiers as well, since many companies have stock ownership plans, and loyal employees who believe in the future of their companies often voluntarily invest.

Customers and suppliers exchange resources for the products and services of the firm and in return receive the benefits of the products and services. As with financiers and employees, the customer and supplier relationships are enmeshed in ethics. Companies make promises to customers via their advertising, and when products or services do not deliver on these promises then management has a responsibility to rectify the situation. It is also important to have suppliers who are committed to making a company better. If suppliers find a better, faster, and cheaper way of making critical parts or services, then both supplier and company can win. Of course, some suppliers simply compete on price, but even so, there is a moral element of fairness and transparency to the supplier relationship. For businesses in the 21st century, the supply chain from customers to suppliers is often integrated into the operations of the business. Many of these supply chains have impacts on the natural environment, and there has been a great deal of innovation in business in mitigating the effects of global supply chains.

Finally, the local community grants the firm the right to build facilities, and in turn, it benefits from the tax base and economic and social contributions of the firm. Companies have a real impact on communities, and being located in a welcoming community helps a company create value for its other stakeholders. In return for the provision of local services, companies are expected to be good citizens, as is any individual person. It should not expose the community to unreasonable hazards in the form of pollution, toxic waste, etc. It should keep whatever commitments it makes to the

community, and operate in a transparent manner as far as possible. Of course, companies do not have perfect knowledge, but when management discovers some danger or runs afoul of new competition, it is expected to inform and work with local communities to mitigate any negative effects, as far as possible. “Community” is an ambiguous term. Some companies define it narrowly to mean only those places where they have facilities. Others define it broadly to include the communities where their suppliers are located. And, some even define community more globally to include billions of people who may use their products or be affected by them.

Oftentimes, management theorists overemphasize the role of definition in theories or frameworks. As a pragmatist philosopher, I believe that definitions often lack precision, and that this is a good feature of language for most purposes. For instance, much is written about the definition of “stakeholder.” “Does it include NGOs or competitors? Yes or No? Once and for all, let’s get it right,” they say. My response is that it depends on what problem you are trying to solve. For certain problems, like governance at the board level, you may want a narrow definition, while for some societal problems, you may want a broader one. There is no one right definition, as the definition in use depends on the problem one is trying to solve, whether theoretical or practical.

First of all we could define the term fairly narrowly to capture the idea that any business, large or small, is about creating value for “those groups without whose support, the business would cease to be viable.” Almost every business is concerned at some level with relationships among financiers, customers, suppliers, employees, and communities. We might call these groups “primary” or “definitional.” However, it should be noted that as a business starts up, sometimes one particular stakeholder is more important than another. In a new business start-up, sometimes there are no suppliers, and therefore paying a lot of attention to one or two key customers, as well as to the venture capitalist (financier), is the right approach.

There is also a somewhat broader definition that captures the idea that if a group or an individual can affect a business, then the executives must take that group into consideration in thinking about how to create value. Or, a stakeholder is any group or individual that can affect or be affected by the realization of an organization’s purpose.

Much value can be gained by examining how the stakes work in the value creation process and what the role of the executive is.

Executives play a special role in the activity of the business enterprise. On the one hand, they have a stake like every other employee in terms of an actual or implied employment contract. And, that stake is linked to the stakes of financiers, customers, suppliers, communities, and other employees. In addition, executives are expected to look after the health of the overall enterprise, to keep the varied stakes moving in roughly the same direction, and to keep them in balance.

No stakeholder stands alone in the process of value creation. The stakes of each stakeholder group are multi-faceted, and inherently connected to each other. How could a bondholder recognize any returns without management paying attention to the stakes of customers or employees? How could customers get the products and services they need without employees and suppliers? How could employees have a decent place to live without communities?

