Cost of Conscious Capitalism

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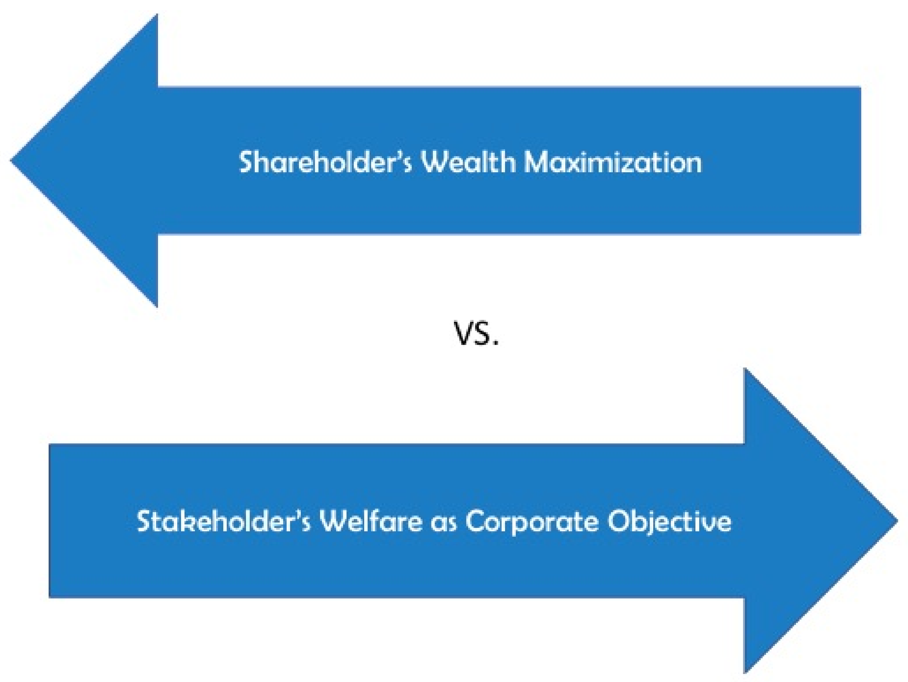
Abstract

This paper examines the cost of conscious capitalism (stakeholder governance) to investors using the adoption of state-level constituency statutes as an exogenous shock. These statutes permit board members to consider the interests of all stakeholders, not just shareholders when making decisions. Using a sample of U.S. publicly traded firms, we observe a significant decline in transparency by firms incorporated in adopted states. While we find firms experiencing losses use conscious capitalism as an umbrella to remain opaque, firms that need financial markets for capital remain transparent despite such statutes. Our paper contributes to the debate on 'objective of the firm'.

Revisiting Classical Debate



Hypotheses

Hypothesis 1: Firms incorporated in a state with a constituency statute will reduce transparency to shareholders more than firms incorporated elsewhere.

Hypothesis 2: Firms incorporated in a state with a constituency statute will reduce the readability of their financial statements than firms incorporated elsewhere.

Hypothesis 3: Firms incorporated in a state with a constituency statute will experience reduced coverage by financial analysts and analyst report accuracy compared to firms incorporated elsewhere.

Hypothesis 4: Firms incorporated in a state with a constituency statute will experience reduced ownership by institutional investors compared to firms incorporated elsewhere.

