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8 Focus

Stakeholder Engagement and the Board: Integrating Best Governance Practices

Foreword by Peter Zollinger

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The Forum sponsors regional and local initiatives that address the corporate governance weaknesses of middle- and low-income countries in the context of broader national or regional economic reform programs.

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DISCLAIMER

This publication is an attempt to assess and explain the universe of issues and challenges facing boards and companies in the area of stakeholder engagement. It is not a formal position or expert opinion on this topic. A list of resources and expert sources is offered. However, readers are advised to seek professional expertise or guidance to design or implement stakeholder engagement initiatives.

FOREWORD

Three often found misconceptions in business can be summarized as follows (and, I admit, somewhat provocatively): First, the term stakeholder is seen as a euphemism for polarizing, anti-business campaigners (read troublemakers). Second, stakeholder engagement is for companies that are aspiring for political correctness (at best) and risk to hand the steering wheel to groups that have little legitimate voice (at worst). And third, there are no real-life connections between best practice corporate governance and stakeholder engagement.

This *FOCUS* Publication effectively dispels these misconceptions and presents a structured and practical case for stakeholder engagement as a means to business success and societal trust.

More and more business leaders recognize that their traditional management recipes are providing insufficient guidance on how to handle changing societal expectations around the globe. Frequently, reputable companies are caught in what appears to them to be a surprise controversy, despite professional public relations work and elaborate mechanisms of internal control. It should raise an alarm bell if company executives have to admit ever that they were surprised by the level of negative publicity. Have their internal radar systems been insufficiently tuned? Or has the internal escalation of warning signals failed?

'No surprises' is one of the most important principles of good corporate governance. This report explains how systematic stakeholder engagement enables both the supervisory body and the executives in any corporation to be prepared to detect, assess and manage any change in their global societal environment that may prove to be critical for strategy and their capacity to implement it. The report does not call for additional functions to be taken over by boards. Rather, effective corporate leadership involves the integration of stakeholder engagement *within the accepted core functions* of boards as part of best practice corporate governance. Such core functions include policy setting, accountability and control, and the selection of executive management.

But beyond managing risk, the 'champion's league' of stakeholder engagement is to embed openness and collaboration in a company's approach for innovation. More and more new business models live off what some call 'strange bedfellows', novel partnerships between business, NGOs or governments to deliver new services or come up with new products.

At the beginning of any company successfully embracing stakeholder engagement as a formula to increase diversity of thought and secure a licence to operate based on society's trust stands a recognition by the owners (investors) and their agents (boards) that 'engagement' needs to be established as a core corporate value. People up and down the corporate hierarchy have to be empowered and instructed to engage (a word whose essence of 'being prepared to being influenced by what others have to say' is not easily translated beyond English). This new briefing publication provides change agents at all levels with the structure and arguments they need.

The correct conceptions of stakeholder engagement would therefore be: First, stakeholders include those who have a legitimate interest in a company's work and are open to constructive engagement. Second, stakeholder engagement is for leading companies who accept to be stronger in partnership based on mutual trust. And third, stakeholder engagement enables companies to go 'beyond compliance' and to live up to the spirit (rather than the letter) of the principles of good corporate governance.

Peter Zollinger
Senior Vice President
SustainAbility

I. INTRODUCTION

Companies have always had relationships with their stakeholders, which include shareowners, customers, suppliers, employees, regulators, and local communities. In fact, it would be difficult for a company to stay in business if it did not operate with the interests of these key groups in mind. When engaging with its stakeholders, a business is acknowledging that it is an interdependent entity, which is impacted by and has an impact on many different groups. For many companies, however, finding the right approach to stakeholder engagement and tapping the wider benefits it offers to their business is still uncharted territory. This *FOCUS* Publication provides an introduction to stakeholder engagement from the perspective of internationally recognized, good corporate governance practices. It is aimed at senior executives and company directors and explains how stakeholder concerns can inform and enhance the risk management and wealth creation responsibilities of boards of directors. It provides practical tips and tools to help navigate stakeholder engagement in a way that strengthens the long-term sustainability of companies and enhances trust and reputation among stakeholders.

> "Our stakeholders are our business."
>
> Standard Bank • 2005 Annual Report

Taking stakeholder concerns and interests into account can improve relationships, which may make it easier for a company to operate, lead to ideas for products or services that will address stakeholder needs, and allow the company to reduce costs and maximize value. Researchers have also found correlations between stakeholder performance indicators and conventional measures of corporate profitability and growth. The reasons may vary. For instance, companies that take a stakeholder view may have a more responsible approach to risk-taking, which can deliver higher returns by not unreasonably pursuing competitive advantage. Stakeholder-oriented companies are also welcomed more readily into new markets, as existing companies embedded in those markets perceive them as less hostile to local values and ways of operating (Fauver and Fuerst. 2006). Overall, stakeholder-responsive corporate governance results in a more comprehensive understanding of corporate risk and opportunity while contributing to a strong reputation over time.

Most companies communicate with stakeholders, providing information about the organization and its products, services, and operations to shareowners, customers, staff, business partners, and suppliers. The process of communicating with these groups is one type of stakeholder engagement and the strategic importance of engagement is immediately obvious. There are also many good strategic and operational reasons to engage with less-traditional groups and on less-traditional issues.

> "Every decision the Board makes takes into account the needs and expectations of all our stakeholders."
>
> BHP Billiton • 2007 Annual Report

Stakeholders can have economic, technological, political, social or even managerial effects on a company and engagement is therefore an important part of anticipating business opportunities and risks, which, in turn, is fundamental to proactive, strategic management. Over time, as economies, labor markets, and supply chains have become increasingly globalized, the number and variety of stakeholders impacted by individual companies has grown and the need for stakeholder engagement has become an essential part of doing business.

Moving toward a stakeholder-conscious governance model, with broader input and ongoing engagement, is an important aspect of corporate accountability. Terms describing the business-society relationship — corporate social responsibility, corporate citizenship, corporate environmental and social performance, and sustainability — all speak to the role of business as providing some 'good' to society. Because the emphasis is on relations with society, the stakeholder view of the company is central to most of these concepts. Stakeholder engagement is not, however, the same thing as sustainability or corporate responsibility. It is certainly possible for a company to engage with stakeholders and yet operate in ways that abuse natural resources or human rights.

Effective engagement is also characterized by dialogue — a two-way process where stakeholders are not merely consulted or listened to, but the company makes a sincere attempt to respond to stakeholder concerns. Of course, if a company is to avoid paralysis, it must prioritize stakeholder interests.

Experience shows that trust and relationships take time to build but are valuable assets. To build trust, the company must show it has listened and acted in response to stakeholder concerns. This is why ongoing communication with and reporting back to stakeholders is such an important component in any engagement strategy.

Ultimately, stakeholder engagement should become a core value for the business and be managed as a business function with clear objectives and lines of responsibility. The following chapters show how this approach fits with the leadership responsibilities of boards. In particular, chapter IV provides practical tips for prioritizing stakeholder interests and successfully managing stakeholder engagement.

II. STAKEHOLDER ENGAGEMENT AND CORPORATE GOVERNANCE

Corporate governance refers to the systems by which companies are directed and controlled. The structure and operation of the board of directors, financial reporting, transparency and audit, separation of powers and minority shareowners' rights are integral to the corporate governance system. Corporate governance is also increasingly recognized as a means to address the converging interests of competitiveness, corporate citizenship, and social and environmental responsibility, and as a mechanism for encouraging efficiency and combating corruption (King Report, 2002).

Weak corporate governance systems that lack transparency and protection for minority shareowner rights have been shown to reduce foreign investment and capital flows to developing economies. At the company level, good governance practices have been found to be associated with creditworthiness and higher average annual total returns (Brown, Muchin and Rosenman, 2004).

There are a number of different codes or sets of principles for good corporate governance. Many highlight the importance of stakeholders to good governance. One such example at the global level is the OECD Principles of Corporate Governance, which is the defined international standard. The core values of the OECD corporate governance principles are:

I. Rights of shareowners and their protection

II. Equitable treatment of all categories of shareowners

III. Role of employees and other stakeholders

IV. Timely disclosure and transparency of corporate structures and operations

VI. Responsibilities of the board towards the company, shareowners and other stakeholders

These principles underpin the development of a strong governance framework that, in turn, supports the development of sound capital markets.

Definitions of Stakeholder Engagement

The term “stakeholder” has been used since at least the 1930’s, when a Harvard Law Professor, E. Merrick Dodd, publicly supported the identification of four major groups of business stakeholders: shareowners, employees, customers and the general public (Preston & Sapienza).
A 1963 internal memo at the Stanford Research Institute used the term to refer to “those groups without whose support the organization would cease to exist.”

By definition, stakeholders have a stake in the company, and have the possibility of gaining benefits or experiencing losses or harm as a result of company operations. Some types of stakeholder groups include employees, local communities, local elected officials and local and central governments, regulatory agencies, customers, suppliers, financiers, shareowners, and non-governmental organizations. The stakeholders of each organization are different, and, in large organizations, different divisions or operational entities may have different stakeholder groups.

The more recent surge in interest around corporate social responsibility (CSR) has placed renewed attention on the rights and interests of stakeholders and the responsibilities of companies to respond to them. In “The Stakeholder Fiduciary: CSR, Governance and the Future of Boards”, Allen White of the US-based organization Business for Social Responsibility (BSR) describes the following three phases in the evolution of corporate stakeholder engagement over the last three decades:

> “Corporate Governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The corporate governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, corporations and society.”
>
> SIR ADRIAN CADBURY in *Corporate Governance and Development,* Global Corporate Governance Forum, World Bank, 2003.

1. The concept of ‘stakeholder management’ emerged in the 1980s as a practice whereby companies recognized the interests of significant, non-financial stakeholders — those with sufficient influence and visibility to gain the company’s attention — and took steps to communicate with these groups and address their concerns, usually related to specific issues.
2. The broader practice of ‘stakeholder engagement’ emerged in the 1990s as it became clear that companies needed to be aware of a wide variety of stakeholders affected by or affecting their operations and to build long-term relationships of constructive engagement. Besides shoring up corporate reputation, this approach has been shown to help companies anticipate and manage risk more effectively as well as to identify new business opportunities by tapping unique stakeholder perspectives. Engagement, as opposed to ‘top-down’ management, is often characterized by dialogue — a two-way process in which stakeholders are not merely consulted or listened to, but the company makes a sincere attempt to respond to stakeholder concerns in seeking to determine shared values around areas or issues of mutual interest or common concern.