Stakeholder interests are joint. That is why business works. Many theorists argue that stakeholder interests are essentially in conflict, but this misses the basic idea of capitalism. It is a system of cooperation whereby customers, suppliers, employees, communities, and financiers cooperate together to create value that no one of these groups could create alone. The primary responsibility of the executive or the entrepreneur is to create as much value as possible for stakeholders. (And this directive is at least as clear as the one given by the dominant model to maximize shareholder value.) Where stakeholder interests conflict, the executive must find a way to rethink the problems so that these interests can go together, so that even more value can be created for each. If trade-offs have to be made, as often happens in the real world, then the executive must figure out how to make the trade-offs, and immediately begin improving the trade-offs for all sides. *Managing for stakeholders is about creating as much value as possible for stakeholders, without resorting to trade-offs.*

To create value for stakeholders, executives and entrepreneurs must see business as fully situated in the realm of humanity. Businesses are human institutions populated by real live complex human beings. Stakeholders have names and faces and children. They are not mere placeholders for social roles. Most human beings are complicated. Most of us do what we do because we are self-interested and interested in others. Business works in part because of our urge to create things with others and for others. Working on a team, or creating a new product or delivery mechanism that makes customers' lives better or happier or more pleasurable all can be contributing factors to why we go to work each day. And, this is not to deny the economic incentive of getting a pay check. The assumption of narrow self-interest is extremely limiting, and can be self-reinforcing—people can begin to act in a narrow self-interested way if they believe that is what is expected of them, as some of the scandals, such as Enron, have shown. We need to be open to a more complex psychology—one any parent finds familiar as they have shepherded the growth and development of their children.

With these preliminaries about how I see stakeholder theory, I want to introduce five challenges to value creating stakeholder theory (VCST). If you have a different view of stakeholder theory, for instance, that it is incompatible with currently received theory in strategic management or economic theory, then you will reject these challenges, and instead substitute some very different ones.

## The Total Performance Challenge

Do profits measure the total performance of a business? Jones and Freeman (2013)<sup>3</sup> argue that the pursuit of profitability does not always lead to the greatest wealth creation and that we need to reexamine the very nature of how we determine firm performance. One of the most general forms of the problem is revealed in the following fundamental questions:

1. What is the total performance of any business?

While an answer to this question will be the result of much research and critical thinking in the disciplines of business, we shall argue that it is in fact a tractable question. VCST suggests that any business generates effects on its customers, suppliers, employees, shareholders, and communities. We might state this as:

TVC = Total Value Created  
CU = Total Value Created for Customers  
SU = Total Value Created for Suppliers  
FI = Total Value Created for Financiers  
EM = Total Value Created for Employees  
CO = Total Value Created for Communities.

Thus:

$$\text{TVC} = f(\text{CU}, \text{SU}, \text{FI}, \text{EM}, \text{CO})$$

where “ $f$ ” is a complex function that combines the value created for each stakeholder into a measure of total value creation. One way to specify “ $f$ ” would be through the use of normal accounting and financial data. The well-documented problem here is that many externalities are not captured in the conventional systems. Furthermore, conventional accounting systems are aimed at securing data for investors where some measures like profitability (or Free Cash Flow, or EBITDA, etc.) may capture well enough the value created for shareholders. We might think about “ $f$ ” with respect to a particular issue or decision. For each decision that a company faces we could think about how that decision creates value for particular stakeholders. The difficulty, in the real world, is that unlike in neat theoretical models,

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<sup>3</sup>This section is based on T. Jones and E. Freeman (2013), “Sustainable Wealth Creation,” working paper at University of Washington and University of Virginia.

decisions do not often come in such discrete packages, and even if they did, most stakeholders have a sense of history and a sense of the future.

2. What are the conditions for specifying the total performance function “ $f$ ”?

Another and more general way to think about “ $f$ ” is that it is a “business model” that takes the interests of each stakeholder and puts them together in a way that creates (or destroys) wealth for the entire set. In such business models, “ $f$ ” is seen in relational terms. It is about how a business, over time, creates value for its stakeholders. This idea is partially captured in [Dyer and Singh \(1998\)](#) but only to the extent that resources are seen as existing over time. These authors also presuppose that pursuit of profits is best, and that profits measure total firm performance.

Once we begin to think in relational terms, it is easier to see that stakeholder interests are joint. Obviously, we can improve value for financiers by improving value for customers. When a supplier suggests more efficient means of supply chain management, it can improve value for customers, suppliers, employees, and financiers. When these efficiencies also create a less potent waste stream or a better transportation plan, value can be created for communities as well. This gives rise to a third question.

3. How is each of the terms of “ $f$ ” related to the others?

We might express this jointness relation in the following way.

$$CU = g(SU, FI, EM, CO, X)$$

where “ $g$ ” determines how the interests of suppliers, shareholders, employees, and communities interact with the interests of customers, and  $X$  is an interaction term that is not fully captured in the total value created for the other stakeholders. There are similar equations for the total value created for each of the other stakeholder groups, leading to the following question.

