THE CENTRE FOR INNOVATION IN MANAGEMENT

Measuring The Business Value Of Stakeholder Relationships

PART ONE

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The **Centre for Innovation in Management (CIM)**, located in Simon Fraser University's Faculty of Business, is a partnership of faculty, researchers, business leaders and social entrepreneurs dedicated to helping business create social as well as shareholder value. CIM conducts research, facilitates collaborative learning and disseminates new ideas in the areas of non-financial performance measurement and stakeholder relations.

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Introduction

"It doesn't matter how good the market research is, how bright the management team is, it is the quality of relationships among all people in the organization that has an enormous bearing on the quality of decisions and their execution."

Jeff Mooney, Chairman & CEO, A&W Food Services

In a rapidly globalizing, knowledge-based economy, sources of value creation in business are shifting from tangible assets such as land and equipment, to intangibles such as intellectual, human and social capital. While the relative importance of various assets is open to debate, we believe that relationships between a firm, its employees and other stakeholders constitute an important and yet undervalued business asset.

This report presents the conclusions of the first phase of a CICA sponsored research project on the business value of stakeholder relationships. The research addresses the following questions:

Under what conditions, and through which pathways, do stakeholder relationships create business value?

What are the essential attributes of an organization that facilitate the creation of positive stakeholder relationships?

What measures are most useful in assessing the quality of stakeholder relationships?

As a first step toward answering these questions, this report includes a review and critique of academic research on the business value of stakeholder relationships. We also propose a model of the contribution of stakeholder relationships to business value and suggest a provisional set of measures for assessing the quality of stakeholder relationships drawing on the concept of social capital.

This report outlines a research framework for examining the various 'pathways' that link stakeholder relationships to competitive advantage. During the next phase of the project, case studies will be conducted in collaboration with approximately six Canadian companies who strive to create competitive advantage, and ultimately business value, from their stakeholder relationships.

Shifting Paradigms and the Criticality of Stakeholder Relationships

Manual Castells, in *The Rise of the Network Society* (2000), argues that technology and globalization are making networks of relationships a decisive business asset. In much the same way that the Ford Motor Company's assembly line was the icon of the industrial age, Castells argues that the globally networked business model is at the vanguard of the information age. Kevin Kelly, in *New Rules for the New Economy* (1999), reinforces this view with his observation that "the network economy is founded on technology, but it can only be built on relationships. It starts with chips and ends with trust."

Contemporary organizations are flatter and characterized by more diffuse decision making, accelerated information flows and an emphasis on learning than are their predecessors. With this in mind, the creation and nurturing of relationships may rival the primacy of human and financial resources. As Charles Leadbeater noted recently in *Living on Thin Air* (1999), corporate-stakeholder relationships matter because they "foster[s] the co-operation and risk-sharing that promote innovation and flexible responses to change in a global economy." (p. 152)

Although we do not seek to address the corporate governance implications of this analysis, we have little doubt that fundamental changes occurring around and within businesses are leading to a redefinition of how companies must function in order to optimize the creation of economic value.

A Stakeholder View of the Corporation

Defining Stakeholders

The term 'stakeholder' has been defined as any group or individual who can affect or is affected by the achievement of a firm's objectives (Freeman, 1984). Primary stakeholders have interests that are directly linked to the fortunes of a company including shareholders and investors, employees, customers, suppliers, and residents of the communities where the company operates. Some theorists have also added individuals and groups that speak for the natural environment, non-human species, and future generations to this list (Wheeler and Sillanpää, 1997)

Secondary stakeholders, on the other hand, have indirect influences on an organization or are less directly affected by its activities. They include the media and pressure groups, and others that inhabit the business and social networks of the organization.

A typology of stakeholders reveals the variety of interests or "stakes" that groups of people hold in organizations or causes. The stakes of investors, for example, are based on equity. Other direct stakeholders, including customers, employees, competitors, suppliers, and debt holders, have economic stakes or interests in a company - they can directly affect or be affected by a corporation's financial success. Labour unions, community groups, environmental organizations, human rights organizations and consumer advocates have a stake in the company's impact on people and the environment, as well as their economic impact.

Sustainability and the Business Value of Stakeholder Relationships

Increasingly, large companies, including members of the World Business Council on Sustainable Development are using the term 'sustainability' to reconcile how value is created for firms, as well as for their stakeholders, in economic, social and environmental terms. This more inclusive approach is based on the premise that corporate performance should be assessed against a 'triple bottom line' of economic development, environmental quality and social justice or equity (Elkington, 1997).

A number of business leaders and management theorists have sought to place environmental or sustainable development considerations in a strategic business context. Research shows that the inclusion of sustainability issues in corporate mission and values statements - particularly in larger companies - is becoming more common and there is a parallel increase in measuring, reporting and communicating on such issues in real time (Wheeler and Elkington, 2000).

Companies are increasingly learning their way into sustainability issues - whether it be the rapid growth of ethical finance, the increasing interest of consumers in certified sustainable products and services, or the downward (and occasionally lateral or upward) pressure on supply chain partners to demonstrate environmental and social responsibility (Elkington, 1998; Beloe, 2000).

Finally, the magnitude of sustainability issues, such as global climate change, population growth, and economic globalization, means that companies which are not ready for major instability in marketplaces and political regimes may see their competitive advantage eroded and their business success threatened (Hart and Milstein, 1999).

Levels of Corporate Response: Compliance to Stakeholder Engagement

A number of prominent Canadian companies have focused on building strong stakeholder relationships as a key element of their business strategy. Simply by way of illustration, consider companies such as United Parcel Service, Dupont and Dofasco (employee commitment and loyalty), IKEA, Honda and Toyota (supply chain engagement), VanCity and Scotiabank (strong links with communities), and Suncor Energy, Placer Dome, Weyerhaeuser and Shell Canada (relationships with non-governmental organizations and communities).

Not all companies, however, have adopted the sustainability agenda and the assumption that establishing positive relationships with stakeholders makes good business as well as ethical sense. By examining the levels of corporate response to stakeholders we can distinguish between various orientations and better understand the role that certain kinds of stakeholder relationships play in the creation of business and societal value.

In 1975, management theorist Sethi developed a three tier model for corporate social responsibility which included i) social obligation (a response to legal and market constraints), ii) social responsibility (congruent with societal norms), and iii) social responsiveness (adaptive, anticipatory and preventive). Sethi's second tier requires that a company move beyond compliance and recognize and internalize societal expectations. The third tier requires that a company develop the competence to navigate uncertainty, maximize opportunity and engage effectively with external stakeholders on issues and concerns.

A Stakeholder View of the Corporation

If we take Sethi's model as a starting point, we might describe it thus:

Level 1 Compliant: avoiding harm in three dimensions of sustainability, for example ensuring safety of products and workers, avoiding economic losses, corruption and (illegal) environmental damage.

Level 2 Responsive: meeting reasonable individual stakeholder expectations in three dimensions, for example, achieving good levels of customer satisfaction, employee morale, returns to investors and reducing environmental impacts of operations, products and services.

Level 3 Engaged: maximizing economic, social and environmental value, for example, achieving simultaneous sales and stock value growth, customer and employment growth and eliminating or offsetting environmental impacts.