Engaging with stakeholders has governance implications because it goes to the heart of how power and authority are understood and used within the company. By definition, stakeholders have a stake in the company, and have the possibility of gaining benefits or experiencing losses or harm as a result of the operations of a company.

3. Finally, White argues that a concept of ‘stakeholder governance’ is now emerging, which shifts the focus to how boards themselves operate and the extent to which stakeholder interests are integrated into core functions so that board decisions “fairly balance the claims of all key stakeholders.” This in turn highlights one of the central challenges of stakeholder engagement, which is to prioritize stakeholder interests and avoid paralysis.

The approach adopted by a company may vary between these three concepts depending on the nature of its business, national corporate governance regulations or best practices, types of issues the company faces, and the level of attention given to these issues by stakeholders. However the underlying principles and benefits of stakeholder-responsive corporate governance are likely to apply to most businesses. In the following sections, we explain some of the common elements of and effective strategies to tackle stakeholder dimensions within the corporate governance context.

DEFINING COMMONLY USED TERMS: THE ROLE OF STAKEHOLDERS IN CORPORATE SUSTAINABILITY AND RESPONSIBILITY

The terminology describing the business-society relationship has seen a slow evolution since the 1950's with terms such as corporate social responsibility, corporate citizenship, environmental and social performance, and sustainability favored at different times. All terms speak to the role of business as providing some 'good' to society, which may include jobs, law abidance, or environmental stewardship. Because the emphasis is on relations with society, the stakeholder view of the company is central to most of these concepts. Companies committed to operating responsibly and sustainably need to manage social contracts and face inevitable tradeoffs. In this context, corporate governance can provide a framework to help with decision-making.

Corporate citizenship is the expectation that drives companies to interact with their wider communities in an ethical and socially responsible manner. Increasingly, organizations are reconciling their corporate goals with those of their stakeholders, including local communities and their customers' values. Good corporate citizenship involves legal compliance, employee relations, good environmental performance, transparency, human rights, product stewardship, communication with stakeholders, profitability, strategy integration, and community involvement.

Corporate social responsibility or **corporate responsibility** is a systems approach to the relationship between business and society, which acknowledges responsibilities to both internal and external stakeholders, as well as local and international communities and the natural environment. Corporate responsibility is generally understood to be voluntary behavior that goes beyond legal compliance. Laws, regulations, and norms are absolutely necessary for good corporate governance and serve as safeguards against arbitrariness in practice. Yet, by themselves, they are insufficient to achieve sustainability.

(CONTINUED NEXT PAGE)

DEFINING COMMONLY USED TERMS: THE ROLE OF STAKEHOLDERS IN CORPORATE SUSTAINABILITY AND RESPONSIBILITY *(CONTINUED)*

Sustainability implies that a process or state — such as a company's operations — should be managed in a way that it can be maintained at a certain level indefinitely. The most common definition of **sustainable development** is "development which meets the needs of the present without compromising the ability of future generations to meet their own needs" and was created in 1987 by the World Commission on Environment and Development (the Brundtland Commission). In *Market Movers: Lessons from a Frontier of Innovation,* IFC and Sustainability describe sustainability as "a business approach embodying open and transparent business practices, ethical behavior, respect for stakeholders and a commitment to add economic, social and environmental value". To assess the sustainability of products, services, and other activities, companies need to use social and environmental criteria as well as financial judgment. Stakeholders are likely to have varying opinions about how such criteria are measured and interpreted.

Stakeholder Engagement and Sustainability

As the power of the private sector grows, it is now fairly widely accepted that businesses have responsibilities beyond making a profit and there are many good business reasons why it is advantageous for companies to ensure that business activities are ethical, responsible and environmentally and socially sustainable. Experiences of leading companies have shown that a demonstrated commitment to values and sustainability can help companies to achieve a variety of benefits:

- Gain and retain loyal customers while avoiding boycotts or other undesirable consumer actions;
- Be perceived as more desirable places to work and have an easier time recruiting and retaining talented staff members;
- Identify ways to increase efficiency and reduce costs in their operations, such as through more sustainable energy use and waste management, or reduced employee absenteeism;

- Forestall legislation or regulation by adopting voluntary programs, allowing them to develop discretionary standards according to their particular circumstances and challenges or to adopt industry agreed codes of practice; and
- Win the support of the communities where they operate and jointly solve problems that affect the company as well as the local population.

By adopting sustainable practices, businesses can create value not only for themselves but also for the broader society in which they operate. A sustainable, responsible business strategy seeks to ensure long-term business success while at the same time contributing towards economic and social development, a healthy environment, and a stable society. Importantly, such a company recognizes the need to be accountable and transparent towards stakeholders regarding the way it manages performance.

Ultimately, it is a company's stakeholders that give it legitimacy as a responsible enterprise. Even if a company believes it is acting responsibly, it will have little credibility and may suffer reputational damage if stakeholders do not perceive it to be acting responsibly. A growing number of companies now publish annual sustainability reports to communicate about their social, environmental and economic performance. These companies often also obtain external assurance or verification to increase the credibility of their reports. Sustainability reporting is one amongst various communications methods that companies can use to build stakeholder trust. This dimension is discussed further in chapter IV.

COCA-COLA'S USE OF GROUNDWATER IN INDIA

More than one out of every six people on Earth live in India, yet the nation has less than four percent of the world's freshwater resources. In the southern Indian village of Plachimada, persistent droughts have dried up groundwater and local wells, forcing many residents to rely on water supplies trucked in daily by the government. Some villagers linked the groundwater depletion to the arrival of a Coca-Cola bottling plant in the area.

In 2004, the High Court in the southern Indian state of Kerala ordered Coca-Cola to stop extracting ground water for its bottling operations. Justice K. Balakrishnan Nair told the company that it owned the 40 acres of land where its plant stood, but the groundwater beneath the land is a national resource belonging to the entire society. The complaint against the company alleged that the water table was being drawn down by Coca Cola, which used deep bore wells.

> "Through experience, we've learned that operating responsibly is not enough; it is also critical to really understand stakeholder concerns. [...] Our future success depends on finding workable solutions to the challenges facing the world in which we do business."
>
> THE COCA-COLA COMPANY
> www.thecoca-colacompany.com/citizenship/stakeholder_engagement.html

At the time of the ruling, large Coca-Cola customers in other parts of the world demanded that the company provide detailed explanations of its activities in India. The University of Michigan, for instance, with annual expenditures of approximately $1.3 million for Coca-Cola products in 2004, extended some contracts on a short-term, conditional basis while the company was given an opportunity to agree to a third party, independent audit to review the complaints.

Following a year-long scientific study, the High Court of Kerala determined that the primary cause of the water shortage in the local area was due to reduced rainfall and that Coca-Cola had the right to withdraw and use water from the local aquifer. Despite the ruling, Coca-Cola decided not to reopen its plant in Kerala.

In India, Coca-Cola had already begun to engage with stakeholders at the time of the court case in Kerala, and their engagement steadily increased in the years following.

The company formed an Indian stakeholder advisory board in 2003. Chaired by a former cabinet secretary, the board provides guidance on operational, environmental and corporate governance issues in India. In its 2006 Corporate Responsibility Review, the company noted that it had increased engagement with stakeholder groups in India, including critics of its water management practices.

The company has taken Indian stakeholder concerns about water seriously, addressing them in two important ways. First, the company provides detailed reporting on its water consumption and actively works to reduce its water usage. The company has also invited NGOs to provide objective assessments of its water management practices. Secondly, the company has partnered with government bodies and researchers, sponsoring hydrological studies to increase understanding of how to protect watersheds.

The Shareowner Model versus the Stakeholder Model

In most countries, the law makes it clear shareowners are the owners of companies and that boards of directors and managers have a fiduciary responsibility to act in the interests of shareowners. Most academic literature on governance begins with this perspective. In this ownership model, companies are seen as another form of personal property ownership.

Shareowners do own shares in a company and this ownership conveys certain rights and privileges. These include the ability to vote in the election of company directors, a claim to any distributions of income in the form of dividends, and the ability to sell their ownership stake.

In family-owned or employee-owned companies, shareowners may be quite involved in business operations. Shareowners owning a significant percentage of a company may also attempt to directly influence business operations. These examples, however, are exceptions. While shareowners are entitled to a return on their investment, they cannot actually do anything with any part of a company, nor do they usually have any expectation of doing so (Post, Preston and Sachs, 2002).

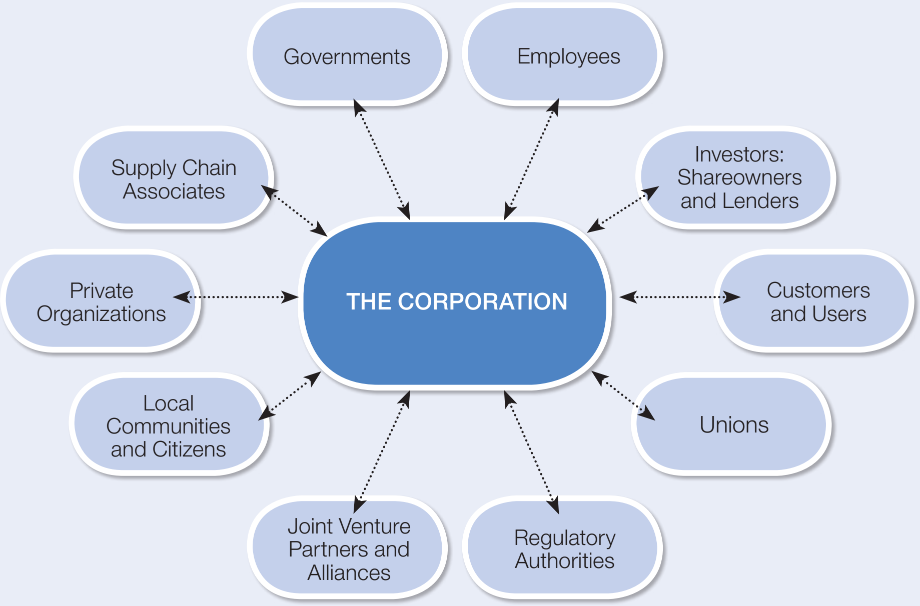
Many other types of stakeholders also have interests that are protected by law. A company may have legally binding contracts with suppliers or customers. In countries where certain employee rights are protected legally, society has agreed that companies have responsibilities to employees. While companies have legal obligations to investors, most also have legal obligations to other stakeholder groups.