4. How do we measure the total value created for each stakeholder?

The total value created for each stakeholder is best expressed as a multivariate function that includes variables that have meaning for stakeholders and that can potentially be measured. Hence, for example:

$$CU = h(CU1, CU2, CU3, \dots, CU_n)$$

where “CU1” might be a standard variable like *price*, and “CU2” might be a variable that measures *quality*, and “CU3” might be a variable that measures *fairness in the relationship*, and so on. There are no boundaries on the kinds of variables that a stakeholder may use to determine the value created. Ultimately, we may want to rethink the standard system of accounts to reflect the actual total performance of a company, but our task here is to set out a “possibility argument.”

This general argument is not as far-fetched as the conventional mechanisms for measuring corporate performance might indicate. Every serious marketing company that we know spends a great deal of time and money trying to figure out the function “CU.” Many companies try to determine the function “EM” as well. And, of course it is assumed that some notion of profitability measures the function “FI.” What is less pedestrian is the totality of value created, TVC, or the function “*f*” that we have designated the business model.

Even with this skeletal notation, we can set forth at least three different kinds of business models, or variations of “*f*,” that will help us understand how total wealth creation can be reinterpreted in terms of value creation for stakeholders.

First, we can increase TVC by increasing the value to some stakeholders and decreasing the value to others. Such “trade-off functions” represent one major way of thinking about value creation, such as Kaldor functions (Jones et al., 2016). A second method would be to improve value for one group and not decrease the value for others, such as Pareto functions. Or we can increase TVC by increasing the value for each stakeholder. The key variable here is the imagination of the participants in the value creation process. Given the set of alternatives at a particular time, it may not be possible to find a solution that increases value to all stakeholders, or even a Pareto solution. When this occurs, the participants need to reimagine the space of outcomes. This can happen in several ways.

First, each participant may well redefine what counts as value creation. Perhaps there is another way to interpret, for instance, CU so that a new aspect of CU, say  $CU_i$ , creates value in a way that was unseen. Indeed, Priem (2007) discusses ways to discover unrecognized value with respect to customers. Figure 1a suggests that there are many paths to the trade-off frontier which create value for both X and Y. As we get closer to the trade-off frontier, the possibilities for creating value for both X and Y diminish; creating value for one at the expense of the other becomes increasingly necessary.<sup>4</sup> Obviously, on the actual frontier, X gains only at the expense of Y

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<sup>4</sup>The spirit of this move is what Hayek (1996) and the other members of the “Austrian School” mean when they suggest that an economy is never “in equilibrium” and that the best we can say is that it moves towards equilibrium.

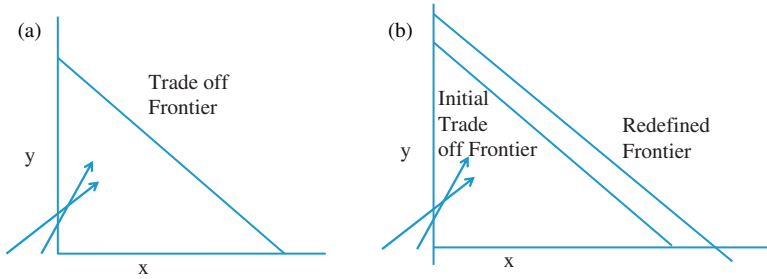


Figure 1: (a) Getting to Trade-offs. (b) Redefining Trade-offs.

and vice versa; we called these wealth transfers above. In Figure 1b, stakeholders X and Y have figured out a way to create even more value and avoid a frontier trade-off. In the real world, such redefinitions and reimaginings happen all the time, and sometimes getting close to uncomfortable trade-offs that are unacceptable to both parties has the effect of producing new thinking that creates more wealth for both. Simply accepting the priority of one particular set of interests over another does not create as much wealth as is possible.

## The Stakeholder Accounting Challenge

This first challenge, or trying to understand how to state and study the total performance of a business, naturally leads to another challenge. The very data that we rely on to study businesses is in part infected with the old narrative, rather than VCST. Hence we have an accounting challenge as well.