This project is especially concerned with firms operating in the second and third levels of the model as it is here that firms may create synergistic and self-reinforcing value in the economic, environmental and social dimensions of sustainability. These relationships may also help the company and its stakeholders avoid dissipating value.

In level 1, we assume that synergistic value is not actively eroded, but neither is it actively created, and, of course, it is more likely to be put at risk through failures in compliance. But is there a business case for operating beyond compliance? We believe that the answer to this question is an emphatic yes. Below we set out evidence for a positive correlation between social (stakeholder) responsiveness, engagement and business success.

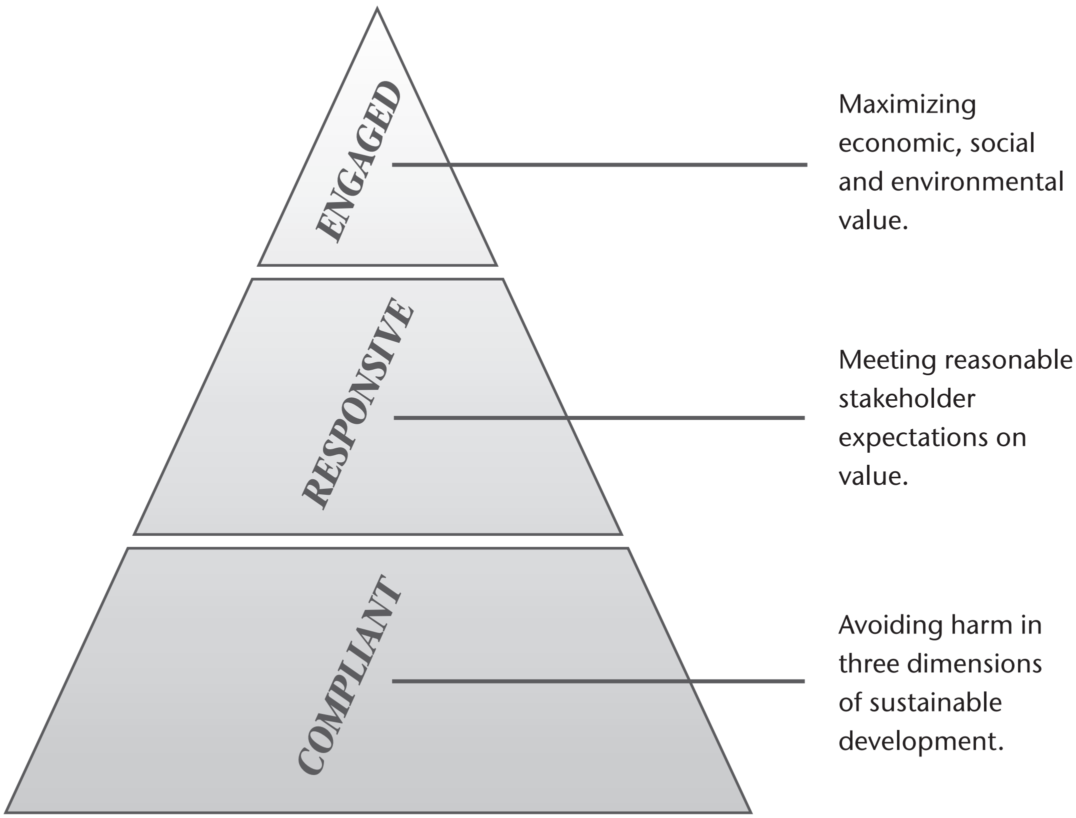


Figure 1: Model developed by Wheeler et al (2001 a, b) for classifying organizations with respect to corporate responsibility and degree of engagement with stakeholders in three dimensions of sustainability (developed from US Committee for Economic Development, 1971; Sethi, 1975 and Carroll, 1979).

Evidence of Link Between Quality of Stakeholder Relationships and Business Success

Stakeholder-Focus and Performance

The past thirty years have seen a rapid evolution in understanding about whether and how stakeholder relationships contribute to business success. While research which looks at the link between corporate social responsibility and financial performance have shown mixed results, there are a few significant studies which show there seems to be a strong correlation between good stakeholder relationships and business success.

Harvard researchers John Kotter and James Heskett, in their book *Corporate Culture and Performance (1992)*, for example, showed that over an eleven-year period, sales and employment growth at stakeholder-oriented companies were significantly higher than at shareholder-focused companies. Specifically, stakeholder-oriented companies reported four times the growth in sales and eight times the growth in employment. The authors argued that successful, visionary companies, although very diverse in other ways, put a lower priority on maximizing shareholder wealth and greater emphasis on serving the interests of a broad mix of stakeholders.

Arie de Geus reinforced this finding in his book, *The Living Company (1997)*. Here, the author found that stakeholder-oriented companies remained in harmony with their environment by keeping "feelers" out and by developing strong relationships. He also noted that companies which survived for twenty five years or longer tended to be cohesive, conservative in their financial dealings, and more likely to have decentralized decision-making.

In a Canadian context, a path-breaking study by Max Clarkson, former director of the Clarkson Centre for Business Ethics at the University of Toronto, found that firms that place a premium on ethics and social performance make the most money. Clarkson's research suggests that companies that concentrate exclusively on the bottom line often make poorer decisions. He suggested this may be because they lack information from stakeholders and the environment that would allow them to anticipate opportunities and solve problems when they are small and less costly to remedy (Clarkson, 1991).

Corporate Social Responsibility (CSR) and Financial Performance

A number of studies have used CSR databases to correlate measures of stakeholder relationship quality with financial performance (Collins and Porras, 1995; Waddock & Graves; 1997, Berman et al, 1999; Roman et al, 1999). Waddock and Graves and Berman et al., used measures for the quality of relationships with employees, customers, communities, minorities and women, and the natural environment that were based on CSR ratings derived from the

Kinder, Lydenberg, Domini (KLD) Socrates database. Waddock and Graves (1997) correlated companies' previous year CSR ratings with financial performance on measures such as return on assets (ROA), return on equity (ROE), and return on sales (ROS). They found quantitative support for the assertion that there is a connection between how a company treats its stakeholders and financial performance.

More recently, Berman et al, (1999) tried to determine which kinds of CSR behaviors were most strongly tied to ROA. They found that CSR behaviors that dealt with the company's relationships with employees and with customers had significant direct effects on ROA. The authors also examined the possible mediating role of company strategy, which was deduced from financial reports as selling intensity, capital expenditure efficiency, or capital intensity. Behaviors related to communities, minorities and women, and the natural environment proved to have a mediating effect, depending on the company's strategy.

Berman et al, speculated that mediating factors (e.g., impacts on the natural environment, and thus relationships with environmental groups), might not be of equal importance across industries. Similarly, relationships with minorities, as indexed by board and senior executive diversity, might be more important to financial performance in more racially and ethnically homogeneous geographic regions than in more diverse regions.

