Educational Administration: Theory and Practice
2023, 29(2), 756-759
ISSN:2148-2403
https://kuey.net/
Research Article

Stakeholder Theory and its Importance

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Citation: Dheeraj Chilamakuri et al. (2023), Stakeholder Theory and its Importance, *Educational Administration: Theory and Practice*, *29*(2), 756-759
Doi: 10.53555/kuey.v29i2.9115

ARTICLE INFO **ABSTRACT**

Every organization created has a purpose. The purpose of a for-profit organization is to maximize wealth, while a non-profit's goal is to help its target group of people. Initially, before the development of stakeholders theory, organizations usually thought about their shareholders, but this idea was changed after the introduction of stakeholder theory by R. Edward Freeman. He is the first to identify the importance of maintaining a solid relationship with its customers, employees, vendors that supply resources to the company, the communities that depend on the organization, and its investors.

If a company wants to prosper, it must start accepting the importance of engaging with stakeholders rather than focusing only on shareholders. Engaging with stakeholders has many advantages. The most significant advantage of engaging with stakeholders is establishing excellent communication channels. With incredible communication channels, we can acquire all the right information for developing or updating a product, correcting the direction in which the company is moving, or strategic planning. If an organization engages with the stakeholders, there is an increased buy-in from its employees, so productivity increases, and the company's value also increases. In this paper, the authors will define the words Stakeholder and stakeholder theory and discuss stakeholder theory's relation to corporate social responsibility, Value Creation, Finance, and ethics.

Keywords: Stakeholder theory, corporate social responsibility (CSR), value creation, ethics, capitalism, stakeholder relationships, financial performance, corporate governance, business ethics, and stakeholder engagement.

Purpose of Research:

Some areas in stakeholder theory are very unclear, particularly in defining the roles of different stakeholders involved. The problem with not understanding Stakeholder theory is not rooted only in management. Still, it is more rooted in how capitalism is perceived and how capitalism and Stakeholder theory concepts can co-exist in near-perfect harmony. The

primary purpose of this paper is to identify the areas where the principles can be applied what kind of gaps exist. How much new evidence can we produce to support the importance of stakeholder theory and why it should be used by every organization or every project an organization is starting?

Literature Review:

The term stakeholders has been defined in multiple ways by multiple authors. For this research paper, I adopted the definition given by Mr. R. Edward Freeman (1984) in his book Strategic Management: A Stakeholder Approach. In his book, he defined Stakeholders as "any group or individual who can affect or is affected by the achievement of the organization's objectives" (Freeman, 1984). If we further examine the stakeholders and who they are, we can classify them into Internal and External. Each Stakeholder has a different role in the functioning and success of an organization. The Stakeholder theory explains the relations between the stakeholders and the organization.
The Stakeholder theory of the firm states that "corporations serve a broad public purpose: to create value for society" (Anne Lawrence, 2020). The stakeholder theory describes many concepts and their interrelations. "Stakeholder theory is not a single theory per se but an amalgamation of eclectic narratives which has emerged from and is subject to multiple interpretations and applications from business ethics and corporate social

responsibility to strategic management, corporate governance, and finance" (Miles, 2017). Many authors argue that stakeholder theory is vague, and this vagueness is the main limitation when applying it to the real world. There has been a battle between shareholder theory and stakeholder theory. The cause of this conflict is rooted in the economics of the organization. "Shareholder primacy was justified because, without some heightened protective position of the shareholder, no one would feel comfortable contributing equity capital to a new venture" (Goossen, 2017). Essentially, a person investing money in a corporation wants to maximize one's wealth. This argument further leads to the concept of balancing wealth maximization while being socially responsible.

In some cases, a company's social responsibility can lead to missed opportunities for wealth maximization and vice versa. Now, the company's investors have to unitedly in which direction they would like to move forward. Setting the company's approach can help in balancing these opposing forces. If we do not strike a balance between these opposing forces, the organization will have financial and reputational losses. This leads to a decrease in brand value and might also cause irreparable damage to the company and society.

Stakeholder Theory and Ethics:

"Most strategic management scholars originally did not embrace stakeholder theory because of the perception that a higher level of morality in business would necessarily lead to lower financial performance" (Jeffrey Harrison, 2019). We often see that higher morality leads to fewer financial returns in many companies whenever a company gets into trouble for doing something not technically illegal yet morally wrong. Jeffery Harrison et al., in their paper Instrumental Stakeholder Theory Makes Ethically Based Relationship Building Palatable to Managers Focused on the Bottom Line suggested the following benefits to following the stakeholder theory (Jeffrey Harrison, 2019):

a. Improved reciprocal coordination,
b. Better knowledge sharing,
c. Attraction of stakeholders that are better able to contribute to the creation of joint value,
d. A higher level of moral motivation
e. Lower transaction costs.

