

THE WEALTH OF CORPORATIONS

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**Conference on:
Muslim, Christian, and Jewish Views on the Creation of Wealth
University of Notre Dame
April 23-24, 2007**

Wealth—its definition, measurement and distribution—is one of the defining issues of the 21st century. Even the casual observer cannot help but be impressed with the resources devoted to the subject. Gross national product (GNP) performance, the most common metric of a nation’s wealth, is subject to regular and expansive commentary in the media. Government reports comparing GNP growth in a given quarter relative to growth twelve months earlier garner headlines and voluminous commentaries in the business press. Company performance expressed as earnings per share, the most common short-term measure of a company’s shareholder wealth, is a quarterly ritual that drives the behavior of analysts, investors and managers alike. Executive compensation, an indicator of corporate wealth granted to business leaders, has attracted intense scrutiny as pay scales have reached unprecedented levels in both absolute and relative (to average or lowest paid employee) terms.

Why all the attention to wealth? Put simply, absolute wealth provides a window into the productivity and power of a nation, the valuation of a corporation and, to a degree, the well-being of the individual (Kenny 2005; Stutz 2006). Wealth distribution, on the other hand, provides a window into society’s tolerance for social disparities. Extreme wealth disparities at any unit of analysis—national, corporate, household or individual—signals either inability or unwillingness to intervene in the wealth generation and distribution process such that its fruits are fairly shared across societal sectors.

In this brief paper, we focus on a particular aspect of wealth generation process, namely, the evolving nature of wealth created by corporations, its distribution among those responsible for its creation and new measurement tools that redefine how such wealth is measured and disclosed. The key conclusion of our assessment is that the dramatic changes in the nature of the wealth creation process since WWII is unmatched by changes in how such wealth is measured and publicly reported. This divergence is creating a widening gap between information disclosed by companies and the information needs of the company’s diverse stakeholders.

The solution to this “disclosure deficit” is a fundamental rethinking of what should be measured and what should be reported to meet 21st-century needs and expectations among the firm’s diverse stakeholders. Such rethinking is not only a methodological

challenge. It is equally an ethical matter in that those who contribute to wealth creation in the 21st-century economy are denied awareness of the results of their contribution to corporate output and, moreover, the tools needed to advocate for equitable distribution of the wealth associated with deployment of their assets.

Changing Sources, Unchanging Tools

In the developed nations, structural changes in the nation's economy began in earnest after World War II, heralding the beginning of a shift away from a focus on tangible assets to intangibles such as patents, knowledge management systems and capacity to innovate (White 2006a). At an accelerating rate, human intelligence in the ensuing decades displaced raw materials as the principal driver of wealth creation. Machine tools, appliances and textiles gradually gave way to medical instruments, semi-conductors and software as the leading industrial sectors that continue to redefine the structure of 21st-century Western, and increasingly, global economies.

Even within mature industrial sectors, value creation is heavily rooted in new knowledge generation. Auto manufacturers, experiencing a convergence in price and quality within the same class of products, are investing major resources in technological innovation for hybrid fuel vehicles and in-car electronics such as global positioning systems and rear-seat entertainment systems. Segments of the chemical industry are shifting away from bulk (commodity) chemicals to science-intensive advanced materials and biotechnology. The pharmaceutical industry, already among the most intensive knowledge-based industries, regularly forms alliances, partnerships and joint ventures with kindred industries such as biotechnology, diagnostics, health care and information services—themselves knowledge, rather than materials-intensive, sectors.

Yet as the underlying sources of wealth creation continue to shift from materials to knowledge, the tools by which such wealth is measured and publicly reported remain stuck in frameworks developed a half-century ago. Balance sheets remain notably unbalanced when it comes to disclosing the quantity and quality of both human capital and environmental (or “natural”) capital that companies either enrich or diminish in the course of producing goods and services. The market value of a large company, such as Microsoft, Intel, Cisco or GE, typically exceeds by factors of five, ten or more its “book” value, which is dominated by traditional physical assets—e.g., plant, equipment and inventory. While this discrepancy is not entirely attributable to knowledge assets, it is a particularly powerful determinant in science- and technology-based companies. Consistent with this overall trend, 1997 marked the first time in United States history that investments in intangibles such as research and development (R&D), training, and brands, estimated at approximately \$1 trillion, exceeded investments in property, plant, equipment and other tangibles (Low and Kalafut 2002).