Some companies are managed — and it can be argued that all should be managed — to create wealth for and avoid causing harm to multiple stakeholder groups. Comprehensive stakeholder management and stakeholder governance requires recognition of stakeholders who voluntarily associate themselves with a company in pursuit of their own interests, such as supply chain vendors, and those that are involuntarily impacted by corporate activity, such as communities living near company operations.

This stakeholder model of the company is built on the idea that stakeholders contribute, either voluntarily or involuntarily, to a company's wealth-building capacity. Stakeholders are either potential beneficiaries or risk bearers of company activity, and their interests should therefore be considered by management and boards of directors. The wealth-building capacity of stakeholders is considered further in chapter III, but Graphic 1 illustrates the multiple linkages between a company and its diverse stakeholder groups.

Stakeholder engagement can help companies better understand the interests and concerns of stakeholder groups so that they can make informed decisions about balancing the interests of all of the groups to which they may have some obligation. Considering stakeholder concerns and interests can improve relationships with stakeholder groups, which in turn makes it easier for a company to operate, may lead to ideas for products or services that will address stakeholder needs, and may allow the company to reduce costs and increase wealth.

Graphic 1


Governments
Employees
Supply Chain Associates
Investors: Shareowners and Lenders
Private Organizations
THE CORPORATION
Customers and Users
Local Communities and Citizens
Unions
Joint Venture Partners and Alliances
Regulatory Authorities

SOURCE: Post, Preston and Sachs (2002) *Redefining the Corporation: Stakeholder Management and Organizational Wealth*

To some extent, the distinction between the shareowner and stakeholder models is a false dichotomy. Stakeholders and shareowners alike are searching for methods of ensuring the long-term health and prosperity of companies.

Two broad notions have been used to make the case for stakeholder-oriented governance. The first, enlightened self-interest, argues that shareowners will ultimately be better off if they allow managers to pursue long-term objectives, including objectives that are important to stakeholder groups. In this approach, the supremacy of shareowners as owners of a company is not challenged. Because the short-term term interests of stakeholders are still given priority, there is still clear accountability of the board to shareowners.

The second interpretation is to make companies directly responsible to a broad group of stakeholders. Sometimes referred to as a pluralist approach, this requires company boards to demonstrate that the business is operated in a way that takes the interests and concerns of stakeholders into account (Cowe, 2001).

So, what does this look like in practice? Well, companies can capture and respond to stakeholder concerns in three ways:

- The corporation makes business decisions that take into account its understanding of stakeholder interests.
- The corporation engages with stakeholders to get their input on what decisions should be made and then makes the decisions itself.
- The corporation involves stakeholders in the decision making process.

Regardless of process, one also needs to consider the principles behind the decision making process. Will the corporation take stakeholder interests into account only when they have a direct influence on existing business performance? Will the corporation take stakeholder interests into account when the actions of the corporation affects stakeholders but a change will either not improve performance or make performance worse?

The disadvantage of the enlightened self-interest approach to stakeholders is that there are limits to the convergence between increasing profits and pursuing stakeholder interests. In many cases, there may be conflicts between these objectives.

Enlightened shareowner value' is a related concept commonly associated with the UK Companies Act of 2006. In addition to acting in the best interest of all shareowners, including future shareowners, the Act includes in the general duties of a company director the responsibility to consider other interests that may affect a company's success. This implies that stakeholders directly impact the company's ability to create wealth even though the interests of various stakeholders are frequently divergent. The Act places the onus on directors to balance and prioritize these potentially competing interests in order to ensure business success.

> “1. A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to —
>
> a. The likely consequences of any decision in the long term,
>
> b. The interests of the company’s employees,
>
> c. The need to foster the company’s business relationships with suppliers, customers and others,
>
> d. The impact of the company’s operations on the community and the environment,
>
> e. The desirability of the company maintaining a reputation for high standards of business conduct, and
>
> f. The need to act fairly as between members of the company.”[1]

Similarly, the 2002 King Report on Corporate Governance (King II) in South Africa states that “a key challenge for good corporate citizenship is to seek an appropriate balance between enterprise (performance) and constraints (conformance), so taking into account the expectations of shareowners for reasonable capital growth and the responsibility concerning the interests of other stakeholders of the company”.

In Germany, corporate governance regulations offer an even stricter definition of the responsibilities of the company to incorporate stakeholder interests. German companies follow a two-tiered governance model comprising a board of directors and a supervisory board, which must include employee representatives. Similarly, since 1995, European companies with at least 1,000 employees within the EU and at least 150 employees in each of at least two Member States have been required to establish Works Councils whereby employee representatives meet with company management at least annually and are consulted on major business decisions (AccountAbility and Utopies, 2007). French law requires that workers’ representatives be able to attend board meetings and the Japanese governance model emphasizes consensus among management and employees in decision-making processes (Aoki, 1990).

[1] United Kingdom, Companies Act 2006; 172: Duty to promote the success of the company

These various approaches demonstrate a tension between leaving it to the company's board and management to address stakeholder concerns versus ensuring that stakeholders are represented in key decision-making processes. All point to ethical as well as business reasons to balance stakeholder needs with those of shareowners, and that in fact these have areas of commonality. For instance, if customers, trading partners, and regulators favor stakeholder-oriented companies, then this will reinforce the financial return to shareowners and contribute to the long-term success of the company.

Boards of Directors and Stakeholder Engagement

While board structures and responsibilities vary according to local norms, laws, and regulations, most boards are responsible for:

1. Setting general policies and strategic direction
2. Shaping the company's framework for accountability, control, and risk management
3. Selecting and overseeing compensation of key managers, including the CEO

The second area of responsibility is where stakeholder engagement, or bringing opinions and information from outside in, relates to board leadership. The board of directors can play an important role in making sure that an outward looking approach — including transparency, integrity, and win-win relationships — is valued within a company and that these values are implemented. So what can the board do to embed stakeholder engagement in the company's governance? The following are key steps:

I. Define stakeholder engagement as a core value

II. Identify, discuss and prioritize key risks associated with changing societal expectations

III. Determine the board's financial and nonfinancial information needs for decision-making, management oversight, and monitoring key stakeholder relationships associated with generating value and wealth

IV. Discuss and approve key performance indicators for social, environmental, and financial performance

V. Approve a policy for external reporting

VI. Integrate stakeholder issues into annual general meetings of shareowners

VII. Discuss the risks and impacts of projects and operations and provide transparent disclosure information to shareowners and other key stakeholder groups

VIII. Convene stakeholder forums and invite key stakeholder representatives to address board meetings

In addition to being an important part of corporate accountability, stakeholder engagement can be useful as a learning and information tool for company leadership. While board members are often tasked with maximizing shareowner value, different blocks of shareowners may have different interests and ideas about how value should be maximized. Engagement and dialogue can help the board better represent these disparate interests.

Board members also have a responsibility to ensure that appropriate risk management systems are in place. Just as the board should ensure that financial statements are properly audited, it is also responsible for ensuring that management is aware of and properly manages nonfinancial risks. In this regard, stakeholder engagement provides a broader view of potential risks.

Of course, many so-called nonfinancial risks — such as the impact of climate change or global supply chain management — may ultimately have financial consequences. Often it is indirect consequences of nonfinancial risks that are hardest to oversee and manage. One example is the corporate governance failures at Enron. Despite its unwillingness to engage in other aspects of corporate oversight such as intense monitoring of business results and financial controls, Enron's board approved a disclosure policy that ultimately contributed to a lack of financial transparency and approved a compensation strategy that made managerial compensation highly sensitive to share price changes.

A key element of corporate governance is ensuring the accountability of boards of directors. Shareowners have largely been left with the role of protesting excessive pay or board compositions that do not comply with accepted guidelines. The process of stakeholder engagement increases overall accountability and encourages questions about operations. In the example of Enron, feedback from the media and the financial community about Enron's reporting could have served as an early warning to the board of directors. The company's stunning collapse was at least partially blamed on the board's unwillingness to demand transparency and accountability and to curb excessive arrogance.

Boards should consider that reputational and relationship issues are fundamental to business operations, so stakeholder engagement should be given as much consideration as dialogue with financial institutions. Just as discussions with major shareowners help a company understand how it is viewed and what investors want, engagement with other stakeholders can be crucial to helping companies understand what society expects. Engagement may produce clear financial benefits from increased staff motivation or improved reputation.

Roles and Responsibilities of Stakeholders

Much has been said about the responsibilities of companies towards stakeholders. More recently, as familiar structures of cooperation and engagement have evolved, the roles and responsibilities of stakeholders have in turn become more defined.

Stakeholders are characterized by their relationship to the company and their arising needs, interests and concerns, which will be foremost in their minds at the start of an engagement process. However, as the process unfolds they will soon take a particular role with related tasks and responsibilities. The following are just some of the different roles that stakeholders can play:

- **Experts,** such as academics, who have been invited to contribute knowledge and strategic advice to the company's board;

- **Technical advisors** with expertise on the social and environmental risks associated with particular technological and scientific developments invited to sit on scientific and ethical panels in science-based industries;

- **Representatives of special interests,** such as employees, local communities or the environment, commonly invited to participate in stakeholder panels to review company performance and/or reporting practices;

- **Co-implementers**, such as NGOs, who have partnered with the company to implement a joint solution or program to address a shared challenge; and

- **Co-monitors,** such as impacted communities, that have entered into an agreement with the company in which both parties will be responsible for monitoring outcomes of the company's sustainability projects.

In each case, stakeholders engaging with companies have an obligation to understand the company's objectives and to be well informed so that dialogue is constructive. Finding solutions that benefit everyone is only possible when stakeholders understand and appreciate the economic and legal objectives of a business.

Stakeholders can only be well informed and knowledgeable if companies are transparent and report on issues that impact stakeholders. Both parties have an obligation to communicate sincerely and attempt to understand, not just be understood.

III. THE BUSINESS CASE FOR STAKEHOLDER ENGAGEMENT

Companies that excel at stakeholder engagement excel in business. The skills developed through effective stakeholder engagement are invaluable in an increasingly complex world where companies deal with many different relationships that all potentially impact their business. For businesses with diverse geographical locations, this can be particularly challenging.