Rather more indirectly, correlations between social and environmental performance and stock price performance have been examined in the context of indices such as the Dow Jones Sustainability Index, the Innovest EcoValue Index and the Jantzi Social Index. Where these indices include the social dimension, their measurement is not based on the quality of stakeholder relationships. Rather, they equate social performance with observers' subjective ratings of actual corporate behaviors. In that respect, they focus on the outcomes or consequences of corporate stakeholder relationship quality. Moreover, the correlations are claimed to be the simultaneous manifestation in three dimensions of performance of a common factor, namely, management competence.

We propose to investigate the hypothesis that the ability to create and sustain high quality stakeholder relationships is a necessary management competence, without which financial success becomes unlikely. In any case, the fact that such correlations exist does provide some empirical evidence for the existence of links between social and financial performance.

How Do Stakeholder Relationships Create Competitive Advantage?

Increased attention to the link between positive stakeholder relationships and competitive advantage has been manifested in at least four areas:

(i) The failure to establish and nurture stakeholder relationships creates **shareholder risk.**

(ii) Strong relationships with and between employees, and with supply chain and business alliance partners are a prerequisite for **innovation**.

(iii) A dense network of relationships provides resources and information necessary for the development of **new markets and opportunities.**

(iv) Relationships are the source of a good **reputation** and enhanced **brand value**, both of which create a myriad of business benefits.

Risk Reduction

Companies like McDonalds, Mitsubishi, Monsanto, Nestlé, Nike, Shell, and Texaco have suffered damage to their reputations and sales as a result of public awareness campaigns by advocacy stakeholder groups (Schwartz and Gibb, 1999; Wheeler et al, 2001a, b). At its most obvious, the Internet has made it possible for activists around the world to coordinate boycotts against corporations with direct impacts on sales, albeit usually by a rather small percentage of their potential markets. For example, activist sites such as http://www.corporations.org/corplist.html (updated to Oct. 31, 2000) list dozens of companies currently being boycotted.

In addition to sales impacts, there are probably more damaging long term implications for shareholder value of controversies such as those suffered by the aforementioned companies. Although uncomfortable for companies to discuss and record, and difficult for them to quantify, they may include:

- diminution of license to operate in certain markets (e.g., Monsanto and its genetically modified products in Europe);
- diminution of 'supplier' or employer of choice' status (e.g., Shell's experience after the twin shocks of Brent Spar and Nigeria);
- diminution of brand equity.

These impacts also result in direct costs as companies re-invest in reputation by, for example:

a) employing extra staff to monitor internal practices which are under question (e.g. Nike's experience with human rights controversies in its supply chain);

b) tying up of senior management time during conflicts (e.g., McDonalds' experience in its libel case against London Greenpeace);

c) advertising spending (e.g., Shell's investments in corporate public relations post-Brent Spar and Nigeria);

d) excessive compensation claims (e.g., Texaco's experience in dealing with charges of systematic racism in its US business practices);

e) costs of physical damage to property (e.g., McDonalds experience during anti-globalization protests).

Innovation

In today's highly competitive economy, innovation is of fundamental importance to business survival and success. Research shows that creating highly innovative work teams is largely dependent on establishing positive relationships both between management and employees, and between employees themselves (Cooke and Wills, 1999; Leanna and van Burren, 1999).

Conversely, employees who are motivated by a common vision and set of goals, trust their colleagues, and are linked into diverse and stimulating information networks will tend to be more innovative. In other words, positive relationships are necessary to transform an intangible asset (knowledge) into a tangible one (new processes, products, and services).

"No matter how knowledgeable employees are, if they believe they are working in a hostile, low-trust environment they will hoard information, avoid collaboration, and display very low levels of creativity"

(Nahapiet and Ghoshal, 1998).

Similarly, positive, trust-based relationships with suppliers and business partners are fundamental to spurring innovation, as well as enhancing effectiveness and efficiency. In the past, supply chain relationships were governed by arms-length, explicit contracts. Considerable management effort was spent monitoring and controlling the behavior of suppliers and when contract terms are not met, attempting to remedy the problem and resolve conflicts. Today, supply chain relationships are more likely to be based on implicit, trust-based contracts that are negotiated and renegotiated as demands and opportunities change. This kind of relationship requires more flexibility and hence depends on shared knowledge, interaction and trust (Matthews et al, 1998).

How Do Stakeholder Relationships Create Competitive Advantage?

Reputation

Research shows that a company's reputation is an important determinant of business success. A 1997 national study of consumer attitudes by Cone/Roper (1997) found that 76 percent of consumers would be likely to switch to a brand associated with a good cause. This represents an increase from 63 percent in 1993. Other studies show a downturn in the value of a company's stock when a company is accused of ethical wrongdoing.

Technology and the increased power of the media to influence public opinion have contributed to a rise in the importance of reputation. Companies recognize that their reputation depends on developing credible relationships with their employees, customers, nearby residents, and suppliers. This is especially true in a networked world where everything about a company can be known globally and almost instantaneously.

The influence of reputation is perhaps best illustrated with reference to the well known cases of Shell in the UK and Merck in the U.S. On June 10, 1995 Shell UK began towing a used oil rig, the Brent Spar, into the North Atlantic to sink it. The disposal was the culmination of four years of study and was approved and supported by the regulators and, indeed, by British Prime Minister John Major when he was challenged on the point in Parliament. Greenpeace galvanized community opposition to the project, and compelled Shell to halt the project on June 20.

The costs to the company were considerable. Shell estimated that the direct cost to change the disposal decision was $200 million (US). Additionally, boycotts and threats against Shell service stations led to lost sales. Fifty Shell service stations were vandalized, two firebombed, and one raked with gunfire. Moreover, employee morale plummeted.

Within one month of the Shell episode, phosphorous trichloride leaked from Merck & Co. Inc.'s Flint River plant in Albany, New York. The leak produced a clearly visible toxic cloud above the plant. Forty-five people were taken to hospital, 400 workers were evacuated, and a TV crew broadcast the event. The community response ranged from indifference to laudatory support of Merck.

The reasons why Merck was given the benefit of the doubt are twofold. Firstly, the company's vision, forged in the 1920s, was built upon the core values of integrity, contribution to society, responsibility to customers and employees, and the unequivocal pursuit of quality and excellence. As early as 1993, CEO George Merck articulated the operating philosophy of the company:

"We pledge our every aid that this enterprise shall merit the faith we have in it ... that those who hold aloft that torch of Science and Knowledge through these social and economic dark ages, shall take new courage and feel their hands supported".

Merck believed that the company operated with the consent of the community and the company has, over the years, worked very hard to earn that consent. The company benefits from what Fombrun (1996) has called reputational capital.

Expanded Markets and Opportunities

The capability to engage essential stakeholders in positive relationships can give a firm a competitive advantage (Grant, 1998, 177). The advantage might be manifested in any number of ways in different industries and with different stakeholders. This phenomenon has been well demonstrated by Suncor in its development of oil sands in Alberta and BP in its securing of a community license to operate in Alaska (Wheeler et al, 2001a).

In the case of Suncor, environmental permits were obtained 18 months ahead of schedule as a result of strong community support for its operations.

In the case of BP, a positive reputation for community involvement was key to its successful bid for oil rights in Alaska.

Brand Value

Spurred on by the rapid rise of the service sector, the quality of a company's relationships with its customers began to receive a great deal of attention in the 1980s. Customer satisfaction measurement merged with one-to-one (Peppers and Rogers, 1993) database marketing to become customer relationship value.