How did this disjuncture between assets and reporting evolve? The answer lies in the roots and increasing obsolescence of financial accounting. When companies report on their quarterly and yearly performance, they do so using accounting rules that suffer from

at least the following key shortcomings (Value Measurement and Reporting Collaborative 2006).

- **Backward-looking.** Conventional corporate reporting primarily describes what has already occurred—revenues, net earnings and depreciation of assets during a specified time period. From an investor and broader societal perspective, such reporting is inadequate to judge a company. Stakeholders need to know about future prospects, not just past results. Where is the company going and what are the prospects for getting there?
- **Transaction-centric.** The underpinning of conventional financial accounting is the transaction. Reading the annual accounts of a company provides information about the type and magnitude of its transactions—sales of goods and services, payments to suppliers, wages paid to employees. Exceptions exist, such as estimates of “fair value” of an asset yet to be sold. But such exceptions reinforce the rule. The transactions-based foundation, while a necessary component of company performance, is insufficient to rigorously assess its performance and prospects.
- **Missing intangibles.** The modern economy increasingly relies on intangible assets to drive value creation. Intellectual property, capacity to innovate, alliances and partnerships, patents and trademarks, systems and structures for supply chain management, reputation and brand, quality of governance—these intangibles represent a growing, increasingly dominant, share of the company’s assets as well as the critical drivers of future performance. Though intangible assets appear occasionally in the Management Decision and Analysis (MD&A) portion of financial statements, the rigor and completeness of their coverage lies well behind their import.
- **Disconnected assets.** Traditional accounting and reporting emphasize discrete assets, presenting them as additive rather than interdependent. In the modern economy, it is increasingly the *interaction* among assets—people, technology, networks—that drives value creation. For example, capacity to innovate depends on investment in human capital plus the quality of alliances; reputation depends on the quality of supply chain management, which itself depends on the quality of internal auditing and control systems.
- **Financial capital bias.** Value creation by companies depends on the interplay of various forms of capital—financial capital provided by shareholders and lenders, human capital provided by employees, natural capital (clean air, water, land) provided by the environment and social capital provided by government. To understand a company’s performance is to understand how it acquires, deploys and expands all capital assets. In contrast, conventional company reporting is rooted in a single form of capital, namely, financial capital.

To be sure, modern accounting rules during the half century since their creation have not been entirely stagnant. New protocols are promulgated to clarify or further standardize existing accounting elements. Efforts to harmonize international accounting standards under the aegis of the International Accounting Standards Board continue to make progress. And wholly new issues—e.g., accounting for derivatives, stock options,

pension obligations—occupy standard setters in the US and UK which traditionally exert leadership in defining global accounting rules.

But as necessary as these improvements are, they amount to corrections to a foundation that is fundamentally inadequate to capture the complexity of 21st-century economic, social and environmental realities that are integral to the corporate wealth creation process. It is these critical flaws that demand the attention of all parties with a stake in the wealth which corporations are uniquely capable of generating.

From Shares to Stakes

How corporations generate wealth is inextricably linked to one's view of the nature of the corporation itself. For most of the last quarter century, one definition of the corporation has dominated the thinking of both theorists and practitioners: the corporation exists to assemble and combine tangible and non-tangible assets to create profits for its shareholders. Further, to achieve its goal, the corporation organizes itself to ultimately serve its "principal" (the shareholder) by deploying agents (its board and management) to protect and advance the interests of such principals (Jensen 2001). Thus, the measure of success of the entity may be distilled to the elegant and unidimensional single bottom line of profit, share prices or other metrics that track the rise (or fall) of returns to the providers of capital, i.e., the shareholders.

While few would deny the elegance of "shareholder value" as the ultimate measure of a corporation's success, a growing chorus of observers question whether such unidimensional thinking is in fact an accurate depiction of the character of the modern corporation. Ghoshal (2005) puts it this way:

If the value creation is achieved by combining the resources of both employees and shareholders, why should the value distribution favor only the latter? Why must the mainstream of our theory be premised on maximizing the returns to just one of these various contributors?

Ghoshal's response: It should not. Indeed, to preserve the dominance of such theory is not only injurious to society but also to the long-run interests of business itself. It may be convenient to employ quantitative financial models, but the effects on the behavior of managers and, ultimately the health of corporation, are severely detrimental. The willingness of companies to choreograph quarterly earnings to meet analysts' expectations continues unabated, despite calls from many quarters to abandon such expectations and adopt a longer-term business strategy.

