Series on Effective Stakeholder Engagement[1]

Stakeholder Theory

By Dr. Lynda Bourne

1. Ed Freeman

'Stakeholder theory' is a specific approach to recognising and dealing with stakeholders, based on the concept of *stakeholder* developed by Ed Freeman in his books *Strategic Management: a Stakeholder Approach* (1984), and *Stakeholder Theory: The State of the Art* (2010). These ideas are central to the **ESEI™** approach to stakeholder engagement.

The way in which organisations approach stakeholder engagement, the tools and techniques used to engage stakeholders and, at a philosophical level, the purpose of the organisation are built on which view of stakeholders is accepted by the organisation's governing body.

The traditionalist / Friedman[2] view of stakeholders focused on the 'owners' of the organisation (in the commercial world shareholders) with the simple purpose of maximising profits. A range of public relations and physical disasters highlights the short term, self-defeating outcomes of this approach.

R Edward (Ed) Freeman's *stakeholder theory* poses the deeper philosophical question: 'can business leaders make decisions about the conduct of the business without considering the impact of these decisions on (all) those who will be affected by the decisions?' Is it possible to separate 'business' decisions from the ethical considerations of their impact?

The evidence suggests it is impossible to build a sustainable organisation of any type, including a profitable business, if that organisation fails to meet the needs of most (if not all) of its stakeholders, most of the time. Freeman is considered to be one of the early proponents of this wider view of organisational stakeholders, writing that they could be defined as *"any group or individual who can affect or is affected by the achievement of the organisation's objectives"*[3].

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[1] This series of articles on effective stakeholder engagement is by Lynda Bourne, DPM, Managing Director of Stakeholder Pty Ltd (Australia) and author of the books *Stakeholder Relationship Management* and *Advising Upwards*, both published by Gower (UK). Dr. Bourne is one of the world's leading authorities on program/project stakeholder relations. Her author profile can be found at the end of this article.

[2] Milton Friedman (1912 – 2006), American economist, statistician and writer.

[3] This broad view has been accepted by many institutions, for example, the current *PMBOK® Guide* glossary defines stakeholders as: *"Stakeholders are individuals, groups, or organisations who may affect, be affected by, or perceive themselves to be affected by a decision, activity, or outcome of a project, program, or portfolio"*.

In 1984, economics assumed that 'values and ethics' did not need to be considered in economic theory[4]. The limitations of this approach can be questioned in a number of ways:

- Can we really divide the world into 'business realm' and 'ethical realm'?
- Can business executives 'do the right thing': can they separate the 'business' decisions they make from the impacts of these decisions on everyone else (stakeholders)?
- How can we combine 'business' and 'ethics' conceptually and practically?

The artificial separation of business decisions from a consideration of their impact is described by Freeman as the 'separation fallacy', rejecting it by stating there can be no such thing as 'value free economics': "*it makes no sense to talk about business or ethics without talking about human beings. Business is conducted by human beings, decisions are made by human beings, the purpose of the value creation and trade is for the benefit of human beings"*. If business is separated from ethics there can be no moral responsibility for business decisions.

The starting point for a better approach to stakeholders is that *"most people, most of the time, want to, and do, accept responsibility for the effects of their actions on others"*. What this means is that:

- People engaged in value creation and trade (in business) are responsible to *"those groups and individuals who can affect or be affected by their actions"*.
- The affected groups include (at least): customers, employees, suppliers, communities, financiers and shareholders.
- And importantly, no one group can expect to profit at the expense of others over a sustained period – everyone benefits or ultimately no one benefits.

Stakeholder theory is fundamentally a theory about how business can work at its best. It is descriptive, prescriptive and instrumental at the same time. It is more complex than just considering value for shareholders, because there are many relationships involved. Consequently, for any organisational activity there will be a complex web of human beings whose needs and wants (stakes) need to be identified, managed and as far as practical fulfilled to make the business successful.

This concept refutes Milton Friedman's article in the New York Times (1970) which stated that for businesses to become successful they must focus on maximizing profits – a focus on shareholders and 'shareholder value'. To maximize profits there must also exist:

[4] Freeman, Harrison, Wicks, Parmar, & deColle, in their 2010 book *Stakeholder Theory: The State of the Art* trace the evolution of stakeholder theory from 1984 when it was originally associated with the idea of business as being concerned with value creation and trade, through to the current times.