In a similar vein, brand loyalty has been recognized as a valuable intangible asset. Our growing understanding of the links among intangibles like customer satisfaction, customer loyalty, and brand loyalty has facilitated estimates of the financial value of brands, the annual brand "rankings" by Interbrand for the Financial Times being a conspicuous example. The 2000 rankings estimated brand values for Coca Cola and Microsoft at US$72.5 and $70.2 billion respectively (Financial Times, 2000).

A Conceptual Model of the Business Value of Stakeholder Relationships

The Resource Based View (RBV) of the Firm

The proposed research framework begins with a "resource-based view" of the firm that suggests firms have resources, consisting of tangible and intangible assets, which give them distinctive capabilities. When those resources are not widely held or cannot be replicated by competitors (and cannot be replaced by other resources or purchased), they can produce a competitive advantage that can be sustained over the long term (Wernerfelt, 1984, Barney, 1991, Grant, 1991; Dierickx and Cool, 1989).

The advantage of taking the RBV as a starting point is that:

(i) RBV is established in the mainstream strategy literature;

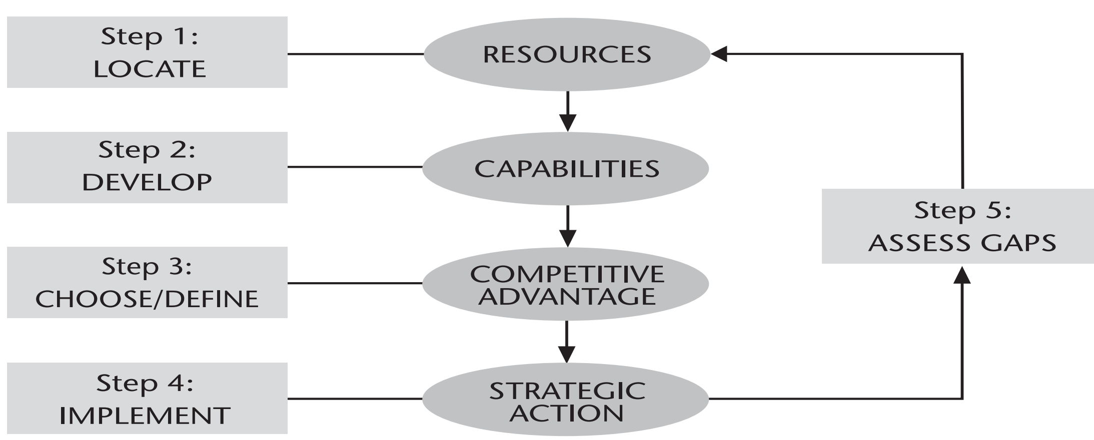
(ii) it provides a link to the language of resources (including tangible and intangible assets, relationships and competencies) and thus to the notion of preserving and building capital: economic, social, and natural;

(iii) it recognizes the inherent value in social relationships within and beyond the firm.

Figure 2 summarizes how a firm's resources affect its activities. Productive activity requires that an organization mobilize its resources to create various capabilities[4]. The rarity and inimitability of resources determines the extent to which they confer a competitive advantage upon the firm. Drawing on that advantage, the organization takes strategic actions to achieve its goals. Those actions have impacts on the company's operations and on society. The organization then assesses the gaps between the intended and actual impacts. If the gap is unacceptable, the organization may seek different or additional resources, or may try to develop different or better capabilities with the resources it has or can acquire.

Figure 2: The Resource-Based View (RBV) of the Firm

Source: Adapted from Grant, R.M. (1998, 180)



Stakeholder Relationships and Access to Resources

Historically, competitive advantage was thought to be the product of economic factors such as price, quality, and service. However, when products become commodities, economic factors become more or less equal across competitors and price, quality and service are no longer the differentiators or drivers of advantage. Advantage is more likely to accrue from the leveraging of intangible assets such as brand awareness, which encompasses both emotional and cognitive characteristics like product quality perceptions, lifestyle associations, or perceived environmental or social responsibility of the firm and its products.

Thus, the ability to engage stakeholders positively is a vital organizational capability in todays information based economy. Its importance seems to be related to the fact that these relationships enable the flow and use of other resources like financial capital, intellectual capital, and human capital.

Stakeholders act as gatekeepers to resources that firms need. For example, customers decide whether or not to give the company money, communities decide whether or not to let a company occupy a location in their area, and employees decide whether or not to share their innovative ideas with their employer or defect to a competitor. Likewise, poor stakeholder relationships make stakeholder controlled resources less accessible.

The quality of a company's relationships with its stakeholders can be seen as an indicator of the organization's capability to access valuable resources.

Depicting resources as only accessible through stakeholders might be overstating the case. However, if employees are stakeholders, then even resources that the company owns cannot be accessed without the cooperation of those stakeholders. At the very least, stakeholders can increase or decrease the cost and speed of access to resources. In that sense, it is not an overstatement to call them gatekeepers of resources.

Differences Across Industries and Life Cycle Stage

The literature reminds us that different industries will derive different business benefits from stakeholder relationships. For example, companies involved in natural resource extraction (e.g., mining, forestry) have significant impacts on the environment and therefore must work especially hard at maintaining their social license to operate. They must pay more attention to their relationships with environmental non-government organizations (ENGOs) and regulators. High tech companies have different preoccupations and must ensure access to highly trained and motivated workers. Under normal economic conditions, technology companies place less emphasis on relationships with communities compared with natural resource companies. Biotechnology firms working on genetically modified food on the other hand may be concerned with multiple stakeholder relationships - with employees, consumers, and ENGOs, as they need to protect their access to social license to operate as well as to ensure the creativity and motivation of highly trained employees.

The stage of development of a business can also affect the business value of various stakeholder relationship. Startup companies with no revenues depend on their initial investors for money, advice, contacts, and encouragement (Steiner, 2000). Established high tech companies, on the other hand, may find that relationships with business partners and sub-contractors take on proportionately greater importance.

Bakers do not Prosper by Bread Alone: Relationships as a Source of Competitive Advantage

To illustrate the model, lets consider how two hypothetical bakers access various resources in unique ways to create competitive advantage.

The first baker has the capability to bake bread according to a unique award winning bread recipe. The second baker has developed strong relationships with the miller, the water supplier, the yeast producer, and the equipment maker, as well as the banker, the accountant, the landlord, the local merchants' association, and customers. Both of these bakers has a set of unique capabilities that confer competitive advantages. Those advantages, however, must be used strategically in order to create business value.

The capabilities of our two hypothetical bakers reflect their strengths and weaknesses as they would be conceived in a strategic planning SWOT analysis (i.e., strength, weaknesses, opportunities, threats). The opportunities and threats presented by the external environment are the same for both of them, but their capabilities give them differential abilities to respond. The baker with the better relationships with the banker can respond better to changing interest rates while the one with the better recipe can respond better to a consumer trend towards developing connoisseur tastes in bread. The strategic action step of the RBV model refers to the actions that these business people take on the basis of whatever SWOT analysis they have formally or informally done.

