CORPORATE GOVERNANCE

Lecture 14 Corporate Citizenship

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TODAY'S AGENDA

- Case Studies
- Stakeholder view of the firm
- Governance and stakeholder theory
- Criticisms
- International aspects of corporate citizenship

- "*Corporate Social Responsibility and Stakeholder Value Maximization: Evidence from Mergers*", Deng, Kang and Low, 2014 JFE

CASE STUDIES

- Bangladesh Factory Collapse
  - Bangladesh factory collapse kills at least 160, reviving safety questions
  - H&M led labor breakthrough by European retailers

CASE STUDIES

- PepsiCo
  - Deal with Mexican farmers
  - Helping farmers improve yield and income
  - Contract Farming
    - the company transfers agricultural practices and technology and procures the produce at a pre-agreed price.

CASE STUDIES

- PepsiCo
  - Helping out small communities and farmers

Partnership With Farmers

Partnership With Farmers

1. STAKEHOLDER VIEW OF THE FIRM

- Corporate Governance from Alternative Perspective
  - From the perspective of agency theory, corporate governance is mainly about the incentive systems and monitors designed to protect shareholder interests.
  - From the stakeholder perspective, corporate governance is the mechanism that ensures corporations take responsibility for directing their activities in a manner fair to all stakeholders.

1. STAKEHOLDER VIEW OF THE FIRM

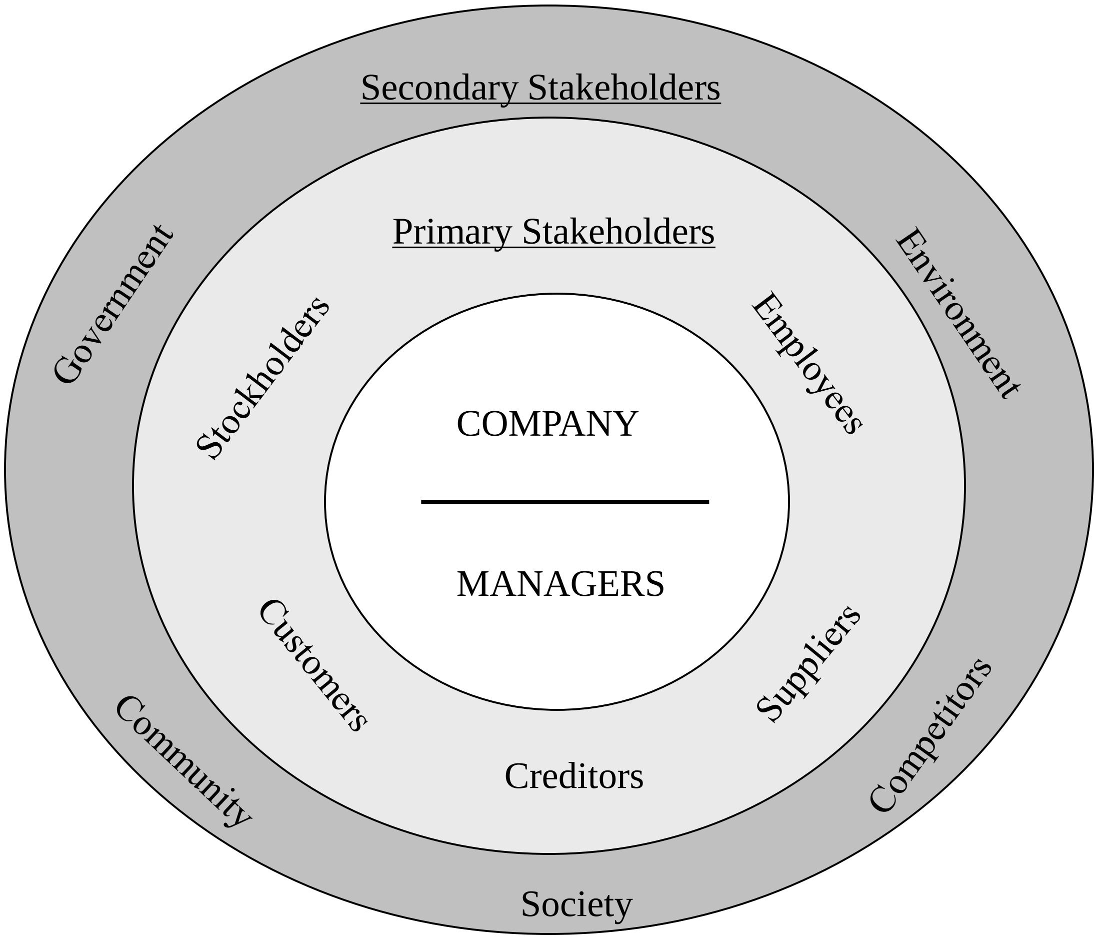
- Stakeholders—people or groups with legitimate interests in various aspects of the company's activities.