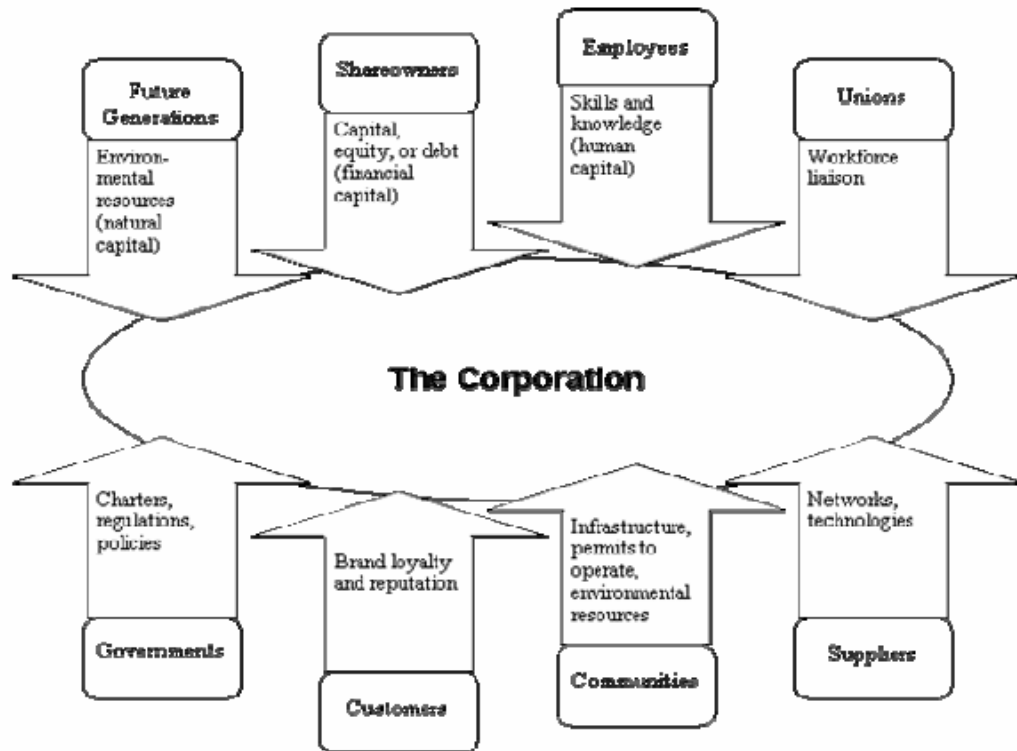
In an interconnected, globalizing world, the obsessive focus on shareholder value undermines the capacity of management to build sustainable organizations. Such a mindset ignores the complexity and richness associated with the broad array of resource providers that bring their assets to bear in creating wealth.

The alternative to the shareholder-centric characterization of the corporation is one that recognizes the dynamism and inseparability of multiple resource providers that form the foundation of the modern enterprise (Greenfield 2007; White 2006a). Rather than focus on a single such provider—the shareholder’s contribution of financial capital—the alternative offers a more nuanced view of multiple providers all of whom contribute their assets and deserve fair returns to the wealth they help create. Blair and Stout (1999) describe this concept as the “team production model” (TPM), a direct challenge to the dominant “principal-agent” model described earlier. The “team” is the assembly of parties, including but not limited to shareholders, who collectively and inseparably contribute to wealth creation. Rather than defining “principals” as solely shareholders, employees, suppliers, communities, consumers and others stakeholders are also principals in the sense that they are indispensable to transforming materials, energy and information into useful products and services.

TPM is one example of introducing systems thinking in the wealth creation process, whether at the global, national or corporate scale (Beinhocker 2006; Senge et al 2004). For the latter, seeing the corporation as a living organism with the capacity to adapt and transform itself in response to shifts in information, technology and competitive conditions provides a more satisfying characterization of the corporation than the narrow construction offered by principal-agent theory. At the same time, shifting focus from “shares to stakes” (Cowe 2001) provides the conceptual foundation for allocating corporate wealth among the multiple parties that are integral to the “living organism” metaphor.

Operationally, Figures 1 and 2 describe in some detail the diversity within the system by which resource providers contribute and ought to benefit from the wealth creation process. Figure 1 depicts the various contributions of different resource providers.

