The Role of Stakeholders in Corporate Governance: A View from Accounting Research

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Contents

Abstract

I review the empirical research on the role of stakeholders in corporate governance with an emphasis in contributions from the accounting literature. In particular, I focus on the following stakeholders: employees, the general public, the media, related firms, the government, private regulators, gatekeepers, and foreigners. This list does not include capital providers (shareholders and debt-holders), as the governance role of these stakeholders has already been covered by prior surveys in the academic literature. The discussion is structured around each stakeholder's incentives to influence managerial behavior, the mechanisms through which stakeholders act on managerial actions, as well as any concerns about this influence. All the analyzed stakeholders appear capable of influencing managerial actions to some extent, but the efficacy of stakeholders' monitoring role is controversial. Empirical research uncovers several factors that undermine stakeholders' incentives to discipline corporate managers. And more critically, in some cases stakeholders' incentives appear to be misaligned not only with shareholders' interests but also with the public interest. Taken together, the reviewed evidence suggests that the monitoring role involves a wide range of actors beyond the board of directors and capital providers. The review also points out that there is still much to learn about stakeholder monitoring.

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Introduction

In recent years, few business topics have sparked as much interest in the general public as corporate governance. Politicians, regulators, and market participants have expressed widely divergent views on the topic. Aware of these views, academics have intensely debated the relative efficiency of, and the case for reforming, corporate governance practices. This debate has generated a rich academic literature that focuses on managerial compensation board composition, and the disciplining effects of shareholder monitoring and the market for corporate control. Some survey papers suggest that corporate governance mechanisms follow an economic rationale and help reduce agency frictions [e.g., Bushman and Smith, 2001; Core et al., 2003; Armstrong et al., 2010]. However, other authors point out empirical problems with these conclusions, including issues with measurement [Bhagat et al., 2011] and correlated omitted variables [Adams et al., 2010]. Adding to these concerns, several empirical papers find evidence of managerial rent extraction and opportunistic behavior, suggesting that our current corporate governance system suffers from substantial inefficiencies (e.g., Shleifer and Vishny, 1997; Bebchuk and Fried, 2004).

While this literature focuses on efficiency of compensation contracts, boards of directors, shareholder monitoring, and the market for corporate control, these are not the only governance mechanisms affecting managerial behavior.[1] Indeed, a growing number of scholars maintain that a wider range of actors should be included in the discussions of corporate governance [e.g., Dyck and Zingales, 2002; Acharya et al., 2011]. For example, Brickley and Zimmerman [2010] argue that "To better understand the incentives of the top-level decision makers, one must look beyond compensation policy and shareholder/board monitoring. Multiple parties and mechanisms (including, auditors, regulators, credit rating agencies, stock analysts, courts, the media, monitoring by banks and other creditors, regulation, the markets for corporate control, product market competition, and corporate policies relating to takeovers) influence the behavior of the top-level decision makers in the corporation." Brickley and Zimmerman [2010, 236] conclude that ignoring the potential influence of these parties could result not only in an incomplete understanding of corporate governance but also in a problem with correlated omitted variables.

[1]In fact, there is no widely accepted definition of corporate governance, but rather a multiplicity of definitions reflecting a diversity of conceptual approaches. The concept is often understood by economists and legal scholars as referring to the protection of shareholders' interests; a protection that is necessary due to the agency problem generated by the separation of ownership and control [Berle and Means, 1932]. This view of corporate governance often emphasizes the role of contracting [e.g., Armstrong et al., 2010] view corporate governance as "the subset of a firm's contracts that help align the actions and choices of managers with the interests of shareholders"). Other definitions include other stakeholders. For example, Shleifer and Vishny [1997] also include creditors among the parties protected by the corporate governance system, a system that they define as "the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment." Other authors avoid focusing on any specific party and define corporate governance more broadly as a set of (monitoring) mechanisms that influence managerial decisions [Larcker et al., 2007] or as the system to direct and/or control operations at a company [Gillan and Starks, 1998]. Similarly, Bushman and Smith [2001] define the concept as "the means by which managers are disciplined to act in the investors' interest". The definition of corporate governance provided by Zingales [1998] even avoids the notion of monitoring and instead takes an incomplete contracting approach (he characterizes the governance system as "the complex set of conditions that shape the outcome of the ex post bargaining over the quasi-rents that are generated in the course of a relationship").