- Companies have varying responsibilities to each of their stakeholders.

- These relationships between managers and stakeholders are based on a moral or ethical foundation (?)

1. STAKEHOLDER VIEW OF THE FIRM

- Company Stakeholders



1. STAKEHOLDER VIEW OF THE FIRM

- The Managers' Goal
  - In a stakeholder view, the managerial objective is to maximize sustainable organizational wealth by optimizing the relationships among each stakeholder group.
  - Many companies now have an organizational unit tasked with communicating with stakeholders.

1. STAKEHOLDER VIEW OF THE FIRM

- Legal Foundations
  - The legal underpinnings of the stakeholder view of the firm stems from property rights.

  - The U.S. government, various state governments, and courts have formalized the rights of stakeholders in corporations.

1. STAKEHOLDER VIEW OF THE FIRM

- Corporate Social Responsibility
  - Proponents of the stakeholder view argue that companies have a social obligation to operate in ethically, socially, and environmentally responsible ways.
  - This active approach is referred to as CSR or **corporate citizenship**.

2. GOVERNANCE AND STAKEHOLDER THEORY

- Aligning managerial incentives with multiple stakeholder groups and measuring overall performance can become a noisy and chaotic process.

- There is still no consensus on how to measure and report on changes in stakeholder welfare.

- Organizational theory states that the firm will only value CSR goals if the company executive exhibits strong leadership in instilling corporate responsibility within the company's culture.

2. GOVERNANCE AND STAKEHOLDER THEORY

- Stakeholder Theories
  - A descriptive theory is used to describe what firms are doing and how they are doing it.

3. CRITICISMS

- It is difficult to assess the stakeholder view because it is not a well-defined theory.
- Even critics of CSR agree that companies should act responsibly and should be seen doing so.
- However, critics also argue that deviating too far from the profit-maximizing role of companies would be harmful to society.