Creating Value and Wealth

Organizational wealth is the cumulative result of corporate performance over time, including all of the assets, competencies, and revenue-generating capacities developed by a company. Compared to less successful companies, wealthier ones can pay higher wages and offer better career opportunities, take greater risks, provide greater customer benefits, respond better to adversity, provide more value for shareowners, and maintain better relationships. They can also increase their capacity to generate wealth in the future by reinvesting in their businesses, launching new and innovative ventures, buying other companies, and building their own internal enterprises.

One way of measuring organizational wealth combines the value of both tangible and intangible assets. In this view, the main components of an enterprise's wealth are 1) the market value of physical and financial assets, 2) the value of distinct intangible assets such as patents or licenses, and 3) the value of relational assets, including stakeholder linkages and reputation (Post & Carroll, 2006).

> The failure to establish and maintain productive relationships with stakeholders is a failure to effectively manage a company's capacity to generate wealth.

This view of organizational wealth, called the stakeholder view, is more dynamic and practical than competing systems of measurement that focus on resources or a company's position within its industry. Companies that view wealth creation as a function of resources or market position are less likely to share information and be collaborative. This behavior can, in fact, be counterproductive, particularly in supply chain relationships or alliances where companies can benefit from collaborative product and process development.

Table 1: Different Concepts of Organizational Wealth

	Resource-Based View	Industry Structure View	Stakeholder View
SOURCES OF WEALTH	• Physical assets • Human Resources • Knowledge • Technology • Financial resources • Intangibles	• Bargaining power • Market power • Collusion	• Relationships that increase revenue or reduce costs • Relational benefits leading to increased wealth
MEANS TO PRESERVE WEALTH	• Barriers to imitation	• Barriers to entry, including government regulation and sunk costs	• Stakeholder linkages

SOURCE: Adapted from: Post & Carroll (2006).

Every company has critical stakeholders in every dimension of its critical environment — resource base, industry structure, and social and political setting. Favorable and mutually beneficial relationships through negotiated shared values with these stakeholders allow companies to create wealth, while conflict often limits or destroys wealth.

The sources of company wealth attributable to different stakeholder groups are summarized in Table 1.

Researchers have found that, at least for Fortune 500 companies, solid financial performance is linked to good treatment of employees, customers, communities and other stakeholders. Companies that treat stakeholders well are also rated by their peers as having superior management (Brown, Muchin and Rosenman).

Because stakeholder management or engagement and company growth and profitability are correlated, the idea that stakeholder objectives involve trade-offs for companies is questionable. Researchers have found evidence that addressing the concerns of customers, employees and community members also benefits shareowners in the long run (Preston and Sapienza).

Table 2: Stakeholder Contributions Associated with Company Wealth

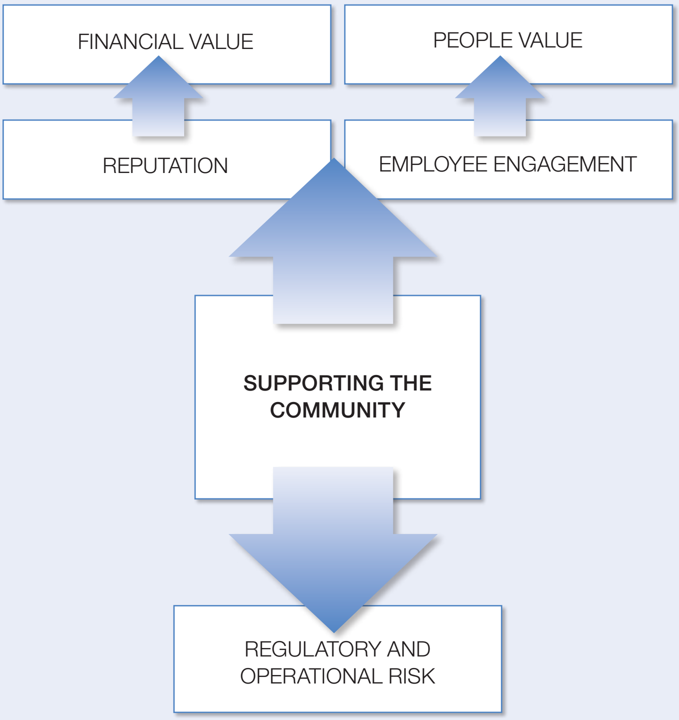
STAKEHOLDER GROUP	CONTRIBUTIONS
Investors and lenders	• Capital, equity and/or debt • Financial market recognition (reducing borrowing costs and risks)
Employees	• Development of human capital • Collaborative workplace relations
Unions	• Workforce stability and conflict resolution
Customers/users	• Brand loyalty and reputation • Repeated/related purchases • Collaborative design, development, and problem solving
Supply chain	• Network and value chain efficiencies • Collaborative, cost-reducing processes and technologies
Joint venture partners and alliances	• Strategic resources and capabilities
Local communities	• License to operate • Mutual support and accommodation
Governments	• Macroeconomic and social policies
Regulatory authorities	• Validation of product/service characteristics or quality levels

SOURCE: Adapted from: Post, Preston and Sachs (2002), p. 47.

Stakeholder engagement helps mobilize multiple stakeholder interests, enhancing social capital. Social capital connects people or groups of people in social networks that generate solidarity, goodwill, and mutual influence, ultimately contributing to both sustainable businesses and the common good (Maak, 2007). While there is widespread agreement that stakeholder engagement creates social capital, there is not an accepted measurement of the value of social capital.

Westpac, an Australian bank, and Anglo American, a mining conglomerate, are two companies that have attempted to understand and explain how they benefit from better relations with stakeholders and increased social capital. Many companies find that strengthening societal relationships directly helps business operations. Healthy societies are more likely to support strong economies with thriving companies.

Graphic 2: How Valuing Community Stakeholders Benefits an Australian Bank


FINANCIAL VALUE
PEOPLE VALUE
REPUTATION
EMPLOYEE ENGAGEMENT
SUPPORTING THE COMMUNITY
REGULATORY AND OPERATIONAL RISK

SOURCE: Adapted from Westpac 2006 Stakeholder Impact Report, pg 51

Reducing Risk

Businesses can reduce financial, reputational, and political risks by engaging with stakeholders. This may be particularly true of companies with highly visible, prominent brands, which can be more vulnerable to reputational risk.

Understanding the concerns and interests of employees, customers, NGOs, politicians and business partners helps a company to manage environmental and social expectations better, resulting in reduced risk of brand assassination, improved access to capital and insurance, cost savings and reduced vulnerability to regulatory changes. Engagement helps companies understand stakeholders' changing expectations and needs and helps to identify issues that could become critical or simply lead to changes in the way a business operates.

> "Overall, one cannot have a healthy economy and healthy and sustainable businesses in a fractured society."
>
> SIR MARK MOODY-STUART,
> Chairman, Anglo American

Tapping Opportunities for Innovation

Where there is risk, there is also opportunity. Because engagement gives companies a better understanding of the society in which they operate, it can provide a platform for better understanding of how to improve services and products to meet changing consumer needs. It may also be a way to get a different point of view about corporate operations, which could lead to ideas for improvement.

Moving beyond what are thought of as core stakeholders, to engage with fringe stakeholders — those who are disconnected from or invisible to the company — can provide even more opportunities for innovation. Hewlett-Packard's Living Lab provides information technology to rural Indian villagers, but it also allows the company to see how this fringe stakeholder group uses technology. In the long run, the company believes the Lab will help it design products for consumers in developing countries. In Bangladesh, Prof. Muhammad Yunus' interactions with poor Bangladeshis led him to reconsider some of the basic premises of conventional banking in setting up Grameen Bank. As a result, he invented the concept of microfinance, for which he won the Nobel Peace Prize in 2006.

ENGAGING WITH STAKEHOLDERS TO REVOLUTIONIZE A BUSINESS

Before privatization, piped water reached only about 60 percent of the households in the Philippines' capital city, Manila. Even worse, the public water utility lost about two thirds of the water in its system to leaks and unauthorized connections, which contributed to pressure and service problems for paying customers.

When Manila Water Company won the concession for water and wastewater services for the eastern half of Manila, it launched a "Walk the Line" in which all company staff visited with customers. Consultations included residents of informal settlements (IFC, May 2007).

Stakeholder engagement and cooperation was integral to improving service across the utility's service territory. By working with and helping to organize residential cooperative groups, Manila Water was able to install "mother meters" serving an entire community. The whole community is now held accountable for water consumption and individual families pay community representatives.

Manila Water's customer base grew from 325,000 households in 2004 to more than 1,000,000 in 2006. At the same time, losses to unauthorized connections plummeted, and customer satisfaction with service reached 96 percent in 2006 from only 3 percent in 2001 (Sutton, 2007).

The Case for Engaging Early, Often and Interactively

Without engaging stakeholders in strategic conversations, management runs the risk of developing a very management-centric, limited perspective of the company, its capabilities and its potential. In his book, *Why Smart Executives Fail*, Sidney Finkelstein, a professor at the Tuck Business School at Dartmouth University, describes this mentality as one of the most common triggers for catastrophic management failure.

Companies can become inward looking when directors are too closely aligned with top management, top management only communicates with middle management and middle management is rewarded for reinforcing what top management wants to hear. Often, opportunities for strategic innovation are only discovered through bypassing business level management and allowing information to flow between top management and outside stakeholders.

Effective stakeholder engagement promotes corporate learning and innovation. This is possible when the engagement is transparent, inclusive and responsive, and is undertaken with the intent that useful information will be applied. If companies think about critical stakeholders as a strategic asset, a source of information and learning that can be a competitive advantage in shaping and informing the direction of the company, then it makes sense to engage with stakeholders early and often to build trust and understanding through defining mutually understood shared values that address their respective interests.

Table 3: Continuum of Stakeholder Engagement

Degree of Engagement	Management Behavior
Inactive	Unilateral decision-making, ignoring stakeholder concerns
Reactive	Management only engages defensively when forced to
Proactive	Management attempts to anticipate stakeholder concerns
Interactive	Company has ongoing relationships of mutual respect, openness and trust with stakeholders

SOURCE: Adapted from Hemphill (2006)

Reactive engagement, or engaging with stakeholders only when there is no other alternative in a crisis situation, attempts to rebuild a corporate reputation with stakeholders that was never very strong to begin with. In contrast, proactive and interactive engagement reduces the possibility of a reputational crisis, and builds goodwill and a sense of cooperation with stakeholders that can be an asset in a crisis situation (Hemphill, 2006).