Notice that the two bakers in our example do not have an equal likelihood of learning about the opportunities and threats in their external environment. The one with the better relationships with the employees and the banker is better positioned to receive information from those sources about both changes in consumer tastes and changes in interest rates. Thus, this baker has an additional capability-the ability to detect opportunities and threats before other bakers.

The above example with the two bakers is satisfactory for illustrating how the RBV model might elucidate the linkages between stakeholder relationships and business value, but it does not prove that such linkages actually exist. Moreover, it does not even begin to identify what all the possible linking pathways might be. For that, empirical research is needed.

Stakeholders and Business Value Creation

While the resource based view of the firm allows us to better understand how stakeholder relationships can restrict or facilitate a company's access to various tangible and intangible resources, it does not explicitly address how a stakeholder orientation is reflected in various management functions, nor how such functions create value for an organization. The proposed stakeholder model (see Figure 3) is an adaptation of the Performance Monitoring and Management System developed by Waterhouse and Svendsen (1998). The model is based on four interrelated ideas.

(i) Corporations exist in a network of interdependent stakeholder relationships These relationships are symbiotic, evolve over time and are mutually defined (Svendsen, 1998).

(ii) A company must have the ability to 'sense and respond' to a changing environment (Haeckel, 1999).

This gives them the ability to filter out "noise" in the environment and the ability to make decisions that will ensure the fiscal well-being of the corporation and the relationships upon which they depend.

(iii) Stakeholder oriented companies depend on multi-layered information and performance measurement systems. Such systems allow the company to constantly improve organizational effectiveness and adapt corporate strategy to changing circumstances. Such systems and their outputs also help to satisfy the accountability demands of internal and external stakeholders and can help a company diagnose relationship problems early and take steps to improve those relationships.

The ability to understand and satisfy the expectations of multiple stakeholders who have diverging and sometimes conflicting interests, is an essential corporate competency.

While performance measurement systems have traditionally been designed and used by organizations for control purposes, we view information and measurement systems as vehicles for feedback, learning and accountability. Given that a company depends on its stakeholder relationships for its continued survival, information and measurement systems that improve organizational effectiveness and build trust are of critical importance.

(iv) There are different levels or orientations toward stakeholders and relationship building. Some organizations may view stakeholders as important because they are legally obligated to do so. Others may feel a sense of social responsibility towards stakeholder groups who are affected by corporate activities. Still others may see stakeholder relationships as essential for creating value for the company, stakeholders and society as a whole. We believe our model is most powerful when applied to organizations who are operating within a sustainability (e.g. triple bottom line) framework and who are focused on maximizing economic, social and environmental value.

Stakeholder oriented companies use their relationships to systematically search out, capture and interpret clues from the environment in real time.

The Model

In this section we describe and explain the model illustrated in Figure 3. We begin with corporate strategy which defines what a company plans to do to achieve its business goals. Once a company has established its goals, it identifies the stakeholders who have the greatest capacity to influence the achievement of those goals. It chooses a set of strategies and processes that reflect and support its web of stakeholder relationships.

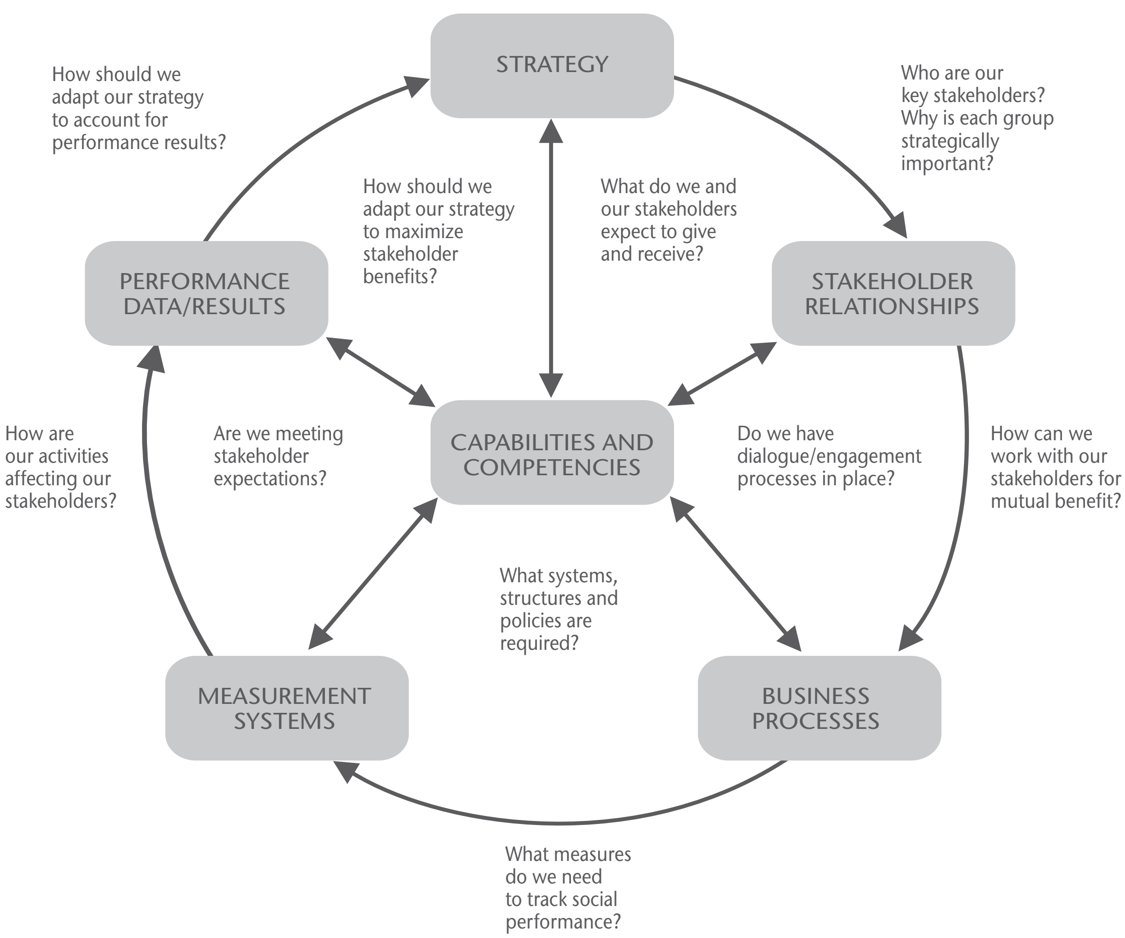
To ensure that its strategy will meet the expectations and requirements of stakeholders, the company creates opportunities for stakeholder dialogue. Through face to face and technology-enabled stakeholder conversations, the company can refine strategies, adapt business processes and identify new opportunities to work collaboratively with stakeholders for mutual benefit. An example might be a automobile manufacturer that invites interested customers to visit its website to identify new design features, or a forest company that meets regularly with leaders of international environmental organizations to discuss emerging issues and to identify forest management approaches which are acceptable to these groups.

The company then establishes business processes that reflect stakeholder expectations and requirements. This is an important managerial task because such processes, once established, are hard to change while stakeholder expectations and the environmental context are in constant flux. Also, the capacity of corporate management to simultaneously consider the interests and expectations of multiple stakeholders while dealing with the harsh realities of global competition and cost-cutting is extremely difficult.

