Stakeholders and corporate governance
(Relevant to Paper II – PBE Management Accounting and Finance)
Lee Siu Po, Simon, The Chinese University of Hong Kong

Students may have heard the word "stakeholders" mentioned in the media from time to time. In accounting and finance, stakeholders represent an important topic in corporate governance.

Corporate governance refers to a system by which a company is directed and controlled. A company is formed by a contribution of equity from shareholders and debt offered by creditors. Shareholders can vote in the annual general meeting on important decisions while bondholders cannot as they are not owners. Shareholders expect to get their returns both from share price increase (called capital gains) and dividend (called dividend yield).
Creditors, on the other hand, expect to get their returns from interest and repayment of the principal. From statistics in the financial market, we can see that the return from stock is higher than the return from bonds. This is reflected by cost of equity versus the cost of debt. The cost of equity is always higher than the cost of debt. Thus, shareholders normally expect to get higher returns than bondholders. When a higher return is expected, the related risk is also higher. We can say that shareholders normally tolerate higher risk in order to get a higher return than bondholders. In that sense, there is conflict of interest between shareholders and bondholders as the former want high returns with risk but the latter want low returns with low risk.

As well as shareholders and bondholders, there are other groups of stakeholders. Shareholders delegate the daily management authority to managers and employees. This group of people expects salaries, benefits and increments. They may or may not act in the interest of the shareholders. For example, if there is a risky project which gives a high return, shareholders may want to take it but management may refuse because if they do not perform well, their prospects will be affected. On the other hand, almost all employees want to receive high salaries and benefits. This may not be the wish of shareholders as the higher the salaries and benefits, the lower the profit. With a lower profit, dividend distribution and the stock price will be affected. This again creates a conflict of interest between employees and shareholders.

Now, all the shareholders, bondholders and employees want to know about the company's financial performance. In order to get a fair assessment of the financial results, a company hires auditors to issue the audit report and give an opinion on the financial statements. The audit report is issued to the shareholders but is paid for by the company. The higher the audit fee, the higher audit quality is expected. Paying a high audit fee reduces profit. Shareholders want a higher profit but also want higher audit quality. This creates a conflict of interest as one party (the auditor) wants a higher audit fee while another party (the shareholders) wants it to be lower.

The audit fee is determined by the audit committee which consists of several board members. The board members may consider the wishes of major shareholders but not the minority shareholders. Taking care of the interest of minority shareholders is a popular topic in corporate governance –in many companies their interests are ignored.

Another issue is on the level of board members' remuneration, or directors' fees. Some listed companies pay each board members as much as $500,000 per director per year. Some pay only $100,000. The level of directors' fees may reflect the quality and capability of the directors. Shareholders expect there to be a positive correlation between the level of directors' fees and profitability of the company.

Senior management remuneration is similar to directors' fees. In listed companies, it is determined by the remuneration committee, another committee under the board of directors. The ideal case is where high management remuneration leads to high profitability as measured by the return on equity, net profit margin, etc. There is evidence that some companies pay very high remuneration to senior management at director level but continuously report losses.

Sometimes we see companies hire only family members as senior management. There is no transparent process in the selection process and this may give worries to the small investors as they pay for the management who fail in delivering good performance. There are of course examples with excellent performance delivered by companies with many family members at senior management level.

In the wider perspective, even government, customers and suppliers are stakeholders of a company as they can influence the decisions made by a company. Government can influence companies by setting different laws, such as the environmental laws and privacy laws. It needs to ensure that companies operate in a safe, clean and efficient environment. The government recently implemented a minimum wage. This will benefit some people in the short term but may not benefit them in the long term if their jobs can be automated.

Customers can sometimes exercise influence by consolidating their bargaining power in order to get lower prices. If customers demand certain products, this may influence the owners into reacting. Suppliers can also influence the prices and quality of raw materials consumed by a company. Nowadays many environmental protection groups are active in offering comments on the operations of a company, such as on the temperature of a venue or the use of plastic bags. The latter is a classical example. Some environmental protection groups have argued that plastic bags are overused and have suggested levying a tax on them. Eventually the government a levied plastic bag tax resulting in a substantial reduction in their use and costs savings.

Conflicts of interest between shareholders and bondholders, between employees and shareholders, and the level of directors' fees, auditors' remuneration and senior management remuneration are important issues in corporate governance. Only with a good company structure can these conflicts be minimized and the level of directors' fees and senior management remuneration be in line with company performance. Nowadays stakeholders also include suppliers and customers and they can all influence the decisions made by a company.