SHELL TURNS CRISIS SITUATION INTO A STAKEHOLDER RELATIONS VICTORY

In August 1999, the Italian oil tanker “Laura D’Amato” was discharging its crude oil cargo at Shell’s Gore Bay Terminal in Sydney, Australia, when, for reasons unknown at the time, 300 tonnes of oil was spilled into the harbour. Shell’s Gore Bay Terminal in Sydney Harbour has been operated by Shell since it was opened in 1901 and receives between 85 and 100 ships a year.

Gore Bay and other commercial activities in Sydney Harbour have been continually targeted by pressure groups who believe commercial activity is a threat to the harbour’s value as an international tourist destination. These groups argued that commercial shipping should be removed and the harbor reserved for recreational use only. Shell and others maintained that Sydney Harbor has always operated as a working harbor and should continue as such.

Aware that the risk of a spill or other environmental problem could threaten Gore Bay’s licence to operate, Shell’s External Affairs team devised a stakeholders’ communications plan in the late 1980s. This involved creating and maintaining a community consultative committee with local residents and other interested groups. The plan also involved Shell staff building dialogue channels with NSW politicians and key public servants about company activities.

The spill seriously threatened Shell’s reputation and business. Mishandled, the crisis could ruin stakeholder relations and encourage the government to stop commercial shipping in Sydney Harbor. A halt on shipping would directly affect Shell’s Gore Bay terminal and Clyde refinery which supplies fifty percent of New South Wales’ fuel requirements.

The response:

Media — Shell held a press conference at the site only three hours after the spill was first discovered. The first media release was widely distributed shortly afterwards. A series of six media releases followed over the next two days as the crisis developed. Background information sheets on Gore Bay Terminal and Shell’s shipping operations were also sent to all media. Shell spokespeople were

(CONTINUED NEXT PAGE)

pro-actively offered for radio and television interviews, media briefings, one-to-one phone conversations and personal interviews throughout the crisis.

Government — Shell staff contacted senior advisers for the relevant ministers and government departments on the night of the spill. The next day, personal briefings by Shell senior management were instigated, including a briefing for the NSW Premier by Shell's CEO. Follow-up letters with additional background information were sent to all government contacted. Shell also initiated the offer to co-operate fully with a government inquiry.

Stakeholders — A personal letter from the Gore Bay Terminal manager was hand-delivered to local residents before dawn on August 4. Three follow-up letterbox drops were organised over the next week. Non-government organizations (NGOs) were contacted by phone to discuss the spill.

Employees — An e-mail to all Shell Australia staff was distributed at 3am on the night of the spill so employees were updated as soon as they arrived at work the next day. Follow-up voice mail messages and e-mails were sent to all staff informing them of developments over the next week. After the oil spill clean up, a letter of appreciation was sent to all employees and contractors involved.

General public and customers — Additional staff were employed at Shell's Clyde refinery to handle the increased number of switchboard calls from the general public. Shell's customer service centre was fully briefed on how to respond to oil spill queries from customers. All media releases were posted on Shell's Internet web site. The media releases web page received 300 percent more hits in August than the normal monthly average.

The result:

Shell's rapid and comprehensive response to the crisis has had reputational as well as tangible business benefits. Shell received widespread praise including awards for crisis communications. There was no discernible impact on sales during the crisis, long-term business damage was avoided and Shell's reputation with stakeholders was actually enhanced.

Support from the local community was immense. Many residents and local groups openly praised Shell's involvement and relationship with them. After the crisis, Shell recorded higher than average attendance at the community consultation committee meetings and the next Gore Bay Terminal open day.

During and after the crisis, the NSW Premier Bob Carr announced that Sydney is, and will continue to be, a working harbor that allows commercial shipping traffic. He ruled out closing Sydney Harbor either permanently or temporarily and said moving Gore Bay Terminal was not an option. Today, Gore Bay continues to operate as a receiving and storage facility for Shell.

SOURCE: Adapted from case study by Helen Morgner, External Affairs Officer, Shell Australia Limited, www.grif.com.au

ENGAGING WITH CONSERVATIONISTS AND COMMUNITIES AFFECTED BY MINING

After 20 years of preliminary study, engagement, and forming partnerships, Rio Tinto invested $775 million in operations in southern Madagascar to extract ilmenite, a white pigment derived from titanium ore, which has many industrial applications. A great deal of time and effort went into understanding the social and environmental issues related to the titanium extraction project because Madagascar not only has one of the world's richest ecosystems, it also has one of the most impoverished populations.

Southern Madagascar has long been identified by conservationists as one of the top biodiversity hot spots on the globe, with thousands of rare plant and animal species. To develop the mine, the company had to relocate 80 households and provide compensation to another 510 families that would be affected by mining activity. NGOs also voiced concerns about some 50,000 people living near the proposed site, saying an influx of migrant workers may exacerbate the spread of the HIV/AIDS virus.

(CONTINUED NEXT PAGE)

Local priorities, such as livelihoods and cultural heritage, are not always shared by conservationists. Consequently, stakeholder engagement and constant communication is needed to reconcile differences. Early on, Rio Tinto set out to learn about the local cultural and economic environment to try to determine how the project could be integrated into the local society. Since Rio Tinto plans to operate the mine in Madagascar through its QMM subsidiary for at least 40 years, it developed a community-relations strategy based on mutual respect, active and reciprocal partnerships, and a long-term commitment to the community.

> "It is through consultation with affected communities that we are able to understand and monitor the effects of our operations. What is important is that those in affected communities have a reliable mechanism for bringing issues of concern and interest to our attention."
>
> www.riotinto.com

The company's interest in integrating the mine with the local community is demonstrated by a special co-management agreement for renewable resources. After months of public consultation, the agreement was signed by Madagascar's government and Rio Tinto representatives in 2002. The agreement involves the local population in the sustainable management of their renewable natural resources, and is reinforced by a DINA, a uniquely Malagasy social contract traditionally entered into in order to manage a potential source of social conflict. DINAs are widely applied in Madagascar and have come to be legally recognized. More importantly, as they are anchored in custom and tradition, they render legal agreements culturally acceptable.

To make sure that the mine has a positive impact on Madagascar, beyond direct employment and tax revenue, Rio Tinto is sponsoring project enterprise and microfinance programs to support the development of local SMEs, and considering ways to build the capacity of local communal and government groups.

The company has also partnered with environmental groups to find ways to manage the impact of the mine. In 2004, Rio Tinto developed a corporate biodiversity strategy in consultation with experts from conservation and community development organizations, including the company's biodiversity partners. In 2005, the partners and other organizations continued to assist Rio Tinto to develop a plan to implement the strategy. It commits Rio Tinto to have a net positive impact on biodiversity wherever the company works.

"For Rio Tinto, globalization spells opportunity combined with the need to engage better with the communities within which we operate. We recognize the importance of listening to, understanding and respecting the beliefs of those who do not understand or share our views. That takes time and resources, but it is worth the effort. Done well, it reduces risk and allows us to trade with and develop projects in nations that, not so long ago, opposed foreign investment and free trade," said Charlie Lenegan, Managing Director, Rio Tinto.

IV. BEST PRACTICES FOR PROACTIVE AND EFFECTIVE STAKEHOLDER ENGAGEMENT

There is no single engagement strategy that will work for all companies. Different types of businesses or operations will have different impacts and will therefore require different types of relationships or engagements with stakeholders. A nuclear power plant will, of course, need to have more substantial interaction with regulators and community members than a bakery, and producers of highly visible name-brand products may need to do more engagement than producers of intermediate products.

This chapter includes an overview of how management should engage with stakeholders on a day-to-day basis. In addition to championing engagement as a core business value and ensuring that management is engaging in ways that are useful and meaningful, boards of directors can also be directly involved. As companies increasingly consider stakeholder issues and concerns when making decisions, boards may incorporate a stakeholder engagement or governance model, managing companies to increase value for all stakeholder groups.

General guidelines for management best practice:

- **Start early.** Relationships take time to build. Trust and mutual respect are established over time. Trust is also much harder to build if stakeholders are only consulted when there is a problem or crisis.
- **Keep an open mind.** The outcome of a truly open and responsive stakeholder engagement process cannot be defined in advance as solutions that satisfy multiple parties can seldom be guessed at beforehand. Consultation where the company has already determined their plan of action is likely to be perceived as an untrustworthy public relations exercise.
- **Tailor engagement practices to the needs and interests of the company and its stakeholders.** Explain what input is needed from stakeholders and how it will be used in the decision-making process — again, driving the "shared values" continuum. Ask for input on how information should be disclosed.
- **Manage engagement as a business function.** Taking a systematic approach that is grounded in the business strategy and operations increases the likelihood that engagement will create value. As with other key business functions, direct reporting lines and the engagement of senior management are critical.

- **Take a long-term view.** For issues that are intrinsically related to company strategy, ongoing dialogue and standing stakeholder bodies can be more valuable than one time, ad hoc engagement. Publicly disclosing information that is important to stakeholders helps to ensure that ongoing dialogue is useful for all parties involved.

Identifying and Prioritizing Stakeholders and Their Issues

Because it is neither possible nor desirable to engage with every possible stakeholder on every conceivable issue, appropriate planning is necessary to engage strategically, in a way that will be useful for a company.

Because it is neither possible nor desirable to engage with every possible stakeholder on every conceivable issue, appropriate planning is necessary to engage strategically, in a way that will be useful for a company.

Two ways of prioritizing are by stakeholder group or by issues. Businesses generally begin engaging with core stakeholders, those that have the most legitimate and urgent issues or those most likely to have an obvious, direct impact on the business. Another way of deciding where to begin is looking at issues, rather than stakeholder groups, and initiating engagement around "issues" that are most material to a company.

The following are useful questions to consider when determining how to begin engaging with stakeholders:

1. Who are our stakeholders?
2. Which groups are voluntary stakeholders (e.g. employees and shareowners) and which are involuntary stakeholders (e.g. people exposed to pollution from operations)?
3. What do we think their interests are?
4. What opportunities and challenges do they present?
5. What responsibilities and obligations (economic, legal, ethical, and philanthropic) do we have to different stakeholder groups?