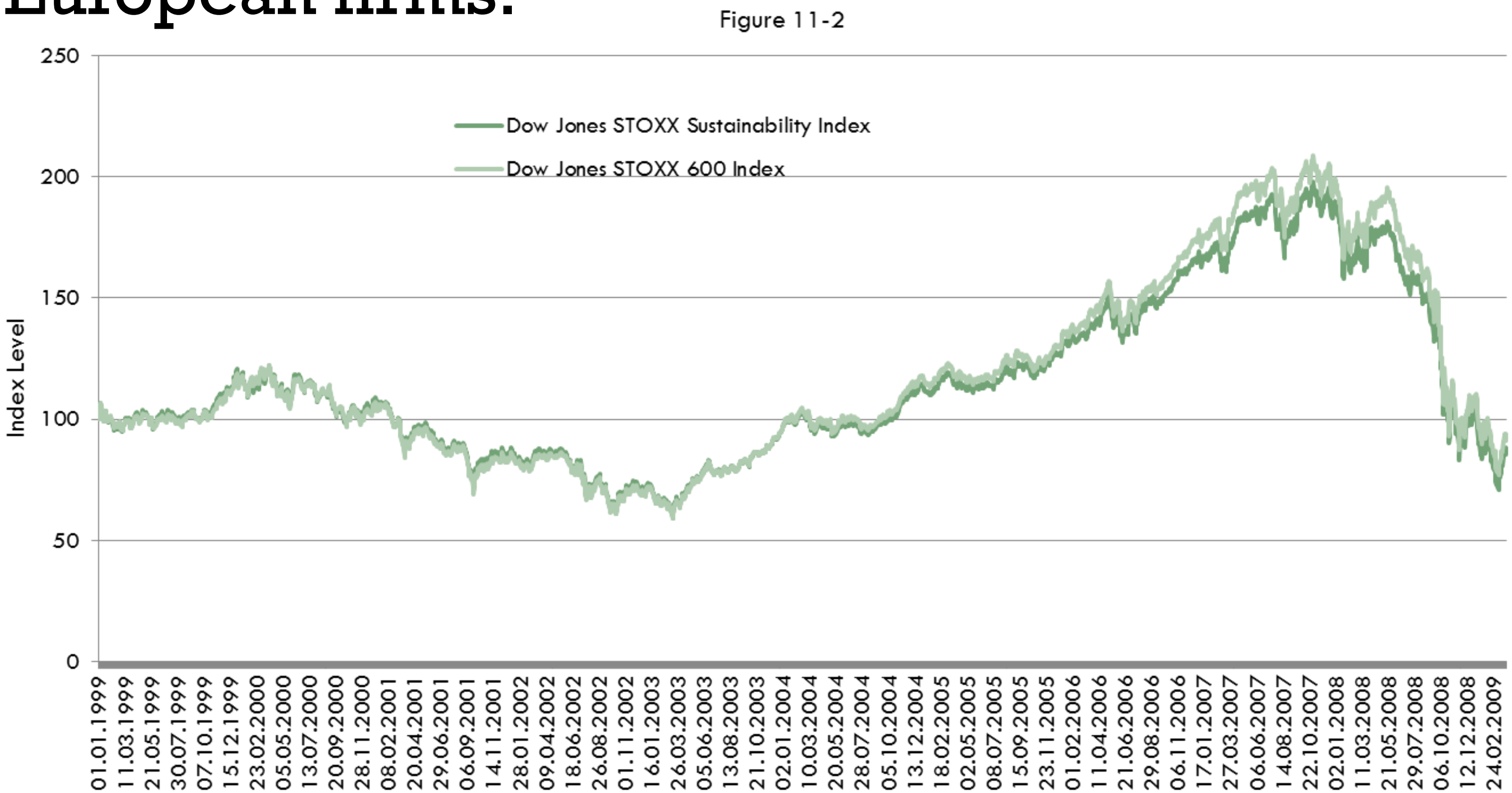
3. CRITICISMS

- Economic progress comes from profit-related activities.

- When managers involve themselves in stakeholder engagement activities, higher costs and impaired business performances are likely to follow.

3. CRITICISMS

- Comparing the performance of European firms that sustain corporate citizenship to 600 other European firms.