Mitchell, Greenwood, van Buren, and Freeman (2015) edited a special issue of *The Journal of Management Studies* to address this issue. Mitchell et al. (2015) propose replacing the standard “entity convention” in accounting with a concept known as the “proprietary convention” (Goldberg, 1965; Riahi-Belkaoui, 2004). The proprietary convention is a generally accepted method for partnership accounting, and they argue that this has a better fit with the idea that stakeholder interests are joint and that value is jointly created by them. They suggest that such a convention can be used to include more stakeholders “in the accounting records of the firm because essentially, *partnership accounting permits share of ownership and share of distribution to be different*, a quality that has dramatic ramifications for the practicality of stakeholder accounting.”

Mitchell et al. (2015) argue that there are four fundamental premises that must be reflected in any method of stakeholder accounting that is developed. These premises encapsulate the following ideas:



1. Business is an activity among multiple stakeholders that creates value and sometimes destroys it for these stakeholders.
2. Stakeholder interests need to be harmonized (Mitchell et al. call this the alignment premise), so that activities can simultaneously make all better off.
3. The interaction of ideas such as purpose, innovation, and ethics must be a part of the accounting system.
4. Since value creation for one group implies value creation for others, “*Reporting* at its core is intended to provide a means whereby the summarized information that produces accountability can be reported in such a way that the collaborating parties receiving the accounting reports can evaluate their risks and apportion rewards.”

While this research is in the beginning stages, it builds on related ideas in “social accounting,” “triple bottom line,” and “the balanced scorecard,” but it puts the principles of VCST in center stage, rather than forming an “investor centered” approach. There is much more work to be done here.

## **The Behavioral Stakeholder Theory Challenge**

The current narrative about business is filled with models of investor and manager behavior. There is a growing trend to study the actual behavior of investors, in behavioral economics and finance. We need a similar set of studies around other stakeholder behavior. While there is some work in marketing and management, there is relatively little work that adds “ethics and values” explicitly into the equation. Wouldn’t it be interesting to study consumers as if they were moral agents? How would we understand their behavior as moral agents? What about customers who are also employees and owners? Is their behavior different from those who are customers only?

There are numerous questions that come to mind when we add the human/moral element and the idea of stakeholders and multiple stakeholder roles to behavioral theory. My colleagues, Adrian Keevil at PlusTick Partners, Bidhan Parmar at Virginia, and Kirsten Martin at George Washington University, as well as many others are undertaking many studies that use stakeholder theory as an underpinning/unit of analysis for this new behavioral approach. Just as the groundbreaking work of economists and psychologists such as Daniel Kahneman and Thomas Schelling has yielded many insights into real human behavior in economics, these theorists will also build a better version of stakeholder theory.

One project which has begun to show some results is that on public trust. After an initial report done for the Business Roundtable Institute for

Corporate Ethics,<sup>5</sup> a number of studies were designed to study whether or not there was a difference in the public trust of business and stakeholder trust of business. For instance, the public may well distrust business as an institution, but if you ask whether or not they trust the businesses that they do business with in some stakeholder role, the answer may well be different.

This challenge to stakeholder theory is part of a larger challenge to reorient and redefine the disciplines of business in more stakeholder-oriented terms. If we eschew the separation fallacy, we can ask questions such as: What is the role of finance in society? How would marketing change if we saw customers as moral agents and brands as promises? What we do differently in operations management if we took a more human view of human beings? There is much work on these questions, and the gradual construction of a new narrative of business will highlight many long forgotten and useful ideas.

## **The Public Policy Challenge**

The recent global financial crisis has generated a groundswell of public and political opinion about the state of business around the globe. Questions include:

What is the proper role of government in regulating business? What should be done about regulatory failure? Is there too much reliance on free markets in industries as diverse as autos and health care? How should executive pay, especially for bankers, be regulated? Are we seeing a foundational shift from a reliance on free markets to a more socialist view of society?

Clearly there are multiple causes of the global financial crisis, just as there will be regulatory reform and a backlash of public distrust of business. Unfortunately, the public debate and the political action that will surely result are both based on a faulty understanding of the essence of business and capitalism. This old and shopworn model of business suggests that the secret to capitalism is that business people can maximize the returns to the owners of capital. And, by focusing on such maximization, they will lead to the greatest good for society. Capitalism works on this view because of the self-interest of economic actors, and their desire to compete and win in the battle that is business. Successful businesses, and business people, act in their own self-interest, and with proper incentives,

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<sup>5</sup>This report is available at <http://www.corporate-ethics.org/>

maximize the returns to shareholders, or other financiers, and they seek to beat their competitors.