This monograph reviews the empirical evidence on stakeholders' influence on managerial behavior focusing on stakeholders other than shareholders and debt-holders (i.e., providers of monetary capital). The accounting and finance literatures offer excellent reviews of extant research on executive compensation, board of directors, shareholder monitoring, the market for corporate control, and debt contracting, but do not — to my knowledge — systematically review the potential governance effect of stakeholders other than capital providers.[2] This survey addresses that need, *not* by exhaustively reviewing the (often large) literatures touching on each stakeholder type, but by culling the contributions that speak to stakeholder' influence on managerial actions.[3]

In my review, I follow the definitions of the term "stakeholder" in Freeman [1984] and Jensen [2002]. The latter author argues that anyone who can potentially benefit from an engagement with the firm is a stakeholder, and that the stakeholder's interest in the firm could arise from issues related to human rights, the environment, and the community. Similarly, Freeman [1984] defines a stakeholder as "any group or individual who can affect or is affected by the achievement of an organization's purpose." This second definition encompasses parties that can be negatively affected by the firm's actions through externalities such as unemployment, pollution, or financial instability. Based on these definitions, I consider the following parties to be stakeholders: employees,

[2] Some prominent recent examples include Core et al. [2003]; Adams et al. [2010]; Armstrong et al. [2010]; Edmans et al. [2017]. These surveys do not touch on the role of stakeholders in corporate governance. Rather, these reviews cover executive compensation, board composition, and debt contracting.

[3] Some stakeholders are the focus of specific literature surveys. For example, Mehran and Stulz [2007] review the evidence on analysts, and DeFond and Zhang [2014] survey the literature on auditing research. Other surveys tangentially touch on issues that help explain the role of some stakeholders (one example is Leuz and Wysocki's [2016] review of the literature on securities regulation). My review makes an incremental contribution with respect to such surveys in at least two ways. First, I cross-sectionally integrate the findings of those specific literatures in the corporate governance institutional framework, with the purpose of shedding light on the question of whether stakeholders affect managerial behavior, a question that is not addressed by prior reviews. Second, a number of the papers I analyze in this monograph are recent and thus have not been covered by prior surveys.

the general public, the media, related firms, the government, private regulators, gatekeepers, and foreigners.[4]

When analyzing the role of stakeholders in corporate governance I focus on their ability and incentives to discipline corporate managers. By "disciplining" I mean acting on managerial opportunism, where opportunism includes shareholder expropriation (e.g., misappropriation of corporate assets or self-serving financial transactions) and other agency costs (e.g., managerial consumption, undue perquisites, excessive compensation, shirking, or self-dealing investment decisions), as well as law-breaking behavior (fraud or other violations).

Analyzing the disciplining role of stakeholders on managerial behavior requires going beyond the agency problem generated by the separation of ownership and control by including situations where the aggrieved parties are stakeholders other than capital providers. Pollution, price-fixing, consumer fraud, or unfair competition are some examples While these actions could be beneficial for shareholders, they impose costs on stakeholders and thus can hardly be considered socially desirable.[5] Consistent with this notion of managerial misbehavior, this review includes as part of the corporate governance system all the mechanisms that curb managerial opportunism [e.g., Tirole, 2001].[6]

[4] I refer to the economic actors as "foreigners" based outside the country in which the firm is incorporated. Specifically, I focus on foreign institutions (e.g., foreign regulators) and foreign shareholders. For example, a European firm cross-listed in the US is subject to the scrutiny of a foreign regulator: the SEC. This firm could also have foreign shareholders such as sovereign wealth funds from non-European countries.

[5] I recognize that whether certain unpopular behaviors are indeed undesirable from a social perspective is a matter of debate. A prominent example is whether insider trading enhances or hurts economic efficiency [e.g., Manne, 1966; Schotland, 1967].

[6] Given the difficulty to measure the effect of managerial actions on social welfare, my review often discusses the implications of stakeholder influence on firm valuation. Interpreting this evidence from a social welfare perspective requires caution, as in some situations there could be a tension between the interests of shareholders and those of the rest of society. For instance, a positive stock market reaction to stakeholder influence does not necessarily imply that this influence improves social welfare; some actions could be detrimental for society as a whole but beneficial for shareholders (e.g., pollution, price-fixing, consumer fraud, or unfair competition).