4. INTERNATIONAL ASPECTS

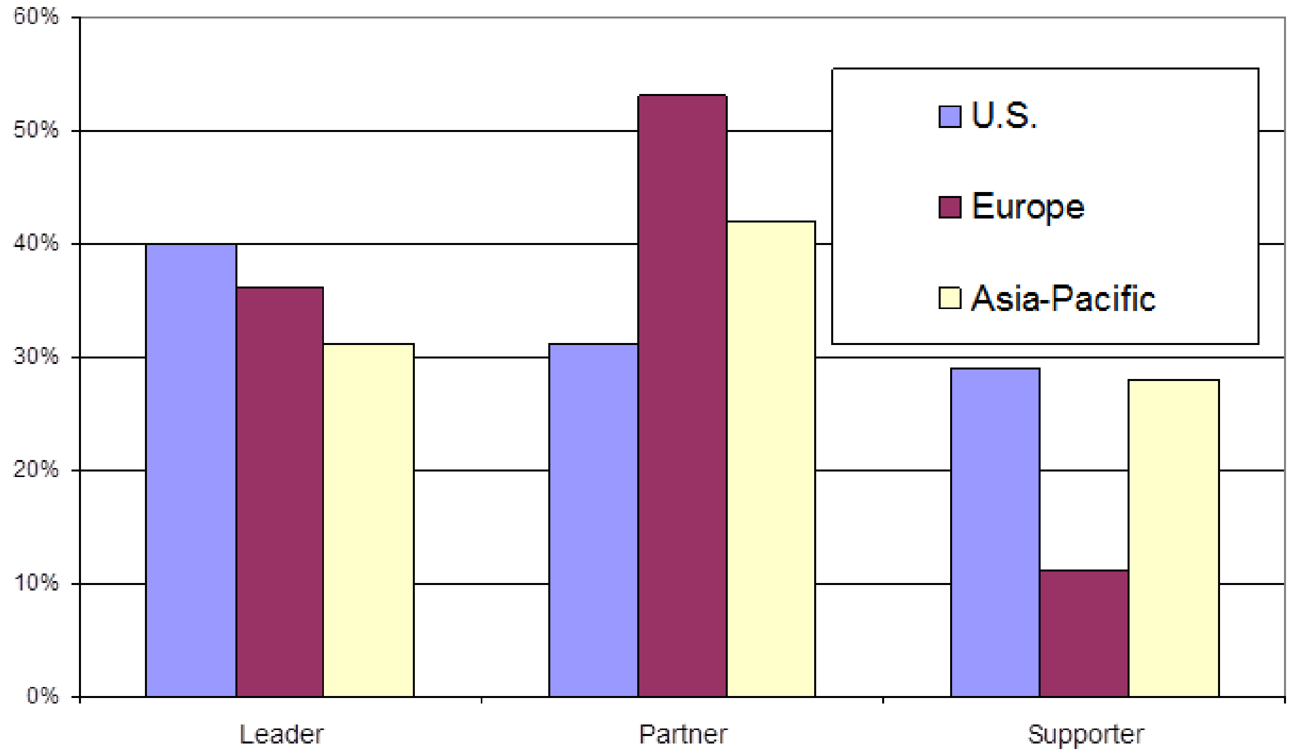
- Corporate citizenship has different historical roots in different regions of the world and is viewed with different perspectives.
  - In US, it derived from the conflict between stockholder-focused managers and social activists
  - In UK, Europe, it has been viewed less negatively
  - In India, the lack of government efficacy in the provision of social welfare has caused corporations to step into.

4. INTERNATIONAL ASPECTS

- A stakeholder view of the firm is also reflected in many laws internationally.
  - UK mandates firms to include the interests of employees in decision-making (Company Act of 2006)
  - Germany requires employee representation on one of the two-tier boards (codetermination laws)
  - EU permits corporations to take into account the interests of employees, creditors, customers, and potential investors (harmonization laws)
  - Korean companies that focused on exporting were even given tax breaks to help them bring capital into Korea after the Korea War in 1950s