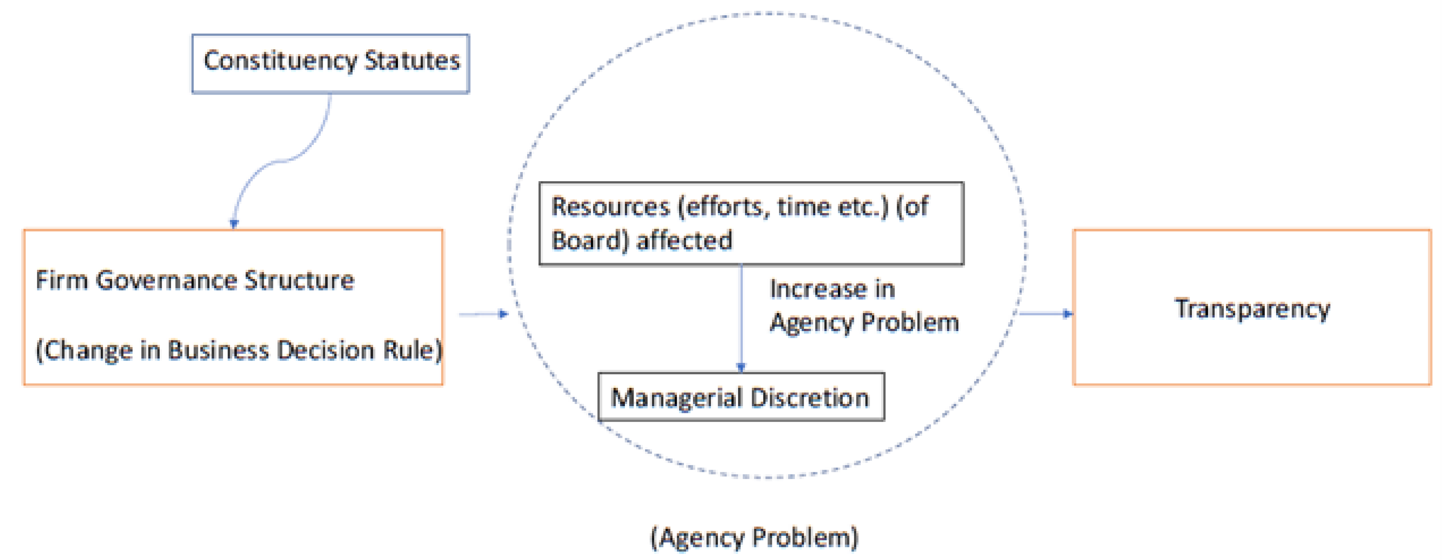
Data and Methodology

Difference-in-difference specification:

$$y = \alpha + \beta_1 Statutes + \beta_2 L + \beta_3 X + \gamma_{firm} + \gamma_{year} + \gamma_{state-incorp} + \epsilon$$

where: y is earnings management, 10-K readability, analyst accuracy, and analyst coverage. Statutes is a dummy variable with value 1 if a firm incorporated in the state that adopted a constituency statute; otherwise 0. X is a vector of firm fundamentals, L is a vector of various anti-takeover laws. γ_{firm}, γ_{year}, and $\gamma_{state-incorp}$ are firm, year, and state-incorporation fixed effects.

Theoretical Model



One-period model with an assumption that the board has limited resources to accomplish its task i.e. to make sure that the manager's incentives are aligned with the shareholders:

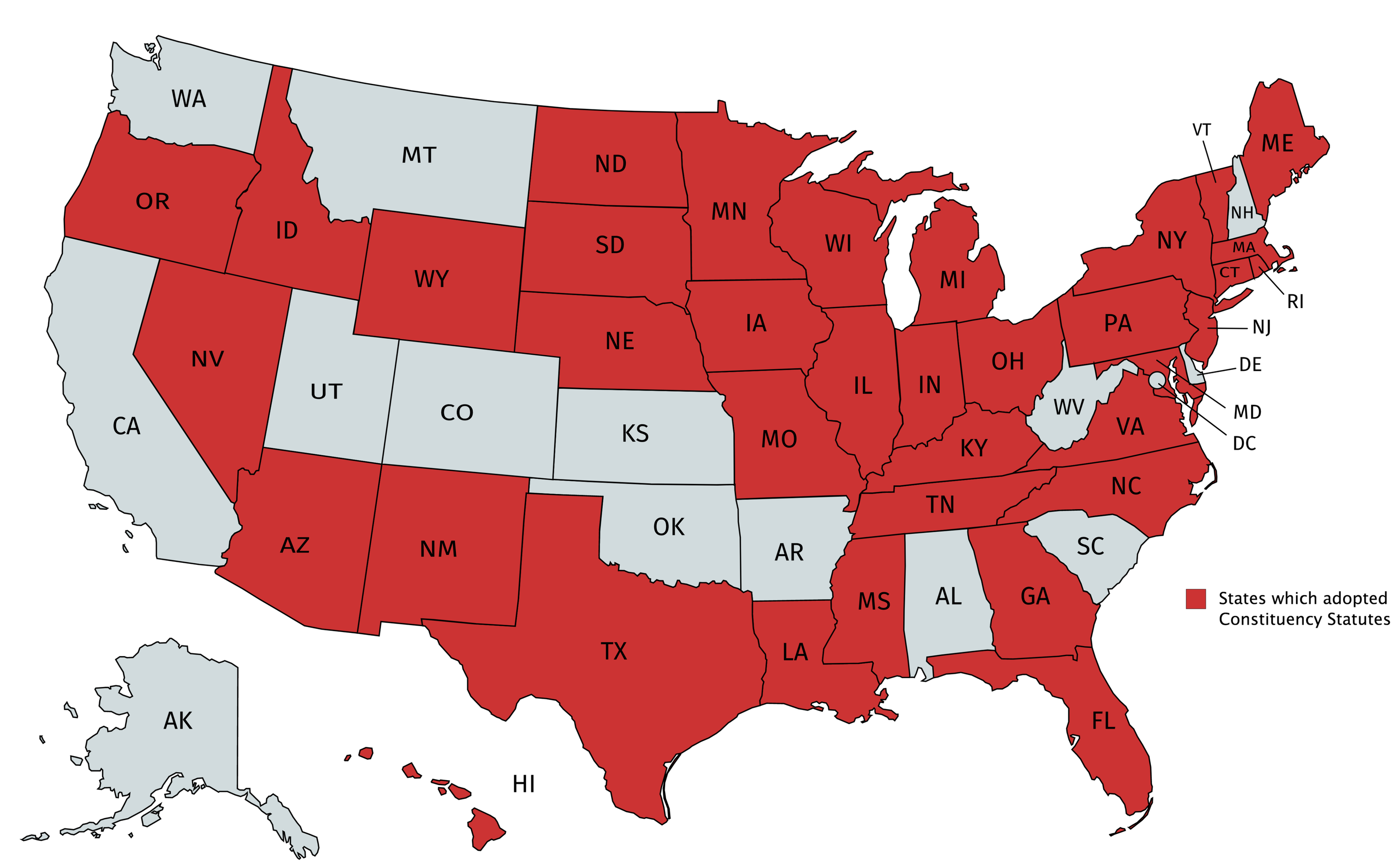
$R = R_{sh}$
$T = f(R_{sh}, A)$ [Before Adoption of Constituency Statutes]