Figure 1: Resource Providers to the Corporation



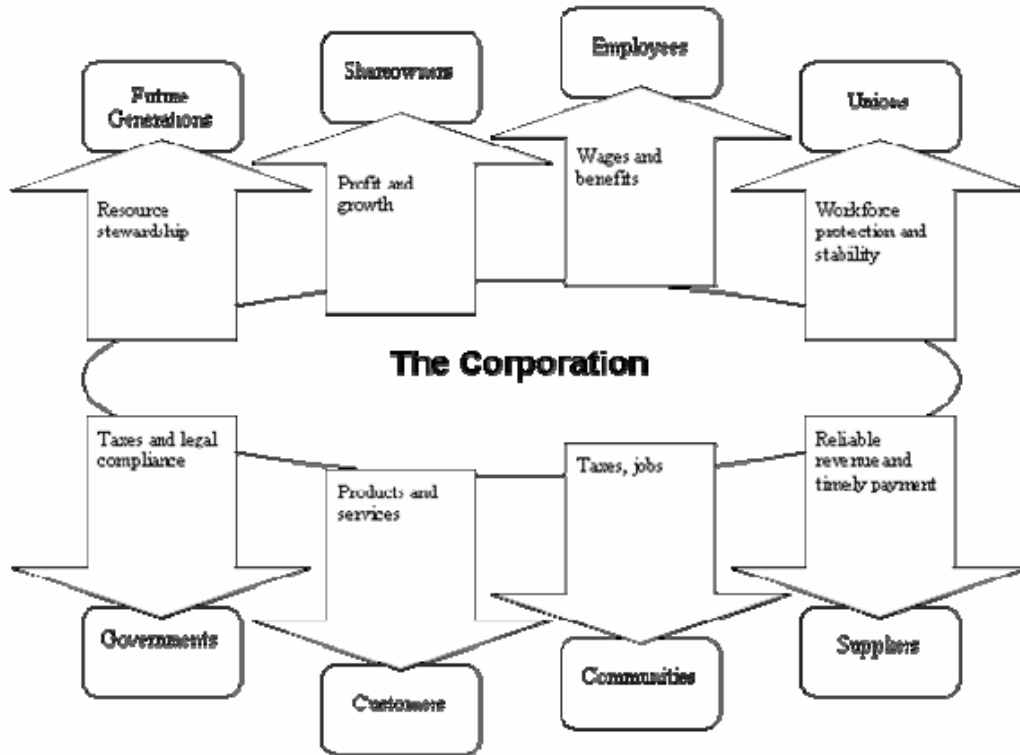
Source: White 2006a, adapted from Post 2002

Eight stakeholders (the number and weight of each will vary across time and enterprises) provide different types of resources, all of which are essential to the corporation's existence, operations and prosperity. Shareholders and lenders provide financial capital that helps transform labor, natural capital and technology into the production of goods and services. Employees provide human capital, unions provide workforce liaison and governments contribute a stable and predictable legal/regulatory infrastructure. Customers provide markets and, over time, brand loyalty and reputation to the organization. Communities provide a local license to operate, as well as access to air, water and land resources by virtue of their permitting and siting authority. Suppliers are providers of networks and technologies essential to the corporation's own production activities.

Finally, future generations lend common assets to the corporation for temporary use, much like communities do on a shorter-term basis. Biodiversity, clean air and water and productive land are "common assets" inherited by present generations with the understanding that contemporary users will be stewards of such assets, protective of both their quality and quantity, such that the stock is preserved for future generations (Barnes 2006). The corporation that exploits and undermines a common asset is, in effect, a delinquent borrower. Such is the case, for example, of those that have produced carbon emissions for generations which now threaten to undo climate stability owed to future generations.

In return for the resources provided, each party merits a return to their contribution (Figure 2). As in the case of resource providers, returns should vary with regard to type and value of the contribution of each provider. Future generations, were they to have a voice in the governance of the corporation, would expect the firm to act as a trustee of the environmental resources, leaving the stock of resources undiminished. Absent such a direct voice, future generations depend on government to act as a proxy, though its capacity to do so inevitably is constrained by political expediency.

Figure 2: Expected Returns to Resource Providers



Source: White 2006a, adapted from Post 2002

In a similar vein, other stakeholder should exercise their legitimate claim to corporate wealth. Shareowners expect dividends and growth in share price. Employees expect wages and benefits commensurate with the value of the human capital they contribute to the production of goods and services. Unions, acting on behalf of their members, expect a safe working environment and a place at the negotiating table.