- Products and services that customers want,
- Good relationships with suppliers to keep operations at cutting edge,
- Inspired employees to stand for the company's mission and push it to become better,
- Supportive communities to allow the company to flourish.

Focusing exclusively on shareholders is counterproductive because it restricts the fundamental driver to short term profits – shareholder relationships. But the only way to maximize profits sustainably it to satisfy all organisations' stakeholders. Instead of the flawed shareholder value paradigm, developing a 'stakeholder mindset' in organisations and by extension in projects and programs is a better way to maximize profits, where:

- Business is a set of relationships among groups which have a stake in the activities that make up the business.
- Business is about how customers, suppliers, employees, financiers (stockholders, bondholders and banks), communities and managers interact and create value.
- To understand business is to know how these relationships work.
- The executive's job is to manage and shape these relationships.

Within this framework the stakes that stakeholders have will include:

- Owners or financiers (shareholders) have a financial stake in the business in the form of stocks, bonds – they expect a financial return.
- Employees have their jobs and their livelihood at stake: They may have specialised skills for which there is only a small market – in return for their labour they expect security, wages, benefits and meaningful work.
- Customers and suppliers exchange resources for the products and services of the firm. They expect to receive in return the benefits of the products and services – these relationships are enmeshed in the way ethics are practiced in business.
- The local community grants the organisation the right to build facilities within its boundaries. The community benefits from taxes and the economic and social contributions of the organisation back into the community.

These relationships are interdependent and require balanced decision making:

- The organisation will not be profitable unless its employees and suppliers work constructively to make goods or services the customers are prepared to buy.
- The organisation has to pay sufficient money and create a culture that attracts the right type of employee, but if employees take too much out of the organisation in the form of excessive pay, the organisation becomes uncompetitive and the employees lose their jobs.
- Organisations are expected to be good citizens – not to expose the community to unreasonable hazards in the form of pollution, toxic waste or substandard goods or services. But the community benefits from consuming the goods and services and it is impossible to create things without some pollution.

The art of managing within stakeholder theory is to find ways to minimise the damage and maximise the benefits accrued by each of the stakeholder groups. This is a creative process and management teams that do it best create the most successful organisations.

There is great value to be gained in examining how the stakes of each stakeholder or stakeholder group contribute, positively or negatively, to the value creation process of a business; and what the role of the organisation's leadership is in stakeholder relationship management. In this context stakeholders may be defined both in a narrow context and more widely:

- Narrow: those groups without whose support the business would cease to be viable: categorized as 'primary' or 'key stakeholders'[5].
- Wider: those who can affect the business, or be affected by its activities categorized as secondary or instrumental stakeholders (a means to an end).

The stakeholder approach preferred by Freeman is this: *Executives need to understand that business is fully situated in the realms of human beings; stakeholders have names and faces and children AND they are not placeholders for social roles*.

Understanding and managing a successful business in the 21st century, using stakeholder theory includes:

- Resolving the basic problem of an organisation's value creation to generate profitable trade on a sustainable basis.
- Combining thinking about ethics, responsibility, and sustainability with the current economic view that the organisations that operate within a capitalist framework must 'maximise shareholder value' – the problem of the ethics of capitalism.
- Dealing with the paradox that an over emphasis on creating shareholder value will destroy shareholder value.

A recent report: ***From the stockholder to the stakeholder*** by Arabseque Asset Management and Oxford University supports this contention[6]. The report is a meta-study that reviewed more than 190 different sources of published research on environmental, social and governance (ESG) issues. The report demonstrates a strong correlation between organisations that take ESG seriously and economic performance. For example:

[5] Similar thinking formed the basis of the categorisation of stakeholders as *'legitimate'* and *'salient'* by Mitchell, Agle, & Wood (1997). However, the term *'legitimate'* can lead to a risky viewpoint that only the *'legitimate'* stakeholders matter. In reality, all stakeholders matter, what differs is the amount of effort that can reasonably be allocated to managing different people.