A company with a strong bond with its stakeholders usually performs better in the long term when compared with companies that do not follow the shareholder theory. The authors recognize that a company cannot follow all the points mentioned above perfectly, but it would still enjoy the same benefits when trying to follow this path. A company can be motivated to pursue a strong relationship with its stakeholders for extrinsic and intrinsic reasons. The extrinsic and intrinsic motivations can be complementary to each other. Once managers of a company realize the value drawn by creating a solid relationship with its stakeholders, even the managers who are only motivated by the bottom line will also continue to maintain Stakeholder management as part of the organization's culture.

One more ethical debate surrounding the stakeholder theory is that, in the cut-throat market conditions, a company that chooses to pursue close Stakeholder relations might threaten the financial performance and affect a company's survival. In these cases, the organization's leaders should be careful about how they want to proceed. The authors will not say naively that the company should always prioritize external solid stakeholder relations over the company. End of the day, the company is still responsible for showing profits to its investors or shareholders and the people working for the company. So, when the company's survival is balanced, the executive leaders should step forward to do what is morally right.

The authors acknowledge that stakeholder theory can be directly in conflict with capitalism. Capitalism can be defined loosely as developing a product to maximize investors' wealth. The authors put forth evidence that strong bonds with all stakeholders can also help increase the investor's wealth, create new opportunities, and improve the organization's value. While living in a capitalist world, the authors acknowledge that some value is monetary, but not all value is monetary. This is the fine line managers, which many executive leaders of a company fail to recognize, causing the organizations to fall long-term.

Shareholder Theory and Corporate Responsibility:

Corporate Social Responsibility (CSR) is something most corporations are engaging in. The CSR is released annually or in a set period set by a company to show how it plans to give back to the communities that helped them build the company. When CSR was very new, many people opposed it because it violated the free-market ideology. This anti-CSR ideology is followed by people who call themselves 'free-market champions' started by Prof. Milton Friedman from the University of Chicago. "Prof. Friedman argued that by using corporate resources to solve non-business 'social' problems, the executives engaging in CSR were stealing from shareholders" (R. Edward Freeman, 2017). They argue that the funds gained by doing business belong to the investors, and utilizing them for non-business-related issues like social issues is fundamentally wrong.

Companies are, in every case, part of society. The Stakeholder theory highlights that the importance of businesses lies in making money and building associations with all stakeholders, no matter how that stakeholder structure is, as typically, this structure shifts depending upon the industries, plan of action, and business operations. Various Stakeholders do not need to be seen by positioning their significance; however, tracking down ways of centering their inclinations in a similar heading. From the stakeholder hypothesis point of view, each association should act in light of a legitimate concern for all stakeholders. Regarding corporate social obligation, the idea is centered around the company's operations towards the general public; for example, CSR centers around one stream of business obligations towards neighborhood networks and society in general. For the most part, while discussing how an association should act, two methodologies (models) are created in the stakeholder hypothesis. The primary instrumental methodology underlines that a significant dynamic rationale in an organization is a market achievement. The organization needs to utilize every one of the variables accessible in its current circumstance to accomplish better monetary outcomes. The second normative methodology is about the ethical commitments towards its stakeholders, which the enterprise should regard legitimately, no matter the instrumental worth of the stakeholders for the organization.

There is little clarity on how CSR and Stakeholder theory are related. We can view CSR as an umbrella covering concepts like corporate citizenship, corporate social responsiveness, corporate accountability, triple bottom line, and many more. All these concepts try to broaden an organization's obligations along with finances. CSR's main limitation is that it cannot explain how to create value. Adding social responsibility to businesses increases the conflict of business interests and ethics.

Stakeholders are interdependent. We can all agree that the companies are involved in a trade-off. A company trades a resource for a different resource. The authors believe there will be lower returns when a company focuses more on social responsibilities and vice versa. “These are false dichotomies. What is omitted in this logic is that stakeholders are interdependent and creating value for one Stakeholder also contributes to creating value for others” (R. Edward Freeman, 2017). The authors believe that CSR and financial consciousness should be blended and carried out. If one is favored more than the other, this will threaten an organization's existence.

The authors believe that any arrangement of activities for any stakeholder has a mix of monetary and moral outcomes. One can expand profits for shareholders or serve communities for normative and instrumental reasons. So, the issue is not precisely when simply 'monetary' and absolutely 'social' pressures conflict but when explicit stakeholder originations with monetary and social aspects struggle. Along these lines, looking at financial and social issues separately is a horrible idea.