For government, taxes and compliance with the law constitute some of the expected returns in exchange for its contribution of social capital, e.g., a fair and stable regulatory environment and judicial processes for adjudicating conflicts among various stakeholders. Customers expect high quality goods and services at fair prices, while communities expect taxes, jobs for residents and an uncompromised natural environment from which the corporation utilizes air, water and land resources to support its operations. For suppliers, long-term relationships that produce a steady revenue stream and timely payment of invoices are anticipated returns.

Framing the corporation as a nexus of multiple resource providers opens new horizons for the role of democratic governance. Why, one may ask, are shareholders the sole stakeholder group to elect corporate directors and to bring lawsuits in cases of alleged breach of fiduciary duty? Indeed, why is fiduciary duty of directors defined, either de jure or de facto, as a duty of loyalty only to shareholders? (Ray 2005; White 2006b). As new definitions of the corporation emerge to challenge the prevailing shareholder-centric model, the answer to these questions invariably shifts from the self-evident conclusions embodied in shareholder primacy to the more nuanced and richer responses that derive from the stakeholder-based definition of the corporation.

New Models, New Metrics¹

The emergence of new definitions of the corporation and associated wealth creation processes underscores the flaws in the current system of how wealth is measured and publicly reported. As our understanding of both the nature of corporate wealth and its distribution among those responsible for its creation changes, the imperative to develop new accounting frameworks becomes increasingly urgent. Absent such frameworks, efforts to track and enhance corporate performance along multiple dimensions—economic, environmental, social—lack a sound conceptual foundation for assessing the status or trends in quantity and distribution of corporate wealth.

In the best of worlds, the accounting community would rise to the challenge of making a major upgrade in its rule-making and disclosure system. This, unfortunately, is not the case. Much like management education that suffers from the persistence of the shareholder-centric view of the firm, mainstream accounting theory has failed to embrace new concepts of corporate wealth. Frustration with such resistance is widespread and lies

¹ This section is adapted from White 2006c.

at the core of the proliferating number of initiatives during the past decade that seek to either complement or revamp conventional financial accounting practices.²

The number and diversity of these initiatives mirrors the complexity of the information which stakeholders need and expect from corporations. Issues such as the quality of corporate governance, fair labor standards, worker health and safety, HIV/AIDs policies and practices and carbon emissions are among the plethora of issues that have emerged as worthy of rigorous measurement and systematic disclosure. In defining and measuring performance of companies against such issues, questions inevitably emerge of both a technical nature (e.g., what information is material to various stakeholders? What measurement methods should apply?) and a process nature (e.g. what institution(s) should oversee the new rule setting process? How can such institutions achieve the legitimacy that is prerequisite to generally accepted practices?).

Among the current wave of measurement and disclosure initiatives, the Global Reporting Initiative (GRI) perhaps provides the most comprehensive answers to these technical and process questions (Global Reporting Initiative 2007).³ Distinct from most initiatives that have emerged in the last decade, GRI is unique in both its purview and governance. In contrast to the topic-specific focus of most initiatives (e.g., carbon emissions, payments to host governments by extractive industries, workplace labor standards), GRI spans the full array of economic, environmental and social issues absent from conventional corporate reporting. And relative to the governance structure of many (though not all) initiatives, GRI's governance from the outset embodied the principles of multi-stakeholderism in its Board, Stakeholder Council and Technical Advisory Committee.

GRI was conceived in 1997 by Ceres, a Boston-based environmental and investor advocacy group, with technical support from Tellus Institute, a Boston-based think-tank. In less than five years, GRI evolved from a bold vision to a leading international standards institution for non-financial corporate reporting. Analogous to the London-based International Accounting Standards Board (IASB), whose mission is to harmonize global financial accounting rules, GRI's mission is to create and continually enhance a generally accepted framework for reporting social, environmental and economic (apart from financial) performance at the organizational level.

The GRI story is instructive for several reasons (White 2006c). First, the initiative was conceived and brought to fruition under the leadership of civil society organizations, rather than business or government.⁴ After a decade of disparate, national-level efforts to

² See, for example: **Enhanced Analytics Initiative (EAI)**, www.enhanced-analytics.com. **Value Measurement and Reporting Collaborative of Canada.**, <http://npi.valuemeasurement.net>; **Extractives Industries Transparency Initiative (EITI)**, www.eitransparency.org; **Carbon Disclosure Project (CDP)** www.cdproject.net/aboutus.asp.