First Order Condition (FOC):
$\frac{dT}{dR_{st}} = f'(R - R_{st}, A)(-1)$
$R = R_{sh} + R_{st}$
$T = f(R - R_{st}, A)$ [After Adoption of Constituency Statutes]

If we relax the assumption that agency cost is constant then,
$A = \zeta(R - R_{st})_\eta$
$T = f(R - R_{st}, \zeta(R - R_{st})_\eta)$
$\frac{dT}{dR_{st}} = f'(R - R_{st}, \zeta(R - R_{st})_\eta)[1 + \eta(R - R_{sh})_{\eta-1}](-1)$
$\eta > 0$, $\zeta > 0$, and $R - R_{st} > 0$

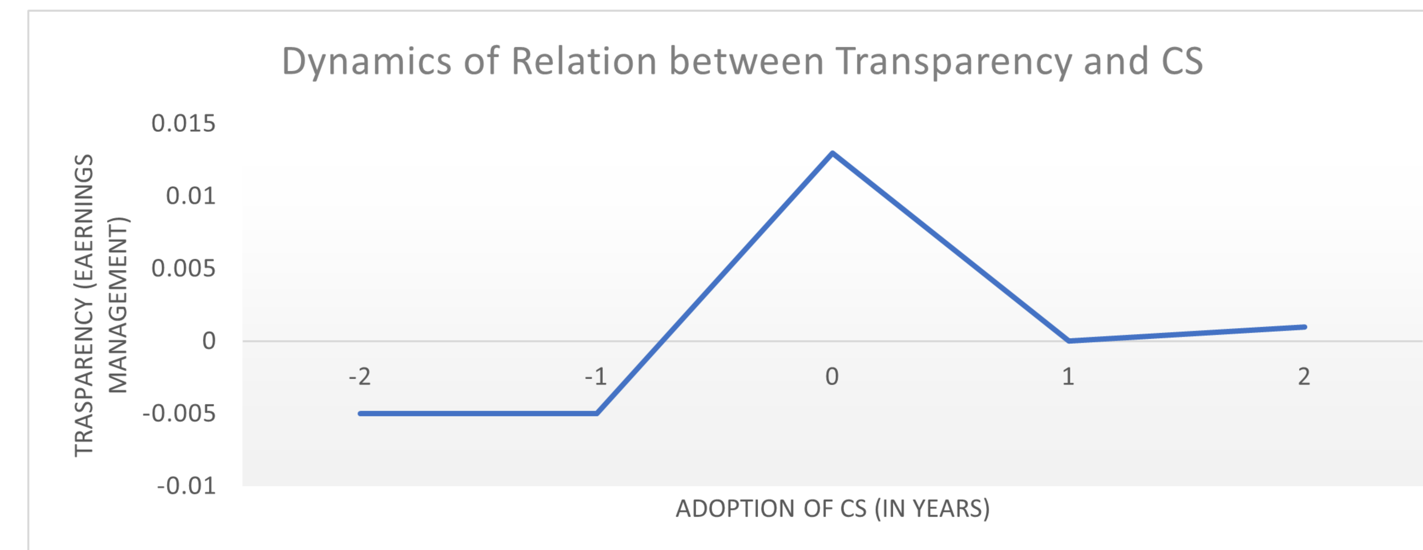
where T denotes transparency, R denotes total resources, R_{sh} denotes resources to shareholders, R_{st} denotes resources to stakeholders, A denotes agency costs. Any additional unit of spending on stakeholders will result in decrease in corporate transparency.

States that Enacted Constituency Statutes



Empirical Results

	Earnings Management	10-K Readability	Analyst Coverage	Analyst Accuracy	Institutional Ownership	
					EPS<0	ESP>0
CS	0.006*	0.879***	-0.058	-0.010***	-0.040**	0.002
Observations	50,432	34,437	60,365	50,432	11,242	38,036
Controls	Yes	Yes	Yes	Yes	Yes	Yes
R-squared	0.565	0.744	0.786	0.724	0.827	0.821
Fixed Effects	Firm, Year, Incorp-State	Firm, Year, Incorp-State	Firm, Year, Incorp-State	Firm, Year, Incorp-State	Firm, Year, Incorp-State	Firm, Year, Incorp-State



Conclusion

Building on the staggered adoption of state-level constituency statutes across the United States, we argue that the introduction of such statutes should lead to lower transparency to shareholders. Three rationales—stretched resources, stretched board members and managers, or an entrenchment mindset among managers aware of the stretched board members—find empirical support utilizing several metrics, including earnings management, abnormal cash flows, readability of 10-Ks and analyst accuracy. Our study also contributes to the ongoing discussion of how shocks to governance regimes through new laws affect firm disclosures and shareholders' access to information.

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