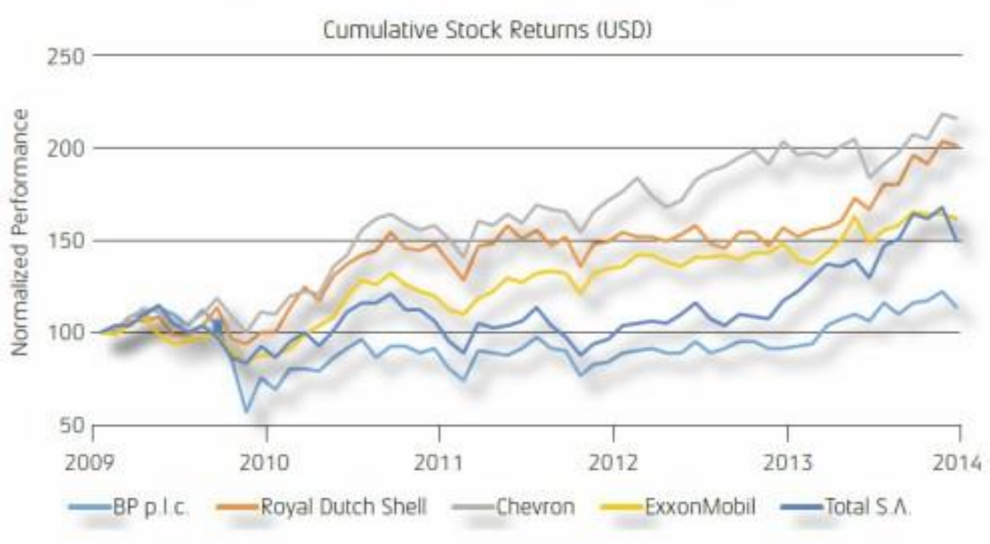
[6] The full report can be downloaded from: http://www.mosaicprojects.com.au/pdf/Stockholder_to_Stakeholder.pdf

- 90% of relevant studies showed that sound sustainability standards lowered the cost of capital;
- 88% of relevant studies showed a positive correlation between sustainability and operational performance;
- 80% of relevant studies showed a positive correlation between sustainability and financial market performance.

To translate superior ESG quality into competitive advantage, stakeholder theory and sustainability must be deeply rooted in an organisation's culture and values. The consequences of failing to take ESG seriously continue to be demonstrated by another of my regular topics, BP[7].

The Arabseque report contains a plot of oil company share prices from 2009 (pre the Deepwater horizon disaster) through to 2014. BP's share price continues to suffer the consequences of the short sighted cost cutting that precipitated the Gulf of Mexico disaster. The report concludes that the best economic interests of corporate managers and investors is served by incorporating ESG considerations into decision-making processes starting at the governance level right down the organisation hierarchy; we concur.

FIGURE 1: BP'S SHARE PRICE COMPARED TO OTHER OIL MAJORS



Shareholder value is a component of stakeholder value; organisations that innovate and create great stakeholder value will also drive shareholder value. And the first step in creating stakeholder value is understanding your stakeholders, their attitudes and their expectations. The **ESEI** approach to stakeholder management has been designed to help you resolve this challenge!

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[7] For my thoughts on the BP Deepwater Horizon disaster see: http://www.mosaicprojects.com.au/PDF_Papers/P142_Stakeholder_Engagement_Free.pdf

About the Author

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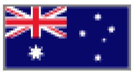

Dr. Lynda Bourne is Managing Director of Stakeholder Management Pty Ltd – an Australian based company with partners in South America and Europe. Through this global network she works with organisations to manage change through managing the relationships essential for successful delivery of organisational outcomes. Lynda was the first graduate of the RMIT University, Doctor of Project Management course, where her research was focussed on tools and techniques for more effective stakeholder engagement. She has been recognised in the field of project management through her work on development of project and program management standards. She was also included in PMI's list of 50 most influential women in PM.

She is a Fellow of the Australian Institute of Management (AIM) and a Fellow of the Australian Computer Society (ACS). She is a recognized international speaker and seminar leader on the topic of stakeholder management, the Stakeholder Circle® visualization tool, and building credibility and reputation for more effective communication. She has extensive experience as a Senior Project Manager and Project Director specializing in delivery of information technology and other business-related projects within the telecommunications sector, working as a Senior IT Project Management Consultant with various telecommunications companies in Australia and South East Asia (primarily in Malaysia) including senior roles with Optus and Telstra.

Dr Bourne's publications include: *Stakeholder Relationship Management*, now in 2nd edition, published in 2009, the second, *Advising Upwards* in 2011. She has also contributed to books on stakeholder engagement, and has published papers in many academic and professional journals and is a columnist for PMI's *PM Network*. Her next book *Making Projects Work* is due for publication in 2014.

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