³ Disclosure: the author is Co-Founder and former CEO of GRI from 1998-2002.

⁴ GRI positioned itself as a voluntary initiative, seeking to build a strong coalition of business and non-business groups while advancing the case for a generally accepted framework of voluntary non-financial reporting. As the program evolved, governments—especially in Europe and Japan—became increasingly attentive to GRI's progress. Government embrace of non-financial reporting, and GRI specifically, continues to intensify and expand. In France, mandatory social and environmental reporting applies to all

strengthen social and environmental disclosure,⁵ GRI filled a leadership vacuum in the area of corporate-level disclosure standards. By the late 1990s, corporate transparency practices were becoming increasingly troublesome for both reporters and report users. While increasing numbers of corporations were disclosing their environmental and, to a lesser extent, social and governance performance, the credibility of reports was severely undermined by the absence of an independent, neutral, legitimate mediating institution that could establish and steward a reporting framework. This was the need, and opportunity, that inspired GRI.

Second, unlike financial reporting, whose principal audience is investors, social and environmental information is of interest to a broader constituency. GRI sought to create a process in which the views and voices of multiple constituencies were convincingly represented. Thus, a multi-stakeholder approach to technical work and institutional governance became indispensable to GRI from its earliest stages.

Third, while many approaches to non-financial reporting had emerged in the late 1980s,⁶ the field was essentially in its infancy at the moment of GRI's conception. For GRI, such uncharted terrain was both an impetus and a hurdle. The impetus was the increasingly obvious shortcomings of financial reporting which were failing to keep pace with new drivers of corporate wealth creation. The principal hurdle was, and still is, the challenge of elevating non-financial reporting to a level of general acceptance equivalent to financial reporting absent government mandates and institutions such as the US Federal Accounting Standards Board and the Securities and Exchange Commission.

Unlike financial reporting, which evolved on a country-by-country basis, GRI was formed at the outset as a global framework, applicable to any business in any sector in any location. It faced a clear, though complicated pathway, relatively unimpacted by powerful competing institutions and traditions as in the case of national financial accounting boards, professional accounting bodies, and securities commissions. While GRI had to remain attentive to the many disparate corporate and national level efforts in non-financial reporting, a window of opportunity existed to build a global framework and institution without the inertia facing organizations such as IASB.

Fourth, the nature of non-financial reporting has required inventiveness that can learn from, but must recognize differences with, financial reporting. Three examples illustrate

companies listed on the Paris Stock Exchange, Australia has adopted a voluntary national environmental reporting framework based heavily on GRI, the South Africa King Commission on Corporate Governance advocates GRI as a component of its best corporate governance practices, and Japan's environmental reporting guidelines (which in Japan is tantamount to mandatory) reflect evidence of a strong GRI fingerprint.

⁵ Examples of such efforts include the US Toxic Release Inventory (TRI), The Netherlands Environmental Protection Act, and the Denmark Green Accounts Act. See KPMG, "Mandatory and Voluntary Standards for Sustainability Reporting," Draft Discussion Document for Sustainability Reporting: Public Policy Trends Workshop, Paris, May 30-31, 2005.

⁶ Various companies experimented with selected disclosures covering, for example, air or water pollutants. But it was not until the formation of the US civil society group Coalition of Environmentally Responsible Economies (Ceres) in 1989, did the concept of systematic, comparable disclosures begin to take shape. (www.ceres.org)

this critical point: principles of reporting, sector-specific disclosures and qualitative indicators of performance.

In the case of reporting principles, embedded in the concept and practice of financial reporting is a set of key elements that transcend specific rules, protocols and metrics. Examples include timeliness, completeness and auditability. For non-financial reporting, GRI developed similar principles to ensure rigor and comparability of non-financial reports that use the GRI framework. But it did not simply import them wholesale from the financial domain. The differences between the two reflect the fact that non-financial reporting covers issues as wide-ranging as corporate governance, labor standards, product safety and worker health and speaks to audiences that include, but are not limited to, investors. Thus, GRI's reporting principles adapt to the familiar financial reporting principles, but also illuminate a "sustainability context" that situates reported information in a broader social and environmental context. Also embedded in the principles is the notion of "inclusiveness", a signal to reporters that systematic stakeholder consultation is a precondition for shaping the final content and scope of disclosures contained in a GRI report.