Stakeholder Theory and Value Creation:

Companies see or define value differently, and the Stakeholders define value differently. “The value created for customers is more important than other types of value creation, as it is fundamental to the concept of a business model” (Birte Freudenreich, 2020). Stakeholder theory suggests that, in a mutually beneficial Stakeholder relationship, the Stakeholders are the ones who create/co-create value and receive the value. The value creation process should be more profound than just transaction-oriented approaches. To have a mutually beneficial relationship, a company and its stakeholders have to have a common purpose, and both should appreciate the contributions made by each other. The value creation process should be continuous, and the value created should be for different Stakeholders; this way, a company can sustain itself longer.

Businesses engaging with stakeholders will also determine the quality of the value created.

In recent years, we have seen companies engaging with people on social media after the explosion of social media. This kind of engagement brings attention to the brand, which increases the brand value. Companies like Adidas, Nike, and other sportswear encourage customers to sign up on their websites to test the products under development and provide feedback. This kind of engagement gives a sense of ownership to the customers who signed up to test the products and spread the message to others. This is what we essentially call word-of-mouth publicity.

Many can see value creation as purely maximizing wealth. Still, the authors argue that value creation involves more than that; if the Stakeholders are not considered partners by the company, they might not buy in and will choose to move to or do business with other companies that satisfy their needs or appreciate their partnership.

Stakeholder Theory and Finance:

Traditionally, finance people have always ignored the morals of stakeholder theory. Now, they realize its value and how higher returns can be expected by embracing the stakeholder theory. From the finance perspective, a firm's primary responsibility is towards the shareholders and why they should prioritize the Stakeholders. When a company embraces the shareholder's theory, it creates agency problems. The managers are essentially maximizing the profits of their shareholders, and the managers consider themselves a priority, making the company's efficiency and value go down.

The main argument behind the shareholder's priority is that they are the group that essentially invests or has a more significant need for the company to thrive to maximize their wealth. We can argue against this logic by stating that the shareholders can quickly sell their stake in the company and invest in a different company if the new company offers to maximize their wealth faster. At the same time, the company's stakeholders, like its employees or customers, seem to find it challenging to move to a different company for obvious reasons.

Finance people cannot seem to discard the singular view of maximizing wealth in terms of prioritizing shareholders, but it is slowly changing. The major problem with the slow change is that the company's definition of value is still vague. Along with the value, the executive leaders should clearly define the company's priorities to set the company's direction.

Practical application of the literature:

Stakeholders' theory gives new perspectives on how to move a company forward. Ever since globalization took over, more people have started to take notice of a company and how its operations are run. We should bring ethics into the center of a business's operations, and this can be achieved by fully embracing the Stakeholder theory. In the past, many people have put forth the conflict between capitalism and stakeholder theory but neglected the conflict between value creation and how businesses conduct their operations. We further explore the conflicts to find solutions so a company can do right by its Stakeholders.

As most companies are for-profit, they are slowly embracing CSR to communicate how they give back to society. Corporate social responsibility and corporate financial responsibility are other areas in which there is a lack of proper research. Again, this stems from a lack of buy-in from financial experts for stakeholder theory. The financial experts should deeply analyze how the external and internal stakeholders of the company are engaging with the company and how we can leverage the necessary skills to increase the company's value. In this paper, the authors have mentioned that a company should define what value is and what direction to move the company. These proper definitions by the executive leader will ensure that all the Stakeholders' visions and purposes are aligned while helping the company prosper.

As mentioned in the paper, the authors will not naively say that the leaders and managers of a company should be completely tied down to the Stakeholder theory when the company's existence is threatened. This also does not mean that ethics can be sidestepped. The authors believe there is a balance that can be struck during testing times.

Conclusion:

The authors presented evidence about how capitalism and Stakeholder theory conflict in people's minds. Many examples can be cited worldwide, such as when a company fully embraces the stakeholder theory. However, can this mean that a company can survive and retain its investors by embracing the Stakeholder theory cannot be determined? The author's conclusion cannot be determined because most theories assume that every person is innately good, but the authors argue that a situation can change someone. So, if a situation can change a person, will he give prominence to ethics or prioritize oneself? The authors believe this question cannot be answered.

Stakeholder theory can be an excellent tool to better a company's performance, but there will be times when the practical application of the theory will falter. We can appeal to people's sense of responsibility to perform or act better, but the question always comes to how a particular situation will bend that person. Many researchers contributed to this study, and there is a long road ahead. The authors think it will be a long time before everyone keeps ethics at the center of business, but learning about the Stakeholder theory will be a great stepping stone to becoming better.

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