Measurement systems can help managers deal with a complex and rapidly changing environment and understand and respond to shifts in stakeholder and public expectations. While financial measures are well developed, non-financial performance measures and especially those dealing with corporate social /stakeholder performance are in their infancy. Accordingly, the focus in this study is on measuring the level of social capital in corporate-stakeholder relationships.

Once measurement systems are in place and data has been collected, the company can determine how its activities are affecting stakeholders and also whether it is meeting stakeholder expectations. By considering its financial, environmental and social performance in an integrated fashion, a company can adapt its strategy to improve corporate performance and maximize stakeholder benefits.

Figure 3: Stakeholder Model of Business Value Creation



Non-Financial Performance Measures

There are very few studies which provide guidance on how we might measure the business value of stakeholder relationships. There is, however, growing interest in more robust performance measurement systems that go beyond traditional financial measures to help companies measure and manage various aspects of corporate social performance. For example, the balanced scorecard concept, introduced several years ago by Robert Kaplan and David Norton (Kaplan & Norton, 1993, 1997), includes measures of customer satisfaction as well as financial performance, effectiveness of business processes, and employee learning and growth.

There is growing interest in more robust performance measurement systems that go beyond traditional financial measures to help companies measure and manage various aspects of corporate social performance.

Interest in non-financial measures of performance is growing because it is recognized that intangible assets such as human capital (e.g., employee knowledge and skills); natural capital, and organizational or structural capital are becoming more important to wealth creation (CICA, 1996; AICPA, 1994). Traditional financial performance measures fail to capture the wealth creation effects of intangibles in a timely fashion and do not provide sufficient information for management to create value from those intangibles.

A recent CICA research report suggests that non-financial performance measures (which would include measures of the quality of stakeholder relationships) are useful because they (1) improve decision-making by helping managers understand and predict the links between activities and outcomes; (2) enhance the ability of companies to manage stakeholder relationships and issues; and (3) improve corporate accountability (Waterhouse & Svendsen, 1998).

Leading and Lagging Measures of Social Performance

Within the nascent corporate social performance field, there are two broad types of measures under development. The first category of measures focuses on the social impacts or "outcomes" of corporate activity. The second category of measures focuses on the quality of relationships that exist between a company and its stakeholders.

Common "impact" indicators include a company employee safety record, reports of human rights violations and the amount of money a company donates to community groups. The Global Reporting Initiative (GRI) and the Task Force on Churches and Corporate Responsibility Benchmarks are examples of impact oriented social performance measures.

Companies have begun to measure and report on their social impacts, at least in part because of accountability pressure from stakeholders. These types of 'outcome' indicators have the advantage of being observable and verifiable. For example, companies can report on the number of women in senior management, or the exact amount spent on community projects in a given year. One disadvantage of outcome measures is that they are retrospective. The information does not help managers understand and respond to what stakeholders want and expect.

A second category of measures focuses "upstream" on the quality of relationships. Often these measures are perceptual (e.g. employee trust and satisfaction). One advantage of these kinds of measures is that they focus attention on the drivers of performance and can therefore be used to predict outcomes. In the Balanced Scorecard framework, leading measures like customer satisfaction and spending on employee learning and growth are treated as predictors of "lagging" measures like sales and return on equity.

The "perceptual as leading/impact as lagging" premise has become well accepted in marketing and human resources. Companies routinely measure the quality of relationships with customers, employees, and citizens through market research, employee surveys and public opinion polls. Satisfaction measurement with employees has evolved into a vast array of standardized tests and specialized surveys. Reputation and brand studies (Fombrun, 1996) are also becoming more prevalent.

Quality of relationship or perceptual measures have yet to be developed in many stakeholder areas (e.g., relationships with environmental groups, regulators, suppliers, communities). Nor is there a robust theory to account for the synergistic effects of high quality relationships with multiple stakeholders on financial performance. However, the World Business Council for Sustainable Development (WBCSD) and a number of their member firms identified information about the quality of stakeholder relationships as a key, but under developed, area of social performance measurement and reporting (World Business Council on Sustainable Development, 2000).

Social Capital: A Measure of Relationship Quality

We propose to operationalize the measurement of relationship quality using the concept of social capital.

Social capital has generally been defined as the relationships among people that facilitate collective action and access to resources. Jacobs (1965) used the concept in the context of neighborhoods functioning as communities. Coleman (1988) discussed social capital's importance in the mobilization of human capital. Putnam (1995) and Fukuyama (1995) have drawn popular attention to the concept in the context of declining public participation in voluntary organizations and increasing mistrust of formal institutions in the United States. The concept has also gained currency in the public health area as a mediating variable in the relationship between income inequality and health status (Kawachi, Kennedy, Lochner, and Prothrow-Stith, 1997). In a community context social capital has been defined in terms of levels of trust and participation in voluntary organizations.

Definition of Social Capital

It has only been in the past several years that researchers have turned their attention to studying social capital within organizations and specifically within business organizations. For the purposes of this study we adopt the definition proposed by Don Cohen and Laurence Prusak, in their recent book, *In Good Company: How Social Capital Makes Organizations Work (2000)*:

This definition supports the view within the management literature (Nahapiet & Ghoshal, 1998; Tsai & Ghoshal, 1998; Cohen and Prusak, 2000) that social capital has the following three key dimensions.

(i) The structural quality of a relationship refers to the structure of the social network in which the relationship is embedded.

(ii) The relational quality of the relationship deals with the levels of mutual trust and reciprocity.

(iii) The cognitive quality of the relationship reflects the levels of shared understanding and goals.

"Social capital consists of the stock of active connections among people: the trust, mutual understanding, and shared values and behaviors that bind the members of human networks and communities and make cooperative action possible".

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Network/Structural Dimension

Social capital is relational. By that we mean that social capital is embedded in relationships between people who are joined in some form of community or network.

Companies and stakeholder groups typically have single link relationships with many organizations. Together these constitute a network. Exploring the structure of such networks is known as "social network analysis". The social network analysis literature contains many studies (see Wasserman and Faust, 1994) that show how single linkages can have very different implications depending on the structure of the network in which they are embedded.

For example, Rowley (1997) describes how a stakeholder group that has a single link with a company has more influence on the company if it also has links with multiple other stakeholders (e.g., suppliers to the company). Linkages among the stakeholders themselves forestall any use of a "divide and conquer" strategy by the company. Therefore, fully understanding the power and significance of single company-stakeholder link requires knowing the structure of the larger network in which the link is embedded.