6. What strategies, actions, or decisions should we take to best deal with these responsibilities?

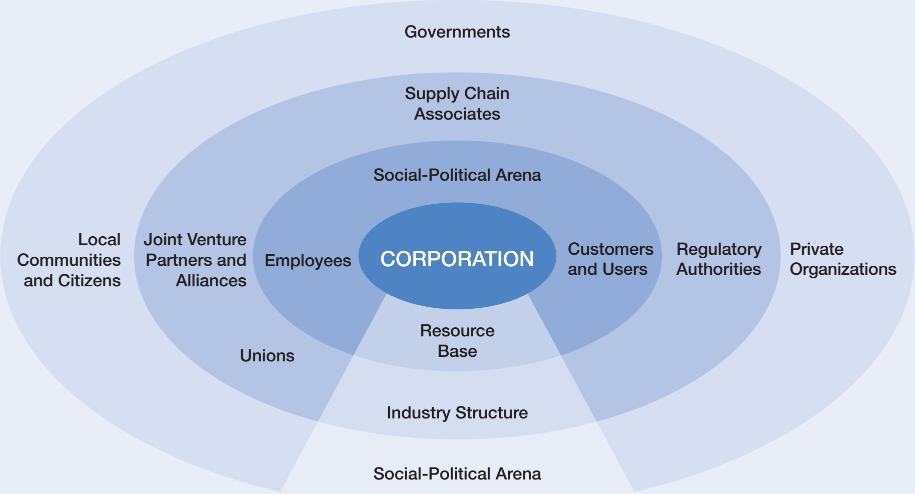
Stakeholders will also decide what issues matter and they will do this regardless of how company managers prioritize issues. It is essential for management to be open to stakeholder concerns to understand what they are and to be able to respond to new concerns when that is appropriate.

Stakeholder mapping involves creating a visual diagram to help analyze and prioritize stakeholder groups. The graphics below provide an example of a template that can be used to prioritize stakeholder groups, ranging from those that most directly impact a company and are most directly affected to groups within the broader socio-political environment. Graphic 3 provides a sample template and Graphic 4 shows how this is used for a specific company.

Note that once a company identifies important stakeholder groups, it must then ensure that engagement takes place with appropriate representatives of that group. For engagement to be perceived as credible, it should be as open and transparent as possible. Not all community members will have the same interests or opinions, for instance. Even shareowners can have very different opinions and interests. Transparent stakeholder engagement allows stakeholders in and between different groups to disagree with each other.

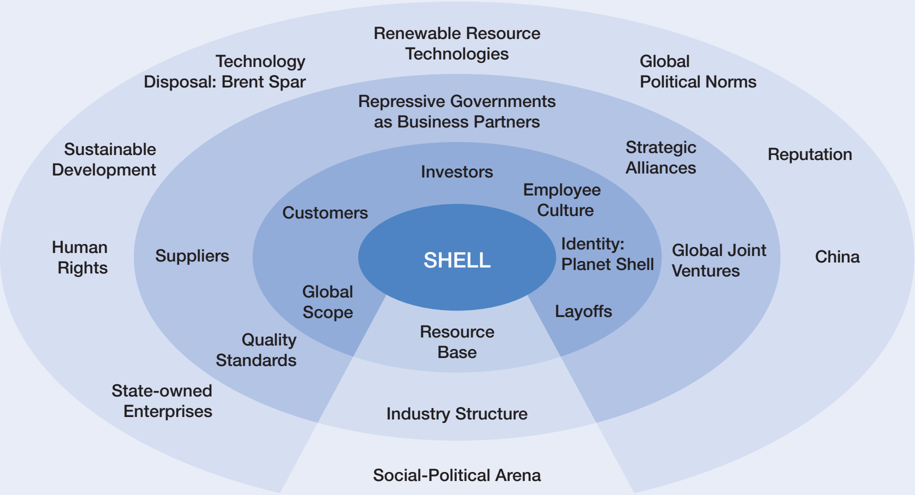
Another way to prioritize stakeholders is to take a list of all stakeholder groups and consider how strongly they influence or are influenced by a company. In the example below, the strength of the connection between a company and each stakeholder group is estimated by answering yes or no to seven questions. The higher the total score, the stronger the connection between a stakeholder group and the company, and thus the more highly the company is likely to prioritize the stakeholder group's interests.

Graphic 3: Prioritizing Stakeholders - Template



Governments
Supply Chain Associates
Social-Political Arena
Local Communities and Citizens
Joint Venture Partners and Alliances
Employees
CORPORATION
Customers and Users
Regulatory Authorities
Private Organizations
Resource Base
Unions
Industry Structure
Social-Political Arena

Graphic 4: Prioritizing Stakeholders - Royal Dutch Shell



Renewable Resource Technologies
Technology Disposal: Brent Spar
Global Political Norms
Repressive Governments as Business Partners
Sustainable Development
Strategic Alliances
Reputation
Investors
Employee Culture
Customers
Human Rights
Suppliers
SHELL
Identity: Planet Shell
Global Joint Ventures
China
Global Scope
Layoffs
Resource Base
Quality Standards
State-owned Enterprises
Industry Structure
Social-Political Arena

Table 4: Prioritizing Stakeholder Groups

STAKEHOLDERS	DOES THIS GROUP STRONGLY INFLUENCE THE COMPANY'S PERFORMANCE?			IS THIS GROUP STRONGLY INFLUENCED BY THE COMPANY'S PERFORMANCE?			WILL THIS GROUP STRONGLY INFLUENCE OR BE STRONGLY INFLUENCED IN THE FUTURE?	TOTAL
	ECONOMIC	ENVIRONMENTAL	SOCIAL	ECONOMIC	ENVIRONMENTAL	SOCIAL		
EMPLOYEES	1	0	1	1	1	1	1	6
CUSTOMERS	1	1	1	0	0	0	1	4
LOCAL COMMUNITY								
INVESTORS								
SUPPLY CHAIN								

SOURCE: *The GRI Sustainability Reporting Cycle: A Handbook for Small Organizations,* 2007, p.27

Deciding Which Issues are Material to Stakeholder Engagement

In accounting, information is considered material if its omission or misstatement could influence the economic decision of users taken on the basis of financial statements. For the purposes of stakeholder engagement, material information is anything that, if unknown or misunderstood, would prohibit management or stakeholders from making sound judgments and taking appropriate action.

One tool for helping to define the materiality of issues is AccountAbility's five part materiality test. To help with engagement planning, this test can be used to rank issues as being of high, medium, or low materiality in the following five areas:

- Issues that have direct short-term financial impacts
- Issues where the company has agreed policy statements of a strategic nature
- Issues that comparable organizations consider within their sphere of materiality
- Issues that the company's stakeholders consider important enough to act on (now or in the future)
- Issues that are considered social norms.

Of course, a company may underestimate the importance of a particular issue to a key stakeholder group. Materiality rankings give some indications about where to begin an engagement process, but the dialogue may change in response to new information about stakeholder concerns. While the goal is to be transparent and open, an enterprise may also decide that there are some issues that it cannot discuss publicly, even if these issues are closely related to operations or stakeholder interests. This might include proprietary information that is valuable to the company or issues that are under review by courts or government authorities.

Ways to Engage: Methods and Channels

Consultation tends to be a one-way flow of information, where a company solicits input from stakeholder groups. Dialogue is a more robust conversation. It gives companies an opportunity to provide context for their operational issues, and also means recognizing the potential for engagement to influence the behavior of regulators, investors, consumers, competitors, and suppliers. For stakeholders that are most closely linked or impacted by a company, face-to-face meetings are most appropriate. Open houses, public forums and disclosure may suit the needs of other stakeholder groups.

While ad hoc stakeholder engagement is generally less valuable than ongoing engagement that develops relationships and trust, it may be useful in the early stages of engagement as a way to get more information about stakeholder interests and find appropriate representatives of stakeholder groups with which to engage.

Consultation tends to be a one-way flow of information, where a company solicits input from stakeholder groups. Dialogue is a more robust conversation.

Formal engagement can take many forms, from partnerships with NGOs, to formal community engagement programs or advisory bodies.

Advisory bodies are often helpful in extractive industries projects, where a standing advisory body can serve as representatives for local communities impacted by mines or drilling. In such cases, a company may have an ongoing relationship with a community for decades, in which case it is worthwhile to develop an ongoing forum to facilitate communication and address concerns.

One financial services company that uses a standing advisory body is Australia's Westpac. The company's chief executive officer annually convenes a Community Consultative Council, which is comprised of representatives from 20 diverse stakeholder groups. Each participant is invited to highlight emerging concerns or trends and propose how the bank should address them and how much relevance the bank should attach to the issue.

Different types of stakeholders will have different preferences for how they prefer to interact with a company. It can be helpful to ask stakeholders how they wish to engage, what information they would like and what their expectations are for the process.

The table below lists all of the ways that Anglo American engaged with various stakeholder groups during 2006.

Table 5: Channels Anglo American Uses to Engage with Different Stakeholder Groups

External Stakeholders	Key Channels for Engagement in 2006
Investors	Results presentations and road shows, annual presentations, sustainable development presentations, bilateral meetings and surveys
Governments	Direct engagement and through industry associations, national partnerships, international partnerships
International organizations	Membership of UN Global Compact, ICMM, WBCSD and Global Business Coalition on HIV/AIDS, EITI, Voluntary Principles on Security and Human Rights. Dialogue with the International Finance Corporation, the World Bank and UN
Communities	Community engagement plans, socio-economic assessment toolbox, various public forums and meetings, impact assessments, complaints procedures and whistle-blowing
Contractors and suppliers	Commercial interactions, tender and compliance processes, open days, safety inductions
Customers	Commercial relationships, complaints procedures, surveys
NGO’s	Engagement on specific issues, involvement in partnerships (e.g. on transparency, biodiversity, human rights or HIV), memberships, social investment

SOURCE: http://www.angloamerican.co.uk/static/reports/2007/sc-engagement.htm

Developing a Structure for Success

Once stakeholder groups and issues are prioritized and engagement methods are considered, the process of developing relationships with stakeholder groups can begin. At the outset, the agenda for engagement should be discussed, so that goals and expectations are mutually agreed in advance. Most engagements have a fixed timetable to ensure that results are achieved. The timetable should be determined with input from all parties.

> It is essential that all employees are clear about the processes, objectives and commitments made as they are often at the front line executing those policies and commitments.