Sector-specific standards are a second point of divergence between financial and non-financial, GRI reporting. Mining, automotive and financial services, for example, share certain attributes that are amenable to comparison. All use energy in their products and services, pay different salary levels to employees and are responsible for product and service safety. However, the significance of each shared attribute in assessing an organization's social, environmental and economic performance varies widely by sector. For example, energy use in financial services represents a substantially smaller fraction of the firm's total "footprint" than it does in an oil or automotive company.

For this reason, GRI's reporting framework operates on two tiers: the first is a generic set of indicators applicable to all sectors, while the second involves sector-specific indicators that capture the details of different types of organizations. Tons of carbon emitted per unit of production, reportable workplace accidents per 100,000 person-hours worked and salary ratios between top paid and average employees exemplify the range of measures that help assess and communicate non-financial performance for all companies. But indicators such as production and sales of toxic substances and company policies regarding disclosure of drug trial information are germane only to specific types of companies.⁷ While Wall Street is accustomed to a few leading financial indicators and indices, non-financial performance, with all its complexities, lacks a common denominator, such as dollars, and thus cannot be reduced to the elegance of single denomination.

Qualitative indicators are a third point of divergence, although this divergence is more one of weight than absolute difference. Although financial accounting rules strive to produce comparable, quantitative results across companies, the resulting financial reports

⁷ In this case, producers and users of significant quantities of chemicals and drug companies, respectively.

are routinely accompanied by non-quantitative information.⁸ This is expected by investors to aid in understanding a company's strategy, technology innovations, competitive position and other critical aspects of its operations and financial prospects. Information of this nature is actually required under SEC rules in so-called Management Decision and Analysis (MD&A) and similarly proposed in the United Kingdom (UK) under the heading of Operating and Financial Review (OFR). In both countries, and in others such as Canada, government regulators find themselves under increasing pressure to enlarge the scope of these disclosures to include environmental and social information that is pertinent to investor decision making.

In the case of non-financial reporting, a much younger and more fluid field compared to financial reporting, no presumption of quantifiability exists. A review of 2006 GRI Guidelines reveals a broad spectrum across the fifty core indicators as well as additional, more experimental ones. This is because the consensus view of the GRI process is that characterizations of social, environmental and economic performance require more than numbers. They require textual explanations that reveal how and why boards think, management decides, employees behave, customers respond, and communities benefit from a company's actions.

Reflections

Evolving definitions of wealth created by corporations have spawned a multitude of initiatives aimed at measuring these new concepts of wealth. The narrow definition of returns to shareholders upon which modern financial accounting and analysis are based is giving way to a more expansive interpretation of how corporations generate and distribute the wealth they generate. Alongside financial capital are now emerging human capital and social capital as critical sources of wealth creation, and alongside shareholders are emerging employees, communities, suppliers, consumers and other "resource providers" increasingly recognized as equal partners in the wealth creation process.

As this redefinition unfolds, so too does the concept of what constitutes a fair distribution of corporate wealth. If multiple stakeholders are integral to and inseparable from the wealth creation process, then such stakeholders should exercise their rightful claims to the residual generated by the corporation.

All signs point to an irreversible movement toward the development of new frameworks that capture these concepts of wealth and its distribution. These developments, still little more than a decade old, remain a work in progress in terms of their scope, scale and content. Like financial reporting a half-century earlier, the current period of experimentation will continue for years to come. But unlike the highly fragmented evolution of financial reporting, the new generation of corporate disclosures holds the

⁸ Examples of such information include information on new products under development, new markets targeted for the coming years, and recent mergers and acquisitions. Also, financial reports typically include qualitative information such as political instability in conflict zones to alert investors to potential risks of investing in the firm.

promise of evolving rapidly toward global norms commensurate with the global economy in which corporations operate today.

As non-financial reporting swiftly moves from extraordinary to exceptional to expected, the case for global standards becomes more compelling. This is so because full and balanced disclosure is taking its place alongside human, labor and environmental rights as a generally accepted, universal norm for business. Like these rights, the “right to know” is part of doing business in the 21st century. Integration of global capital markets, trade liberalization, the capacity of information technology to virtually instantaneously transmit both good and bad news—all these conditions create both a business and an ethical imperative for a next generation of disclosure that stretches well beyond current financial accounting methods to capture the essence of how corporate wealth is created and distributed.

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