4. INTERNATIONAL ASPECTS

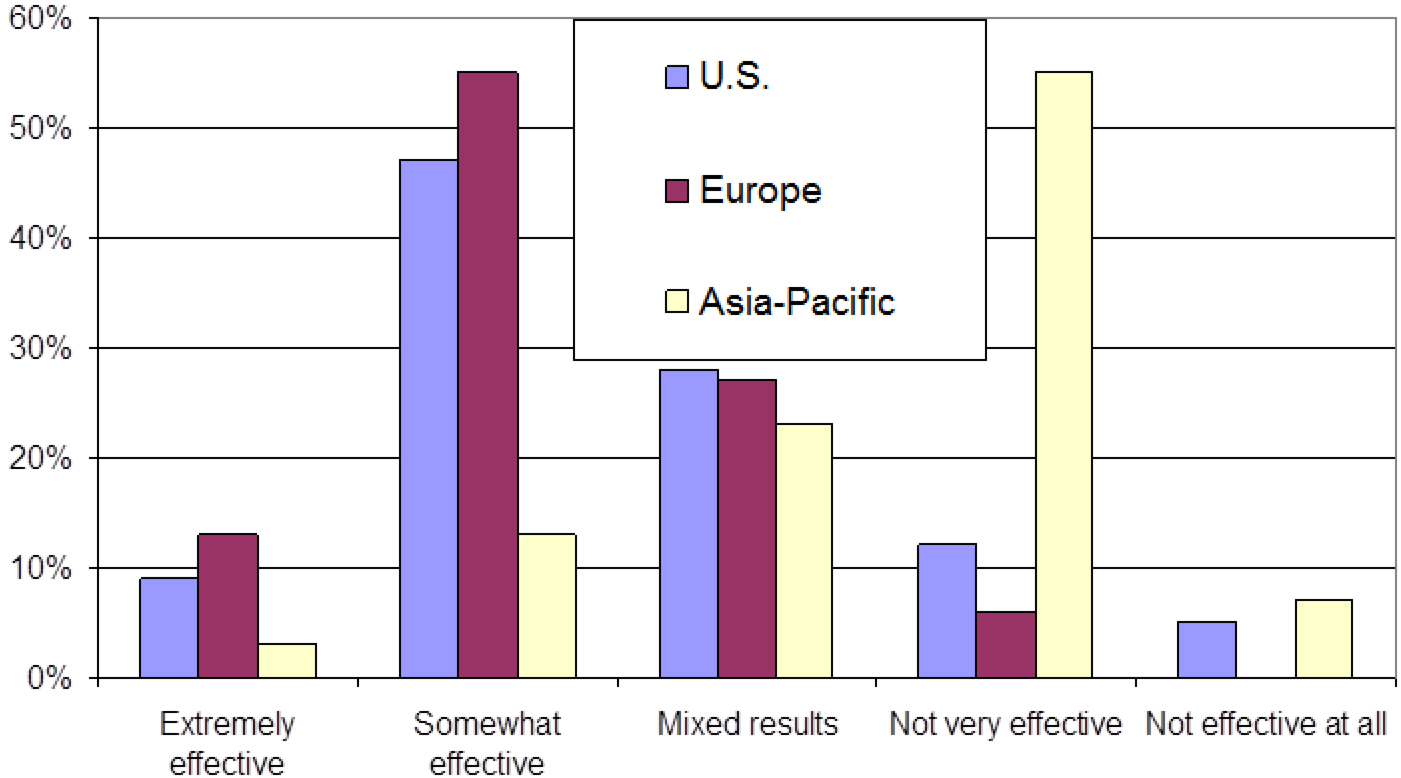
- What Role Will Your Company Play Increasing Good Business and Good Society?



Data Source: Corporate Citizenship in the New Century: Accountablility, Transparency, and Global Stakeholder Engagement, The Conference Board, Research Report # R-1314-02-RR, July 2002

4. INTERNATIONAL ASPECTS

- How Effective are Your Efforts Today to Address the Citizenship Factors that will Assure Your Success Tomorrow?



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5. CSR AND STAKEHOLDER VALUE MAXIMIZATION

- Deng, Kang and Low (2014), Corporate Social Responsibility and Stakeholder Value Maximization: Evidence from Mergers", JFE

- Corporate social responsibility (CSR) has become an important part of U.S. firms' operation over the past decade

- More than 300 U.S. firms published annual CSR reports in 2007
  - CorporateRegister.com
  - detailed information about their CSR activities and achievements

5. CSR AND STAKEHOLDER VALUE MAXIMIZATION

- Socially responsible investing (SRI) funds was $3.07 trillion in 2009, up from $2.16 trillion in 2003
  - Social Investment Forum's Report (2010)

- Why managers invest in CSR activity (i.e., to maximize shareholder wealth or help stakeholders at the expense of shareholders) is subject to much debate

5. CSR and Stakeholder Value Maximization

- Mixed evidence on the relations between CSR and firm performance

5. CSR AND STAKEHOLDER VALUE MAXIMIZATION

- CSR and Merger
  - merger approval process is frequently subject to a range of challenges as well as support from various stakeholders
    - They have a significant impact on the eventual outcome of a merger and play an important role in the post-merger integration process.

5. CSR AND STAKEHOLDER VALUE MAXIMIZATION

- CSR and Merger
  - Mergers are largely unanticipated events and thus using merger announcement returns in the analysis can potentially <u>mitigate the reverse causality problem</u> present in previous studies on the relation between CSR and firm value
    - For example, firms with good performance may invest more in CSR, so that firms with high CSR show high Tobin's *q* or good accounting performance

5. CSR AND STAKEHOLDER VALUE MAXIMIZATION

- Stakeholder value maximization view vs. shareholder expense view

- Stakeholder value maximization view
  - CSR activities have a positive effect on shareholder wealth because focusing on the interests of other stakeholders increases <u>their willingness to support a firm's operation</u>, which increases shareholder wealth

5. CSR AND STAKEHOLDER VALUE MAXIMIZATION

- stakeholder value maximization view
  - the value of implicit contracts depends on other stakeholders' expectations about a firm honoring its commitments
  - firms that invest more in CSR (hereafter, high CSR firms) tend to have a stronger reputation for keeping their commitments associated with the implicit contracts,
  - stakeholders of these firms are likely to have stronger incentives to contribute resources and effort to the firm and accept less favorable explicit contracts than stakeholders of low CSR firms.