It is also important to establish ground rules for public disclosure and managing any expenses related to engagement. How much of the engagement will be publicly disclosed? Which parties are responsible for disclosure and when will disclosure occur? Companies should generally avoid giving money to stakeholder groups as part of the engagement process. If the company pays for travel or other minor expenses, make sure it is well understood what is expected for the money. Monetary exchanges should be reported as part of the reporting process discussed in detail below.

Companies also need to consider the importance of communicating consistently. Someone should be designated as the principle contact for the project or relationship. At the same time, management should also let employees know about the engagement process and what the company seeks to achieve. It is no use if only management is aware of the issues and policy decisions taken, it is essential that all employees are clear about the processes, objectives and commitments made as they are often at the front line executing those policies and commitments.

Using Information from Stakeholder Engagement

Stakeholder engagement provides valuable information that could produce a shift in company thinking or practice. Other stakeholder concerns can be addressed relatively easily. A stakeholder engagement process for the Angola Liquefied Natural Gas project, a multibillion dollar venture located in Soyo on Angola's northwest coast, uncovered villagers' concerns about protecting their homes from venomous snakes and other dangerous reptiles displaced during clearance of the construction site. To address this concern, the energy companies involved in the project hired a herpetologist to capture the reptiles and relocate them to remote areas under the authority of local environmental regulators.

Increasingly, businesses are moving from informing and responding to involving stakeholders directly in projects. In Morocco, LaFarge Cement involved community members in the process of finding a new location for a cement plant. While the company generally attempts to reduce impact on the environment and demonstrate benefits to the local economy, the public often views cement plants as noisy and destroying landscape. LaFarge's Tetouan cement plant, which was originally built at the edge of the town, had come to be located right in the middle as the town grew. The plant was also aging, so LaFarge decided to build a new facility. Visits to nearby sites were organized for residents so they could evaluate the level of nuisance. After several rounds of discussions, the new plant was moved a few kilometers away from its original site and opened with universal acceptance from the community.

During the process of engagement, issues and concerns will come up that a company may not be able to address. Stakeholders often ask pharmaceutical companies to reduce or eliminate their use of animal testing, but many governments require animal tests for product approval. Some pharmaceutical companies, such as GlaxoSmithKline, note that they disagree with stakeholders on this issue. Novo Nordisk, the world's largest maker of insulin products for diabetics, acknowledges that reducing its reliance on animal testing is desirable, but it can only do so when governments are convinced to change approval processes. The company publicly reports on the number of animals used in testing and the company's success in changing or influencing government policies on product testing.

> Increasingly, businesses are moving from informing and responding to involving stakeholders directly in projects.

How does a company determine which stakeholder interests and concerns it should try to address? A company must meet its economic responsibilities (being profitable) and its legal responsibilities (being in compliance with government regulations). Stakeholder interests that conflict with these responsibilities cannot reasonably be pursued in the short term. Long-term plans, such as working to change legal requirements, can be considered.

A company should be particularly careful, however, about rejecting stakeholder concerns because of cost considerations. Addressing stakeholder concerns may involve additional costs, such as the hiring of specially trained experts to manage removal of snakes at the Angola LNG project. However, over the long run, these costs may be offset in other ways, such as ease of project expansion or reduced site vandalism, or even avoidance of product sabotage by disgruntled employees drawn from the affected community.

A company should also look to the long-term implications of projects that respond to immediate stakeholder concerns and may need to be broader in scope or require a different strategy to be fair to other stakeholders. For instance, Anglo American's early efforts to provide antiretroviral drugs to employees with HIV/AIDS soon revealed that the initiative had limited impact unless family members were also treated. Similarly, building schools and communities around large factories or mines can create dependency on the part of communities with a negative impact when the business shuts down operations, downsizes, or moves to a different location. Mining companies frequently find that investing in the immediate community can create jealousy on the part of neighboring communities and lack of capacity among local authorities to manage the royalties from mining operations (See commdev.org).

Communication with Stakeholders

Follow-through is important to any relationship and this certainly applies to relationships with stakeholders. Whether or not a company is able to implement what it has learned from stakeholders, there is an obligation to report back, to make it clear that stakeholder concerns and interests were heard, considered, and valued. In addition to reporting back to specific stakeholder groups, sustainability or triple-bottom-line reporting provides companies with an opportunity to communicate environmental, social, economic, and governance performance to a wider range of stakeholder groups. It can also involve reporting on the process of stakeholder engagement itself, providing transparency about who was consulted or engaged on what topics, and with what results.

Companies have a responsibility to respond to stakeholders about concerns shared, to explain how or whether concerns or suggestions are being addressed. In addition to responding to issues raised by stakeholders, companies should keep track of any promises or commitments they have made to stakeholders. Just as a company would hold themselves accountable for promising earnings growth to shareowners, commitments to community members or NGOs need to be taken seriously for an engagement process to be considered credible.

Information reported to stakeholders should be translated into local languages and in easily understood formats, and any material changes to commitments or implementation actions should be communicated very clearly. Sophisticated stakeholder engagement reports, while commendable and necessary, do not always provide the information communities seek or understand — so there are various tiers to consider in the communications effort across a wide spectrum, and one that can be costly to implement but will help create and preserve reputational as well as business value for the company.

COMMUNICATING LOCALLY: USING STREET THEATRE IN INDIA TO HELP CHILD LABORERS

To address the problem of child labor, Bayer CropScience and an NGO partner established creative learning centers in rural India to prepare child laborers for state-run schools and used street theatre — called kala jatha — to communicate the need for school education to local residents.

When Bayer CropScience acquired an Indian seed company, Proagro, in 2002, it also acquired a supply chain employing children to handle pollinate hybrid seeds. NGOs found thousands of children working for different multinational companies in hybrid cottonseed fields in the heavily agricultural state of Andhra Pradesh. India has a compulsory education policy, but many children are still forced to work to contribute to their family's income. Simply banning child labor would not address the concerns of supply chain and community stakeholders.

In addition to a clear ban included in contracts with farmers, Bayer offered training to improve farmers' productivity and began publicly rewarding production without

(CONTINUED NEXT PAGE)

COMMUNICATING LOCALLY: USING STREET THEATRE IN INDIA TO HELP CHILD LABORERS *(CONTINUED)*

child labor. The company pays a bonus ranging from 5 to 7.5 percent of the purchase price of seeds. At the same time, violations of the ban are met with graduated penalties.

To provide opportunities for child laborers, Bayer partnered with an Indian-based charity, Naandi, to launch a network of creative learning centers throughout Andhra Pradesh. Instruction at these centers has successfully prepared children to join the state-run educational system. As of 2006, 650 children formerly employed in cotton fields were trained in the alternative centers. To increase awareness among parents of the need for school education, Bayer and Naandi sponsored street theatre performances in rural villages.

NGOs have been invited to participate in field checks to verify and confirm significant declines in child labor. As part of the company's reporting process, Bayer has also reported on these initiatives in its sustainability report.

Annual sustainability reports are one of the ways that a growing number of organizations around the world are communicating with stakeholders about their social, environmental and economic impacts and performance.

Sustainability, or triple-bottom line, reporting is aimed at a wide, multi-stakeholder audience. It is a tool to report performance on issues that stakeholders care about as well as a process for monitoring internal performance improvements. A sustainability report should form part of a broader strategy for communicating with and reporting back to stakeholders on the outcome of consultations or dialogues.

To be valuable, multi-stakeholder reports should be characterized by candor, describing a company's programs and policies clearly, accurately, and truthfully. Even, if necessary, highlighting challenges still to be overcome and steps being taken to address this. Reporting should include a clear understanding of key stakeholder groups — who they are and their main needs and positions — as well as a description of stakeholder engagement processes and a summary of how the company is responding to and addressing stakeholder priorities. In addition, evidence of how feedback and engagement processes have been integrated into the company's decision-making processes, supported with examples of results from this integration.

An increasing number of sustainability reports now make use of independent or third party assurance to attest that the information and data in the report are reliable and based on sound information and management systems. Sustainability assurance also evaluates how well the company has identified and prioritized the sustainability issues it needs to address — including consideration of stakeholder needs and concerns — and what it is doing to respond to them. The value of best practice sustainability reporting is that it requires an organization to view sustainability issues not just in terms of producing a report but of managing the issues in an integrated way.

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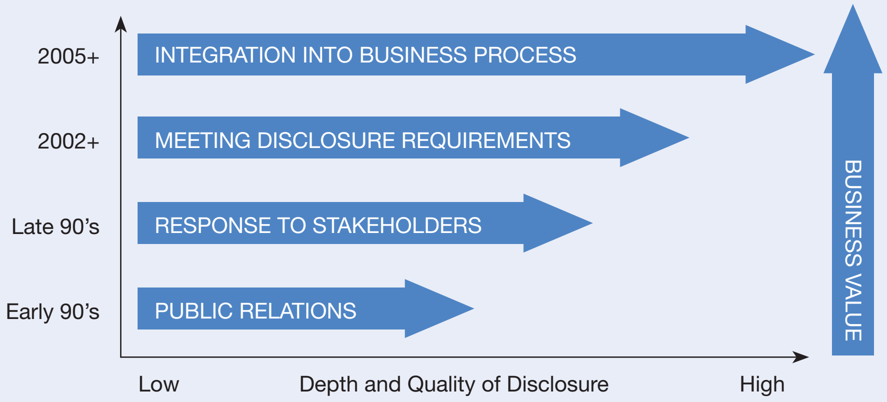
A 2008 KPMG Survey of Corporate Responsibility Reporting found that third parties, such as stakeholder panels, subject matter experts, and professional assurance providers are playing an increasing role in enhancing the credibility of company sustainability reports. The study found that formal third party assurance jumped from 30 percent to 40 percent of the Global 250 reports in the past three years, while 27 percent of reports contained other types of third party commentary, such as stakeholder panels or subject matter expert statements.