Considering stakeholder monitoring as part of the corporate governance system does not imply taking a particular side in the debate of whether corporations should focus on maximizing shareholder wealth or harmonizing stakeholders' interests.[7] In fact, this monograph does not address the question of what firms' objective function should be, nor whether the design of institutions should induce or force management to internalize the welfare of stakeholders. Rather, the question I address is whether, under the current institutional design, stakeholders can help reduce managerial behavior that is socially undesirable. Shedding light on this question is interesting regardless of where one stands in the debate.

For each stakeholder, the review analyzes the economic forces that determine how and to which extent the stakeholder contributes to discipline managerial behavior (see Table 1.1 for a summary). First, I discuss the *incentives* of each stakeholder to influence managerial actions, incentives that vary substantially across stakeholders. Some stakeholders extract a *monetary* benefit from disciplining managers. To name some examples, employees seek to secure their payments and jobs, media companies increase viewership (and thus revenues) by uncovering cases of corporate fraud, and partner firms negotiate contractual clauses to secure a fair share of the partnership profits. But stakeholders' incentives to discipline managerial behavior do not always have a direct translation into monetary terms. For example, *reputational*

Similarly, a negative stock market reaction to stakeholder influence does not necessarily imply that this influence decreases social welfare; the negative reaction could reflect a (socially) optimal wealth transfer from shareholders to other stakeholders. For example, social pressure could induce managers to incur costs to reduce carbon emissions, costs that might not translate into higher profitability.

[7] While the shareholder-centric perspective has gained widespread acceptance among economists, recent theoretical work uncovers important trade-offs between both perspectives [e.g., Tirole, 2001; Allen et al., 2015]. For example, as explained by Tirole [2001], the shareholder-centric perspective avoids problems related to dearth of pledgeable income, deadlocks in decision making, and lack of clear mission for management. However, this perspective could also result in biased decision making. Perhaps as a consequence of this trade-off, the relative support for the two approaches differs substantially across countries. The stakeholder perspective is more popular in Japan, Germany, and France, while shareholders' interests represent the primary concern in the US and the UK (see, e.g., survey evidence in Yoshimori, 2005).

Table 1.1: Framework of the review.

Stakeholder	Incentives	Mechanisms	Frictions
	• *Monetary* • *Reputational* • *Ideological*	• *Monitoring* • *Contracting* • *Other*	• *Opportunism* • *Costs* • *Constraints*
Employees	• Explicit claims (e.g., salaries) • Implicit claims (e.g., advancement opportunities)	• Unionization • Stock ownership • Codetermination (i.e., board representation) • Threat to leave	• Agency problem with employee representatives • Employees' specific preferences
The General Public	• Reduce firm externalities (e.g., pollution)	• Consumer pressure • Pressure from the labor market • Monitoring by societal representatives • Shareholder activism	• Coordination costs and heterogeneous preferences • Manipulation of public opinion • People's bounded rationality
The Media	• Increase sales • Increase viewership/readership	• Monitoring by shaping reputation • Dissemination of information for other monitors	• Lobbying on the media • Opportunism (e.g., sensationalism, ideological manipulation) • Cost of journalistic investigation
Related firms *Competitors* *Suppliers* *Clients* *Partners*	• Gain/maintain competitive advantage • Obtain a share in the surplus of the interfirm relationship	• Competitive pressure • Benchmarking • Contracting with suppliers, customers, and partners	• Competition can also induce misbehavior • Information asymmetry and moral hazard in interfirm relations

(*Continued*)

Table 1.1: (*Continued*)

Stakeholder	Incentives	Mechanisms	Frictions
The Government: *Judges* *Politicians* *Agencies*	The Government as a whole: • Equity stake in the company • Collect taxes from firm revenues • Reduce firm externalities Individual government members: • Reputation • Gain/maintain social support	• Legislation (securities laws and other laws) • Regulation (in particular, regulation of corporate governance) • Enforcement	• Corruption • Special interests • Electoral interests • Inefficient bureaucracies • Regulatory capture • Resources constraints
Private regulators: *Stock exchanges* *Standard setters*	• Increase the number of listed firms and trade volume • Build/preserve reputation	• Regulation (e.g., listing requirements, accounting standards) • Enforcement (by stock exchanges)	• Race to the bottom due to competition among exchanges • Reluctance to punish clients • Special interests • Political interests • Individual interests and biases
Gatekeepers: *Analysts* *Rating agencies* *Auditors* *Proxy advisors* *Other gatekeepers*	• Preserve/build reputation • Avoid litigation	• Specialized monitoring • Disciplining effect of certification	• Conflicts of interest • Lower standards to retain clients • Lack of competition