Indeed, it is this very faulty theory that led the world to the brink of financial collapse. Trying to patch it up with regulatory reform, or defining “proper incentives,” is, at best, an exercise in futility, and at worse, likely to lead to even further damage. It is an arguable point that the last response to crisis, at least in the United States, the Sarbanes–Oxley Act, was partially responsible for the current one. Escaping this cycle of futility should be a major concern for business theorists and policy makers. While that is not likely to occur, I do want to argue that scholars working in the area of business and society should contribute to this important discussion.

One potential project in this area could be called “the business models project.” The purpose of this project would be to examine what companies say about their stakeholder relationships in their public statements. In other words, do companies actually claim to maximize value for shareholders or do they claim to create value for stakeholders. Of course even if the latter is true they may be engaging in bad faith or self-deception, but such a demonstration may well shift the burden of proof to those who claim the dominant narrative as fact rather than ideology.

A second project in this area could examine executive compensation, which is an issue that triggers public distrust. If we take the stakeholder idea seriously, and if we work on the first challenge, we might begin to conceptualize executive compensation along the lines of “stake options” (Freeman, 2016). Such an option would be at least a five-term function that measured how well a company was doing with customers, suppliers, employees, communities, and financiers. For simplicity’s sake assume that each measure is a satisfaction measure (in reality, it would be more complex). Then, an option would vest when, for instance, employee satisfaction reached a certain level. Even if the initial implementation of stake options were perceptual measures that could be tracked and improved over time, we would have alignment between creating value for stakeholders and executive compensation. There could also be a secondary market (at least a Las Vegas style one) for these options.

We need to come to see governments and civil society institutions as part of the value creation process. Of course, government plays a redistributive role and a role as referee, but it can also play a role in facilitating value creation. For instance, educational campaigns on preventing smoking add a lot of value to society for very little costs. A similar campaign to build a generation of entrepreneurs would boost our ability to create value for each other. In addition, focusing on infrastructure and innovation can lead to facilitating a great deal of value creation. We need a new narrative about the role of government as facilitator of value creation in addition to its traditional roles as redistributor and regulator. Again, there is much work to be done here.

## The Ethical Theory Challenge<sup>6</sup>

Once you say stakeholders are persons, then the ideas of ethics are automatically applicable. However you interpret the idea of “stakeholders,” you must pay attention to the effects of your actions on others. There are at least three main arguments for adopting a managing for stakeholders approach. Philosophers will see these as connected to the three main approaches to ethical theory that have developed historically. Some philosophers have argued that the stakeholder approach is in need of a “normative justification.” To the extent that this phrase has any meaning, we take it as a call to connect the logic of managing for stakeholders with more traditional ethical theory. As pragmatists, we eschew the “descriptive vs. normative vs. instrumental” distinction that so many business thinkers (and stakeholder theorists) have adopted. Managing for stakeholders is inherently a narrative or story that is at once: *descriptive* of how some businesses do act; *aspirational* and *normative* about how they could and should act; *instrumental* in terms of what means lead to what ends; and *managerial* in that it must be coherent on all of these dimensions and actually guide executive action. We shall briefly set forth sketches of these arguments, and then suggest that there is a more powerful fourth argument.

### The Argument from Consequences

A number of theorists have argued that the main reason that the dominant model of managing for shareholders is a good idea is that it leads to the best consequences for all. Typically, these arguments invoke Adam Smith’s idea of the invisible hand, whereby each business actor pursues her own self-interest and the greatest good of all actually emerges. The problem with this argument is that we now know, with modern general equilibrium economics, that the argument only works under very specialized conditions that seldom describe the real world. And further, we know that if the economic conditions get very close to those needed to produce the greatest good, there is no guarantee that the greatest good will actually result.