Graphic 5: Evolution of Sustainability Reporting


2005+
INTEGRATION INTO BUSINESS PROCESS
2002+
MEETING DISCLOSURE REQUIREMENTS
Late 90's
RESPONSE TO STAKEHOLDERS
Early 90's
PUBLIC RELATIONS
BUSINESS VALUE
Low
Depth and Quality of Disclosure
High

SOURCE: Global Corporate Governance Forum Presentation

Several international standards have evolved which serve as useful guides for stakeholder engagement, reporting and assurance to enhance credibility and responsiveness of company communications to stakeholder needs. These include the following:

AA1000

Published by The Institute of Social and Ethical Accountability (or AccountAbility), the AA1000 Series is a set of principles-based standards designed to guide companies in implementing systems to improve their sustainability performance and engagement with stakeholders. The Series has evolved from the AA1000 Framework, first launched in 1999, which became the leading global standard for building and measuring credible stakeholder engagement by companies. The new Series was released in 2008 following extensive stakeholder consultation and comprises an Assurance Standard and Accountability Principles Standards.

The AA1000 Series is built on a key foundation principle of *inclusivity,* which is defined as "the participation of stakeholders in developing and achieving an accountable and strategic response to sustainability." To meet the AA1000 Standard, companies must demonstrate:

- An explicit commitment to be accountable to stakeholders
- A process of ongoing stakeholder participation that is integrated and applied across the organization, both at group and local level
- Access to the necessary competencies and resources to operate the process of stakeholder participation

www.accountability.org.uk

GRI Guidelines

The Global Reporting Initiative Sustainability Reporting Framework is the most widely used and globally recognized framework for sustainability reporting. It comprises a set of core principles to guide companies in selecting and compiling material information and to develop the underlying systems for ongoing, effective management of environmental, social and economic aspects of their operations. It also includes a set of standard corporate disclosures and specific performance indicators tailored to various industries that have been developed and are continuously improved through a rigorous and ongoing multi-stakeholder process.

www.globalreporting.org

Organization for Economic Cooperation and Development (OECD) Guidelines for Multinational Enterprises

Promotes consultation and cooperation between employers and employees; disclosure of information on material issues regarding employees and other stakeholders; and adequate and timely communication and consultation with the communities directly affected by the environmental, health, and safety policies of the enterprise and by their implementation.

www.oecd.org

SustainAbility

A benchmarking tool to assess sustainability reports was introduced by international think-tank, SustainAbility, in its 2000 report *The Global Reporters.*[2] The tool assesses how well a company's disclosure enables readers to draw conclusions about its:

[2] http://www.sustainability.com/insight/globalreporters.asp?id= 458

- Commitment to address economic, social, and environmental issues strategically
- Likely future performance
- Operational performance over the reporting period
- Integrity of the reporting process itself, including stakeholder engagement

www.sustainability.com

"Accepting accountability to those it has an impact on (its stakeholders) does not mean that an organization has to do everything that a stakeholder requests, nor that it loses the responsibility to make its own decisions. Inclusivity requires a defined process of engagement and participation that provides comprehensive and balanced involvement and results in strategies, plans, actions and outcomes that address and respond to issues and impacts in an accountable way."

AccountAbility, 2008, AA1000 Accountability Principles Standard 2008

UN Global Compact

The UN Global Compact is the largest corporate citizenship and sustainability initiative in the world. More than 5,000 corporations and 1,500 civil society organizations from 130-plus countries have committed to support and respect 10 universally accepted principles in the areas of human rights, labor, the environment, and anti-corruption. Signatories are also required to report on their performance against the 10 principles.

www.unglobalcompact.org

Best Practices for Boards of Directors

Because stakeholder engagement is a part of responsible, ethical management, board members should be briefed about engagement practices and outcomes. Just as the board should be involved in financial reporting, at least a portion of the board should oversee nonfinancial reporting, including reporting to stakeholders that provides information about the steps taken by a company arising from mutual discussions held through formal and informal engagement processes.

In some companies, nonfinancial or sustainability reporting is overseen by the audit committee. There are also boards with committees dedicated to corporate responsibility or sustainability that monitor or oversee stakeholder engagement and sustainability reporting.

For stakeholder engagement to lead to a meaningful extension of corporate accountability, there needs to be some mechanism by which stakeholder views can feed directly into corporate decision-making and by which stakeholders can hold management to account. In most instances, stakeholders are not represented on company boards. An advisory body can provide representation for stakeholders through a second tier within the governance structure (Owen et al, 2001).

As part of the nonfinancial reporting process, more and more companies are having stakeholder groups review and comment on the company's approach to assessing and reporting on social and environmental performance related to corporate activities. This can take the form of an independent advisory committee or stakeholder panel to serve as proxy for stakeholder groups. Having a non-executive director involved in or as chair of the group can further ensure that recommendations are shared with the board, allowing the board to take a direct interest in these issues and the way they might inform key decisions. Importantly, the advisory committee should be given direct access to the board to ensure that the board gets a broad sense of outside perspectives of the company.

Particularly for companies without stakeholder representation in the boardroom, some mechanism is needed to ensure stakeholder views feed directly into corporate decision-making.

Best Practices for Stakeholders

While there are still plenty of instances of antagonistic relationships between stakeholders and businesses — including industrial espionage and product boycotts or other aggressive campaigns — there is growing recognition of the usefulness of cooperation. Much of the development in broader stakeholder collaboration has grown out of efforts to tackle complex environmental problems.

Various partnerships have emerged across the globe during the past 15 years to address problems such as packaging, deforestation, and mining.

Stakeholder collaboration has also been impacted by the rise of globalization. In response to new issues directly related to globalization, civil society organizations and non-governmental organizations now conduct their activities on a global level. As a result, companies are being confronted with new sets of local organizations and groups that they may not have had relationships with previously (Crane & Matten, 2007).

Stakeholders can be most effective if they focus on areas that produce gains simultaneously for a variety of stakeholder groups including the company being addressed. The interests of shareowners who may want to cut costs may differ most sharply with employees, who may represent significant costs to a business. In some cases this may require looking at long-term versus short-term effects. In the short-term, improving conditions for workers may increase costs, which can be negative for consumers and shareowners. In the longer-term, providing better working conditions may create a more committed, productive work force, which is in the interest of shareowners and other stakeholders.

Looking Forward: Emerging Trends in Stakeholder Engagement

Understanding stakeholder needs, interests and concerns is a fundamental part of managing indirect or nonfinancial risks. In fact, nonfinancial risks often have their own associated costs — whether social, environmental, or economic — and will likely in time affect the company's financial bottom line. Engaging with stakeholders, and using information from stakeholder engagements in decision-making, is fundamental to understanding nonfinanical risks and managing an enterprise responsibly. For this reason, social investment indices, such as the Dow Jones Sustainability Index, give more weight to stakeholder engagement than to any other social impact measure.

The measurement of stakeholder engagement used in standards, guidelines and performance assessments such as the Dow Jones Sustainability Index, AccountAbility's AA1000 standard, and the Global Reporting Initiative's G3 guidelines, rely on the existence of processes and policies for engagement. In other words, companies are judged on whether they do or do not engage. More sophisticated measures of engagement are being developed to measure the degree of "embeddedness" of stakeholder engagement, and it is likely that scrutiny of engagement capabilities will increase.

At the same time, as society's expectations about private enterprise change, companies may need to engage on a broader number of issues. Increasingly, issues that are important to society—water scarcity, HIV treatment, and climate change — are becoming important issues for companies to address. Boards and executives will always need to do what is in the best interest of the company and its shareowners, but in the future, prioritizing issues based on a company's needs may be less effective if these fail to also reflect society's needs.

Finally, in a move toward corporate governance systems that are truly responsive and accountable to stakeholder interests, more and more companies are going beyond engagement to develop collaborative partnerships with stakeholder groups or enlisting stakeholders to propose solutions or monitor outcomes. To be effective and fair, these governance systems should also have the capacity to respond to differences in power and access to resources between and within stakeholder groups.

In *"Plan B 3.0 — Mobilizing to Save Civilization"*, Lester Brown of the Earth Policy Institute makes the case that indirect costs associated with production of goods and provision of services by the private sector have until now been left off the books or omitted by the market when setting prices. For example, what is the real cost of oil if one considers the cost of ensuring oil security and not just production? Or use of water versus the need to maintain and replenish water resources, or the cost of energy when linked to climate change?

In the past, these costs have been borne by stakeholders outside the business, such as government, communities, and the environment. As governments adjust their economic policies to take these costs into account, a similar adjustment will be needed by businesses to fully account for the costs — as well as impacts on various stakeholders — of their products and services. Conversely, businesses sometimes inevitably bear costs associated with challenges that governments and society are not able to solve alone, but which might benefit from the tools and resources that companies possess.

It is thus possible to envision a business world not characterized by the ongoing shareowner/stakeholder debate, but one where shared values are negotiated between the company and various stakeholders (including shareowners). By collaborating with stakeholders to solve complex and demanding social, health, safety and environmental problems, companies should be able to create even more value for shareowners and benefit society at the same time.

USEFUL RESOURCES OF SELECTED ORGANIZATIONS AND INFORMATION SOURCES

Recommended Reading

AccountAbility, *The Materiality Report: Aligning Strategy, Performance and Reporting*
http://www.accountability21.net/publications.aspx?id=560

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http://www.ifc.org/ifcext/sustainability.nsf/Content/Publications_GoodPractice_StakeholderEngagement

The Oil, Gas and Mining Sustainable Community Development Fund (CommDev), Resources for partnership and community engagement
http://commdev.org/content/document/?topic=10

The World Bank, Participation and Civic Engagement
http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTSOCIALDEVELOPMENT/EXTPCENG/0menuPK:410312~pagePK:149018~piPK:149093~theSitePK:410306,00.html

International Sustainability and Stakeholder Engagement Initiatives

AccountAbility, AA1000 Stakeholder Engagement Standard (AA1000SES)
www.accountability21.net

Business for Social Responsibility
www.bsr.org

Collaborative for Development Action, Corporate Engagement Project
www.cdainc.com/cep

CSR Europe
www.csreurope.org

Earth Policy Institute
www.earth-policy.org

Equator Principles
www.equator-principles.com

Global Reporting Initiative
www.globalreporting.org

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Harvard University John F. Kennedy School of Government Corporate Social Responsibility Initiative
http://www.hks.harvard.edu/m-rcbg/CSRI

Institute of Development Studies, participation home page
www.ids.ac.uk/ids/particip

International Association for Public Participation
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www.oecd.org/daf/investment/guidelines

Social Accountability International (SAI), Social Accountability 8000 (SA8000) Standard
http://www.sa-intl.org/index.cfm?fuseaction=Page.viewPage&pageID=473

SustainAbility
www.sustainability.com

United Nations Environment Programme (UNEP) Finance Initiative
www.unepfi.org

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