5. CSR AND STAKEHOLDER VALUE MAXIMIZATION

- Mergers are likely to unsettle key stakeholders in a firm
  - since they put the continuity of existing long-term relationships between the firm and its stakeholders at stake
  - sometimes they force stakeholders to renegotiate their contracts with the new combined firm.

- Thus, a firm's reputation for fulfilling its implicit contracts with relevant stakeholders and maintaining continued relationships with them are crucial to a merger's success

- It suggests that mergers are an important channel through which CSR can have a significant effect on shareholder wealth

5. CSR AND STAKEHOLDER VALUE MAXIMIZATION

- Three testable predictions
  - High CSR acquirers realize higher merger announcement returns, and higher announcement returns on the value-weighted portfolio of the acquirer and the target
  - H1) Better post-merger operating performance of the combined firms

5. CSR AND STAKEHOLDER VALUE MAXIMIZATION

- Three testable predictions
  - Since CSR investments are likely to increase firms' intangible assets, it is possible that the value of CSR is not fully incorporated into the stock price around the merger announcement date but is reflected in improved merger performance over time

  - H2) Higher post-merger long-term stock returns than low CSR acquirers

5. CSR AND STAKEHOLDER VALUE MAXIMIZATION

- Three testable predictions
  - Third, given that high CSR acquirers are less likely to breach their implicit contracts with stakeholders, mergers by these acquirers are likely to receive more support from stakeholders.

  - H3) Consequently, mergers by high CSR acquirers are predicted to take less time to complete and are less likely to fail than those by low CSR acquirers

5. CSR AND STAKEHOLDER VALUE MAXIMIZATION

- Three testable predictions
  - To illustrate the importance of stakeholders' support in mergers, consider the case of Krupp-Hoesch.
  - In 1997, the German steel producer Krupp attempted to take over Thyssen.
  - Thyssen's employees and local community, however, protested and lobbied against the takeover. The regional government also used political pressure to block the deal.
  - As a result, Krupp withdrew its bid and only managed to successfully acquire Thyssen in a second attempt in 1999

5. CSR AND STAKEHOLDER VALUE MAXIMIZATION

- Firm-level measure of CSR performance
  - firm's CSR performance from the KLD Research & Analytics, Inc. (hereafter, KLD) STATS database
  - The sum of yearly adjusted community activities, corporate governance, diversity, employee relations, environmental record, human rights, and product quality and safety KLD STATS corporate social responsibility (CSR) scores.

5. CSR AND STAKEHOLDER VALUE MAXIMIZATION

- Endogeneity Issue
  - two-stage least squares (2SLS) regressions in which we employ religion rank (religion ranking of the state in which the bidder's headquarters is located) and a blue state dummy (indicator that equals one if a firm's headquarters is located in a blue/democratic state and zero otherwise) as instrumental variables

5. CSR AND STAKEHOLDER VALUE MAXIMIZATION

- Findings
  - acquirers' CSR performance ratings have a significant positive effect on
    - their announcement stock returns,
    - the announcement returns on the value-weighted portfolio of the acquirer and the target,
    - post-merger operating performance and long-term stock returns
    - take less time to complete and are less likely to fail than mergers

5. CSR AND STAKEHOLDER VALUE MAXIMIZATION

- Findings
  - significant positive impact of acquirers' social performance on the wealth of other stakeholders (i.e., targets' customers and suppliers and acquirers' bondholders) around merger announcements
  - merged firms' employees tend to be laid off less in mergers by high CSR acquirers than in mergers by low CSR acquirers

5. CSR AND STAKEHOLDER VALUE MAXIMIZATION

- Findings
  - these results strongly suggest that high CSR acquirers undertake deals that benefit other stakeholders, further supporting the stakeholder value maximization view