Managing for stakeholders may actually produce better consequences for all stakeholders because it recognizes that stakeholder interests are joint. If one stakeholder pursues its interests at the expense of all the others, then the others will either withdraw their support, or look to create another

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<sup>6</sup>The material in this section is from Freeman (2009). The author holds the copyright on this paper so it is partially reprinted here with permission.

network of stakeholder value creation. This is not to say that there are not times when one stakeholder will benefit at the expense of others, but if this happens continuously over time, then in a relatively free society, stakeholders will either (1) exit to form a new stakeholder network that satisfies their needs; (2) use the political process to constrain the offending stakeholder; or (3) invent some other form of activity to satisfy their particular needs (Harting, Harmeling, and Venkataraman, 2006; Velamuri, 2002; Venkataraman, 2002).

Alternatively, if we think about stakeholders engaged in a series of bargains among themselves, then we would expect that as individual stakeholders recognized their joint interests, and made good decisions based on these interests, better consequences would result, than if they each narrowly pursued their individual self-interests. Sometimes there are trade-offs and situations that economists would call “prisoner’s dilemma” but these are not the paradigmatic cases, or if they are, we seem to solve them routinely, as Russell Hardin (1998) has suggested.

Now it may be objected that such an approach ignores “social consequences” or “consequences to society,” and hence, we need a concept of “corporate social responsibility” to mitigate these effects. This objection is a vestigial limb of the dominant model. Since the only effects, on that view, were economic effects, we need to think about “social consequences” or “corporate social responsibility.” However, if stakeholder relationships are understood to be fully embedded in morality, there is no need for an idea like corporate social responsibility. We can replace it with “corporate stakeholder responsibility” which is a dominant feature of managing for stakeholders.

## **The Argument from Rights**

The dominant story gives property rights in the corporation exclusively to shareholders, and the natural question arises about the rights of other stakeholders who are affected. One way to understand managing for stakeholders is that it takes this question of rights, seriously. If you believe that rights make sense, and further that if one person has a right to X then all persons have a right to X, it is just much easier to think about these issues using a stakeholder approach. For instance, while shareholders may well have property rights, these rights are not absolute, and should not be seen as such. Shareholders may not use their property to abridge the rights of others. For instance, shareholders and their agents, managers, may not use corporate property to violate the right to life of others. One way to understand managing for stakeholders is that it assumes that stakeholders have some rights. Now it is notoriously difficult to parse the idea of “rights.” But, if executives take managing for stakeholders seriously, they will automatically think

about what is owed to customers, suppliers, employees, financiers, and communities, in virtue of their stake, and in virtue of their basic humanity.

### **The Argument from Character**

One of the strongest arguments for managing for stakeholders is that it asks executives and entrepreneurs to consider the question of what kind of company they want to create and build. The answer to this question will be in large part an issue of character. Aspiration matters. The business virtues of efficiency, fairness, respect, integrity, keeping commitments, and others are all critical in being successful at creating value for stakeholders. These virtues are simply absent when we think only about the dominant model and its sole reliance on a narrow economic logic.

If we frame the central question of management as “how do we create value for shareholders?,” then the only virtue that emerges is one of loyalty to the interests of shareholders. However if we frame the central question more broadly as “how do we create and sustain the creation of value for stakeholders?” or “how do we get stakeholder interests all going in the same direction?,” then it is easy to see how many of the other virtues are relevant. Taking a stakeholder approach helps people decide how companies can contribute to their well-being and kinds of lives they want to lead. By making ethics explicit and building it into the basic way we think about business, we avoid a situation of bad faith and self-deception.

### **The Pragmatist’s Argument**

Much of modern business ethics is built on the traditional “big three” theories in the Anglo/analytic tradition in philosophy. Consequentialism, deontology, and virtue theory have colonized much of what philosophers have written about the problem of the ethics of capitalism. Happily there are signs of change as many management theorists are becoming engaged in the project, and some so-called “continental philosophers” have added their voice, especially scholars such as Mollie Painter Morland and Rene Ten Bos. And, a more careful look at the impressive record of Robert Solomon makes these distinctions very difficult to continue to hold.