Figure 4: Hypothetical Social Network Structure of a Company's Relationships with its Stakeholders

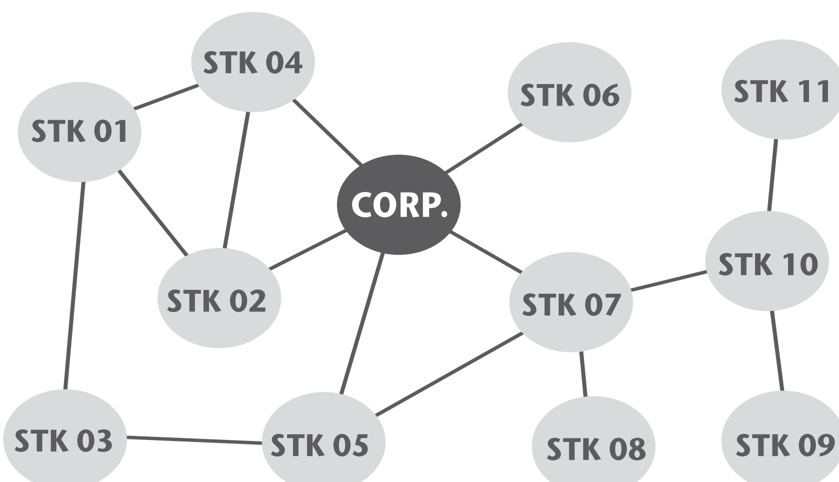

Figure 4 shows a hypothetical social network structure for a company and eleven of its stakeholders. Note how stakeholder six is socially isolated. All else being equal, that single link will have less influence on the company than the single link with stakeholder seven. Stakeholder seven has direct links with three other stakeholders (i.e., 5, 8, 10) and once removed indirect links with another three (i.e., 3, 9, 11). If the stakeholders were all suppliers, stakeholder 7 would be in a better position to hold a higher price than stakeholder six. Generally, the structure of the network in which a relationship is embedded is a good predictor of the power, influence, and similarity patterns that will be observed in the relationship.

Relational Dimension: Norms, Trust and Reciprocity

The relational dimension of social capital deals with trust, norms, and reciprocity. These concepts are all interlinked. This second dimension reinforces the notion that social capital is not the property of an individual or an organization. Individuals and organizations draw on their social capital with others in their networks who they trust and who share a sense of reciprocity. If a member of the network ceases to follow established norms, and if trust and reciprocity are withdrawn, social capital may be depleted or cease to exist.

Cognitive Dimension: Shared Language and Mutual Understanding

The cognitive dimension of social capital deals with interpersonally shared codes, language, and narratives. Tsai and Ghoshal (1998) extended the cognitive dimension to include shared goals, values, and vision. In a case study, Boutilier and Svendsen (2001) found the cognitive aspects of a company-stakeholder relationship to be more important to the emergence of interorganizational trust. Before two organizations can collaborate, they must have agreed on common goals and that agreement, in turn, is facilitated by shared values.

Social Capital in a Systems Context

Bridging, Bonding, and Boundary Spanning

Putnam (2000) popularized the terms bridging social capital and bonding social capital to describe two patterns of social capital that appear particularly relevant to the study of the business value of relationships with different types of stakeholders inside and outside the firm. As an illustration of the differences between the two types of social capital, Onyx and Bullen (2000) used the term bonding social capital to describe high levels of community participation and mutual support in rural communities, but not for those outside the community or for minorities in the community.

Onyx and Bullen associated bridging social capital with the inner-urban area in their study where there was greater tolerance, more ties with members of minorities and outside communities, and more reliance on individual initiative instead of mutual support. Onyx and Bullen's two types of social capital can be differentiated as the group's internal cohesiveness (i.e., bonding social capital) versus the group's external ties (i.e., bridging social capital).

Another perspective on this phenomenon appeared in the sustainability literature in the context of individual and organizational capabilities where the particular ability to network across and beyond the firm via 'boundary-spanning' has been recognized as an important 'dynamic capability' for firms dealing with sustainability in a strategic context (Sharma and Vredenburg, 1998, Sharma, 2001).

Social Capital as an Asset and Liability

Research and commentary on the notion of social capital has increased significantly in the past five years. Policy makers, international aid agencies, civil society organizations and business leaders have engaged in a rich debate about the definition of social capital and its merits and limitations (Schuller, 2001).

Economist Francis Fukuyama has, for example, linked higher levels of social capital with increased economic and social prosperity (Fukuyama, 1999). On a macro level, it is believed that Silicon Valley emerged as a thriving economic region at least partly because of the social capital embedded in relationships between networks of computer specialists associated with Stanford university (Cohen and Fields, 1999).

Within a business context, Cohen and Prusak assert (2000) that social capital creates business value in several ways:

- Better knowledge sharing, due to established trust relationships, common frames of reference and shared goals.

- Lower transaction costs, due to a high level of trust and a cooperative spirit (both within the organization and between the organization and its customers and partners).

- Low turnover rates, reducing severance costs and hiring and training expenses, avoiding discontinuities associated with frequent personnel changes, and maintaining valuable organizational knowledge.

- Greater coherence of action due to organizational stability and shared understanding (p. 10)

While social capital has been seen to be good for business, researchers have more recently paid attention to the fact that social capital can also be a liability depending on the situation and whose goals are being considered. Trust-based relationships with business partners or suppliers can, for example, provide the firm with resources while lowering risks and costs of opportunism. However, those same close relationships can also lead to malfeasance. If managers trust suppliers without adequate knowledge of their business processes or trustworthiness, suppliers may take advantage or may perform poorly.

In a different context, high levels of social capital in a relationship between a manager and supplier can improve coordination and lower costs for a company. Those same relationships can create a liability for the company if the manager/employee uses the network to find a new job.

To add to the complexity, positive stakeholder relationships can be both the cause and consequence of business success. As an example, as a company builds reputation among its peers for fair dealing and reliability in keeping promises, that reputation itself becomes a prized asset useful for sustaining its current alliances and forming future ones. The reputation and the trust are built upon a form of social capital. The social capital is embedded in the relationships that the company has established with its business partners.

The research proposed for Phase Two of this project will undoubtedly clarify aspects of how social capital is created and 'drawn down' and the links between the two.

Defining Pathways

The proposed stakeholder model provides a framework within which pathways from high quality stakeholder relationships to enhanced business value might be studied. Briefly, the relationships can give access to valuable resources and allow the exercise of unique capabilities, which in turn can be deployed strategically as core competencies to yield competitive advantage. The "quality" of company-stakeholder relationships can be the measured using the concept of social capital.

In the following table we summarize what has been learned about the pathways by which stakeholder relationships affect business success. It is intended to stimulate fruitful discussion about the design of research that will be conducted during Phase 2.

