Stakeholder Orientation, Firm Risk and Cost of Capital

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"Minister of International Trade…announced two new initiatives to strengthen Canada's approach to responsible business conduct for Canadian companies…The second is the creation of a ***multi-stakeholder*** *advisory body…These measures will be "best in class," reinforcing Canada's approach to inclusive economic growth, and helping keep Canadian companies at the forefront of responsible business conduct abroad, a competitive advantage in today's marketplace."* - Global Affairs Canada, Jan 17, 2018

The research project aims to study the effect of stakeholder orientation, an increasingly important component of corporate governance, on firm risk and cost of capital. In contrast to shareholders, stakeholders include any party on which firms' governance structure and operating activities can have influence, e.g., creditors, employees, customers, suppliers, local communities, general public and government. I hypothesize that a board of directors that consider the interest of stakeholders when making decisions lead to lower firm risk, lower cost of capital and stronger financial soundness. I gain supporting evidence from preliminary empirical tests, and further find stronger effects in industries with high growth prospect, e.g., innovative industries. This study will contribute to the understanding that stakeholder orientation, not only the shareholder primacy, can be value-adding. The interests of shareholders and stakeholders can be well aligned and do not necessarily conflict. Given that Canadian legislation has not yet passed a systematic corporate governance law to guide stakeholder orientation for firms, this study will provide practical implications for Canadian legislators, corporations and relevant stakeholders.

There is a longstanding debate among practitioners, regulators and economists on the primary goal of firms. In his famous seminal work, Friedman (1970) argued that the board of directors should allocate all resources to maximize the interest of shareholders and refrain from altruistic actions to benefit non-shareholders. A whole system of modern corporate finance literature has been built upon the assumption of shareholder primacy (e.g., Jensen 2001, Rotemberg & Scharfstein 1990, Shleifer & Vishny 1988). However, in the wake of the 2008 financial crisis, it has increasingly become prominent that the board of directors should take stakeholder interest into consideration, instead of solely maximizing shareholder interest, when making decisions for the firm (e.g., Hart & Zingales 2017, Tirole 2001, Magill et at. 2015). However, the effect of stakeholder orientation in corporate governance on firm's financial performance is under studied in current literature.

In this project, I contribute to the understanding and applicability of good corporate governance by studying the effect of stakeholder orientation on firm risk, cost of capital and financial soundness for several important reasons. **First**, it can provide suggestions to Canadian legislators, firm board of directors and stakeholders on issues related to stakeholder orientation in corporate governance. To the best of my knowledge, the Canadian legislation has not yet passed a systematic law to guide stakeholder orientation for firms. However, given the increasing emphasis on stakeholder orientation, it becomes crucial for Canadian institutions to know the quantified effect of stakeholder orientation on society, business environment and firm operations. **Second**, I make methodological contributions to literature on stakeholder orientation. Exploring the causal relations between stakeholder orientation on firm risk, cost of capital and financial soundness is a challenging empirical task, since ordinary regressions suffer from reverse-causality bias, omitted-variable bias and other forms of endogeneity bias. To deal with endogeneity bias and to establish causality relations, I follow Imbens & Wooldridge (2009) to use a difference-in-differences identification strategy by exploiting a quasi-natural experiment, i.e., the staggered passage of laws of stakeholder orientation ("Constituency Statutes") in 35 states in the U.S. The Constituency Statutes let the board of directors consider the interest of stakeholders when governing firms, without breaching their fiduciary duties to shareholders. **Third**, given the similarity of cultural, economic and political conditions between Canada and the U.S., Canadian legislators, firm board of directors and stakeholders can gain valuable implications from the practice of stakeholder orientation in the U.S. It will give Canadian institutions a second-mover advantage, since Canadian counterparties can learn both positive and negative lessons from an U.S. sample which I use to study the effect of stakeholder orientation on firm risk, cost of capital and financial soundness.

I develop hypotheses that stakeholder orientation can lower firm risk and cost of capital. The channel is that previously implicit contracts can now be explicit and better satisfy the needs of stakeholders (e.g., employment contracts with better job security, interactions with local community with more ESG (environmental, social and governance) awareness), thus strengthening firm's financial soundness. I gain supporting evidence from preliminary empirical tests. My findings will shed light on that stakeholder orientation in corporate governance can be value-adding, and that the interests of shareholders and stakeholders can be well aligned and do not necessarily conflict.

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