As many modern pragmatists such as Richard Rorty have suggested, the so-called Big Three of ethical theories are at best partial and often not very useful tools for ethical thinking and action. I want to take this argument further. The previous three arguments point out important reasons for adopting a new story about business. Human beings have been value creators and traders for millennia; however, there is very little mention of

“business” in most of our ethical and political theory. What if the first question of political philosophy were “how is value creation and trade sustainable over time?” rather than “how is the state justified?” What if we focused on how the narrative of stakeholder theory could affect our conception of the self? These and similar questions need to be addressed. Too much of the current writing adopts the Separation Fallacy in the form of “the business sucks story.” There is an assumption that business is somehow disconnected from morality both in practice and in theory. Nothing short of a wholesale revision of ethical theory will begin to address this problem. Thankfully, there is a place to start in pragmatism, even though these theorists, like many of their post-modern and critical studies colleagues, in fact adopt the business sucks narrative.

There is a long tradition of pragmatist ethics dating to philosophers such as William James and John Dewey. More recently philosopher Richard Rorty has expressed the pragmatist ideal (Mendieta, 2006, p. 68):

[...] pragmatists [...] hope instead that human beings will come to enjoy more money, more free time, and greater social equality, and also that they will develop more empathy, more ability to put themselves in the shoes of others. We hope that human beings will behave more decently toward one another as their standard of living improves.

Pragmatists want to know how we can live better, how we can create both ourselves and our communities in such a way that values such as freedom and solidarity are present in our everyday lives to the maximal extent. While it is sometimes useful to think about consequences, rights, and character in isolation, in reality our lives are richer if we can have a conversation about how to live together better. By building into the very conceptual framework we use to think about business a concern with freedom, equality, consequences, decency, shared purpose, and paying attention to all of the effects of how we create value for each other, we can make business a human institution, and perhaps remake it in a way that sustains us.

For the pragmatist, business (and capitalism) has evolved as a social practice; and an important one that we use to create value and trade with each other. On this view, first and foremost, business is about collaboration. Of course, in a free society, stakeholders are free to form competing networks. But, the fuel for capitalism is our desire to create something of value, and to create it for ourselves and others. The spirit of capitalism is the spirit of individual achievement, together with the spirit of accomplishing great tasks in collaboration with others. Managing for stakeholders makes this plain so that we can get about the business of creating better selves and better communities.

In general, we need to end the hegemony of the economic person that is so prevalent in business theory, and that of the political/ethical person that is prevalent in ethics and political theory. In fact, human beings are pretty complicated. We use reason and we have values. We have emotions and we have a history. We are relational, sexual, spiritual, and social, as well as individual. We have aspirations for ourselves and others, especially our families. We want to be a part of something larger than ourselves to create some sense of purpose. We want to master our environment and we want autonomy and connection. We want to live in an authentic way, but such authenticity is a project, as Sartre, de Beauvoir, and their followers remind us. We cannot forget about the constant specter of bad faith and self-deception. Business ethics needs to look less like Kant and more like Foucault; less like Maslow and more like Freud and his followers; less like general equilibrium theory and more like Amartya Sen's *The Idea of Justice*; less like the abstract theory of journal articles and more like the nuanced reporting of Michael Lewis. We need new theory, but it must be based on some ideas that at once are descriptive and aspirational for the way we create value and trade with each other. I want to suggest that putting stakeholder theory at the center of this revision is one way (not the only one) forward.

## **Conclusion**

There are a number of challenges to the ideas in what has come to be called stakeholder theory, and there are existing lines of research to garner insight into these challenges. We need a much more nuanced view of how to measure total performance and how to account for the variety of stakeholder relationships that exist for twenty-first-century businesses. We need to understand how real stakeholder relationships evolve, the causes of actual behavior, as well as the mechanisms for a public policy that encourages business people to create organizations that make our world better. Finally, we must address the fundamental challenge of doing ethics in a different way. Ethics is fundamentally the conversation we have about how we are going to live together. Stakeholder theory is a central part of that conversation just as ethics is a central part of stakeholder theory. There is much work to be done.

## **Acknowledgments**

I have a number of co-authors and colleagues who have helped me with these ideas, and I have drawn heavily on a number of joint papers with



them. I would like to thank them for permission to develop these ideas in the current form. In particular, thanks to Tom Jones of University of Washington, Michelle Greenwood of Monash University, Harry van Buren of University of New Mexico, Ron Mitchell of Texas Tech University, Adrian Keevil of PlusTick Partners, Rob Phillips of University of Richmond, and Bidhan Parmar at Darden. Portions of the Introduction and the section on Ethical Challenges are from Freeman (2009), copyright held by the author.

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