Table 1: Illustrative Pathways Between Stakeholder Relationships and Business Value

SOURCE OF COMPETITIVE ADVANTAGE			
DESIRED BUSINESS OUTCOMES	**FOCAL CAPABILITY**	**KEY STAKEHOLDERS**	**STAKEHOLDER CONTROLLED RESOURCES**
Innovation	a) ability of employees to access new ideas and information	• business and supply chain partners, • industry, professional and R & D associations • universities	• advanced, rare technical knowledge/ information about competitors, innovations and practices
Innovation	b) ability of employees to work collaboratively with others to create value for the organization	• employees • supply chain partners	• valued technical information, new ideas, knowledge and skills
Geographical Expansion of Markets	• ability to identify and take advantage of new markets	• managers • customers • suppliers and business partners • civil society leaders	• detailed market intelligence from afar • referrals to local resources (e.g., supplies, employees) in distant market
Enhancement of Brand Value	• ability to establish a strong emotional connection with customers	• customers • suppliers • investors • opinion leaders (media, analysts etc)	• positive widespread mention, word-of-mouth, commentary
Local Community Support/Social License to Operate	• ability to manage social risk and make a valuable contribution to the community	• managers, employees • local government and community leaders • regulators	• timely approval of permits/proposals • favorable interpretations of regulations • grace period during crisis
Sustained Business Partnerships	• ability to respond quickly and effectively to changing partner requirements	• supply chain partners • business network partners	• supplies and services obtained through very efficient and effective inter-organizational transactions
Recruitment and Retention of Most Talented Employees	• ability to attract and retain high quality employees	• prospective employees • current employees	• highly productive workforce
Reduced Conflict with Unions	• ability to manage relationships with unions to avoid strikes	• union members • union leaders • managers	• labour of employees
Customer Loyalty	• ability to anticipate changing customer wants • ability to engage customers in value creation	• customers • employees	• solid revenue floor (i.e., minimum) • word-of-mouth promotion • lifetime value of customers

FACTORS NEEDED TO BUILD SOCIAL CAPITAL			
INTERPERSONAL	**ORGANIZATIONAL**	**POSITIVE OUTCOMES FOR STAKEHOLDERS AND SOCIETY**	**POTENTIAL RISKS**
• employees part of active external networks • employees and business partners trust each other • they have developed shared language and mental models	• organization supports cross boundary information sharing • rewards for risk taking • hiring from existing professional networks • ethics policy in place and generally supported by cultural norms	• critical mass of industries for regional specialization and innovation (e.g., Silicon Valley) • stable well paid jobs • avoidance of cartels and monopolies	• loss of employees to competitors • loss of advantage due to release of sensitive information
• cross functional teams encouraged; time for informal interaction • employees trust each other and the company • enough shared language and meaning to get conversations started	• organization emphasizes learning/continuous improvement not hierarchy and silos • rewards given for teamwork and informal networking • company puts money/ effort into training/human capital	• highly creative workplace/job satisfaction • innovative products and services • spin-off jobs, multiplier effects	• group think • reduction in critical thinking • lower productivity • higher costs
• cross boundary networks created with non-traditional groups • managers have trust building skills, cultural sensitivity and knowledge	• resources and time available for partnership development • communication systems in place • tolerance for risk taking and 'creative destruction'/disruptive technologies • cultural sensitivity and knowledge	• marginal communities served • companies invest in communities	• conflicts with dissimilar 'partners' • lower productivity • higher costs
• company creates right marketing strategy to connect with value aligned customers • behavior matches rhetoric	• resources for direct marketing • values driven culture • organizational commitment to excellence in quality and service	• ethical customer practices • needs met effectively and with good value for money	• loss of customers who do not share values
• managers establish networks with opinion leaders • employee practices match rhetoric • behavior of managers builds trust • shared understanding created	• company invests in community • local hiring policy • manages environmental and other community risks proactively • respectful approach to downsizing/termination	• significant community benefits (economic, social and environmental)	• over-dependency of community • distortion of internal community economic relations
• sustained contact • trust • negotiated meaning/ agreements	• communication systems in place • trust building routines and practises encouraged • ethics policy in place and generally supported by cultural norms	• ethical business practices • cohesive economic development • avoidance of monopoly	• lack of competition allows inefficiency to develop
• proactive networks created with right prospects • company and managers build trust/reputation	• strong commitment to individual learning and personal development of employees • motivating compensation, incentives and rewards	• workforce developed and maintained in flexible and productive mode	• workforce more challenging and demanding in times of crisis
• opportunities created for dialogue between management and union • managers and employees strive for 'win-win' outcomes • shared understanding developed for key terms and concepts	• company provides desirable compensation and benefits • corporate culture supports open communication, ethical practises	• stable jobs in healthy workplace	• higher labour costs • dependency of firm on unions for communication
• employee behavior builds trust • managers have leadership skills	• company creates networks that are valuable for customers • company gathers and shares information of value to all • communication systems in place (e.g., data bases to contact customers, websites) • resources available for community building	• customers are happy with their product/service • communities receive benefits (e.g., information, cohesion) • company provides jobs	

Next Steps

The primary purpose of the next phase of this project will be to delineate the “pathways” that link stakeholder relationships to competitive advantages. In Phase Two, we will conduct case studies in collaboration with at least six companies that derive prima facie competitive advantage from their stakeholder relationships in a number of different ways. Indeed, one of our criteria for choosing the companies will be their likelihood of providing a sample rich with diverse pathways for creating social capital.

During Phase Two we aim to lay the groundwork for a comprehensive system for managing and measuring one of the most important intangibles in business today, namely, the quality and value of corporate stakeholder relationships. This study will attempt to detail the structural, cognitive, and relational dimensions of the relationships from the viewpoints of both parties (i.e., the company and the stakeholder representative). Then we will explore why the relationship is perceived to represent a certain current quality. Finally, it will seek perceptions of the antecedents and consequences of excellent versus poor relations in each stakeholder area.

This approach has four potential major advantages:

(i) It promises to predict future impacts of positive stakeholder relationships in addition to noting past impacts from a triple bottom line perspective.

(ii) Because stakeholder relationships all have common features, it allows direct comparisons of the quality of relationships across diverse stakeholder groups, companies, and industries.

(iii) It provides company executives with the feedback they need to prioritize and improve the company’s stakeholder relationships.

(iv) It provides for the possibility of gaining insight into sources of strategic competitive advantage that may have positive implications for firms in Canada and internationally.

Endnotes

1. Notable here are Schmidheiny's *Changing Course* (1992), Welford and Gouldson's *Environmental Management and Business Strategy* (1993), Hawken's *Ecology of Commerce* (1993), and Elkington's *Cannibals with Forks* (1998).

2. While these results are compelling, one must interpret them with caution. A commitment to stakeholder engagement, for example, is not a substitute for a sound business strategy, but rather a powerful complement or element within such a strategy. Put another way, stakeholder engagement is a necessary, but not sufficient condition for business success.

3. Welcoming address by George W. Merck at dedication of the Merck Research Laboratory, 25 April, 1933.

4. We assume that a combination of capabilities (usually manifested as recognizable organizational routines) and competencies (which includes tacit and explicit knowledge and attitudes) are necessary for a company to achieve competitive advantage (de Wit and Meyer, 1998). For the purposes of this model, we have included knowledge and attitudes under a company's human resources, though we recognize there may also be organization-level competencies..

5. In accounting, "capital" is the resource(s) an owner of a business provides to the business. For example, the resource might be in the form of equipment or cash. The value of the resource is the owner's equity in the business. Thus, the word has a fairly precise meaning in accounting, a meaning intimately connected to the ownership of a business. In the fundamental accounting equation in which assets equal liabilities plus owner's equity, capital is classified as neither an asset nor a liability. It appears under owner's equity.

6. The literature on social contracting is also relevant here. In accessing resources controlled by stakeholders, companies can be viewed as managing the implicit contracts with those stakeholders (see Atkinson, Waterhouse, and Wells, 1997)

7. This is essentially the distinction between relational capital and social capital. Relational capital is an asset embedded in singular relationships. Social capital is an asset embedded in a 'community' or a network of multiple relationships.

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