(*Continued*)

Table 1.1: (*Continued*)

Stakeholder	Incentives	Mechanisms	Frictions
Foreigners: *Foreign institutions* *Foreign shareholders*	• Protect domestic investors • Generate returns for domestic investors	• Enforcement of foreign regulation • Shareholder monitoring (direct interactions, threat of selling or not buying shares, shareholder activism)	• Enforcement difficulties • Investors' specific preferences • Inefficiencies of government ownership (sovereign wealth funds) • Political interests (sovereign wealth funds)

This table presents the framework structuring the review of the literature on the role of stakeholders on corporate governance. "Incentives" refers to the incentives of each stakeholder to influence managerial actions. These incentives are classified into three types: *monetary, reputational*, and *ideological*. "Mechanisms" refers to the economic mechanisms or channels through which stakeholders influence managerial actions. These mechanisms are classified into three types: *monitoring, contracting*, and *other specific mechanisms*. "Frictions" refers to the frictions that potentially prevent stakeholders from disciplining managerial behavior. These frictions are classified into three types: stakeholder *opportunism* and the *costs* and *constraints* faced by stakeholders.

incentives are key for gatekeepers such as auditors or rating agencies. Also, the motivation of social activists to put pressure on firm managers is often *ideological*.

Second, I describe the channels or *mechanisms* through which stakeholders influence managerial actions. *Monitoring* of managerial actions is one of these mechanisms. Some examples are the monitoring of the media, regulatory oversight by government agencies, or the scrutiny conducted by gatekeepers. Other stakeholders discipline managerial actions through *contracting*, either explicit or implicit. The contractual clauses to limit managerial opportunism negotiated with suppliers, clients, and partners' firms are one example, but there are many others (the firm also writes contracts with employees, gatekeepers, and often also with the government). Some stakeholders might exert a disciplining effect on corporate officials without directly monitoring managerial actions or entering into contracts with the firm. The competitive pressure imposed by rival firms or the influence of social norms imposed by the general public are two prominent examples.

Third, I identify the *frictions* that potentially prevent stakeholders from disciplining managerial behavior. One important friction is stakeholder *opportunism*. Private benefits, corruption, conflicts of interest, or pressure from special interest groups are some examples of the potential drivers of stakeholders' opportunistic behavior. Other frictions relate to the *costs* and *constraints* faced by stakeholders. For example, regulatory enforcement is subject to resources constraints, and the collective action of the general public on corporations faces substantial coordination costs. At best, these frictions could undermine the disciplining role of stakeholders. But even more critically, they could also induce a (socially) suboptimal wealth transfer from shareholders to other stakeholders. For example, employee pressure could induce managers to invest below the socially optimal level, and social pressure could lead managers to incur excessive costs to improve the social image of the organization. As a result of these frictions the disciplining effect of stakeholders on managerial behavior is empirically intriguing.

Based on this framework (see Table 1.1), the review discusses the available empirical evidence on the disciplining effect of stakeholders on managerial behavior, as well as the evidence on the frictions affecting this disciplining effect and the mechanisms used by stakeholders to influence managerial actions. In addition to more specific conclusions (which follow each section), the following broad points emerge from the review. First, all the analyzed stakeholders appear to influence managerial actions to some extent. This suggests that discussions about corporate governance should consider the monitoring roles of many actors — not just the board of directors and financial stakeholders — and implies that stakeholder monitoring could substitute for costly corporate governance mechanisms.

Second, the review of the literature reveals that the efficacy of the stakeholders' monitoring role is not clear-cut. Some of the empirical research provides evidence of factors that undermine stakeholders' incentives to discipline corporate managers. Other research indicates that the value implications of stakeholder influence are unclear, suggesting that the incentives of some stakeholders might be misaligned not only with shareholders' interests but also with the public interest. In general, there is a paucity of evidence on the monitoring role of some of the analyzed stakeholders. All of this calls for further research.

The remainder of this monograph is organized in nine sections. The next eight sections each analyze the governance role of one of the following stakeholder groups: firm employees (Section 2) the general public (Section 3) the media (Section 4), related firms (Section 5), the government (Section 6) private regulators (Section 7), gatekeepers (Section 8), and foreign stakeholders (Section 9). Section 10 concludes the review with a summary of the main conclusions and suggestions for future research.

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