CFA LEARNING OUTCOMES DECODED

In our series *Learning Outcomes Decoded* we break down a single Learning Outcome Statement (LOS) from the CFA level 1 curriculum. This article is written by Mark St. Marie, CFA, a member of the CFA team at The Princeton Review. He has extensive experience working both as an equity analyst on the sell-side and as an equity analyst, trader, and portfolio manager on the buy-side.

CORPORATE ISSUERS: INTRODUCTION TO CORPORATE GOVERNANCE AND OTHER ESG CONSIDERATIONS

LOS: Describe a company's stakeholder groups and compare their interests

Traditional views of corporate governance are that shareholders are the primary stakeholders because they are effectively the company's "owners." However, the more modern concept of "Stakeholder Theory" places equal importance on other types of stakeholder groups besides shareholders in influencing management decisions. Stakeholder Theory forces managements to define and prioritize the objectives of each group and determine the costs of its decisions to each group.

Shareholders: The goal of the equity holder is to maximize value of the company. Shareholders can vote through direct participation at shareholder meetings or via proxy voting. Decisions based on these votes range from electing the board of directors to approving mergers and changing the bylaws, but they have little influence over the day-to-day decisions of management. Lastly, in the event of bankruptcy, shareholders are only "residual claimants" to the company's assets, following bondholders and other creditors.

Creditors: Banks and private lenders can attach covenants to their loans that allow them to influence the company. They also have direct access to management and non-public information. The relationship between a company and its bank is often complex, involving investment banking and custodial services. Bondholders hold small, publicly traded positions in the company's debt. They do not vote and have little or no influence on management. They do not have access to management or non-public information. These stakeholders are most concerned with receiving on-time coupon and maturity payments and minimizing downside risk.

Board of Directors: Elected by shareholders to provide company oversight, protect shareholder interests and provide strategic direction for the company. Conflicts may arise if shareholders believe the board is not acting in its best interest. The board is usually a mix of company insiders and independent members who provide skills and knowledge that are important to the company.

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Managers: A company's managers handle the day-to-day operations and decisions of the company. Management interacts with investors and provides direction and motivation for employees. Best practice is to connect their compensation to the success of the company via stock options and bonuses.

Employees: Provide the human capital in the production process of the company. In return they may demand compensation, working conditions, advancement, training, career development, job security, and health/safety.

Customers: Expect the company to produce goods and services that satisfy their needs, often with ongoing support and guarantees of satisfaction. Customers can influence the company decisions on environmental and social impact of its products by choosing to boycott its products or otherwise cause harm to its business through negative publicity.

Suppliers: Generally seek long-term relationships with the company through repeat sales and reliable on-time payments. Suppliers sometimes develop custom products for the company, increasing dependency of both parties.

Government: Is a stakeholder due not only to its regulatory oversight, but also its dependency on the company for tax revenue. The government has an interest in protecting the general public and the overall economy.

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PRACTICE QUESTION

Which of the following is *least likely* to be a current stakeholder of a company that produces automobiles in the United States?

A. The spouse of a retired company employee.

B. The U.S. Department of Transportation.

C. A supplier of tires to one of the company's competitors.

C is correct. A supplier of tires to a competitor is the least likely to be a stakeholder of the company. However, the supplier could become a future stakeholder by becoming a supplier or may have been one in the past if it had formerly supplied tires to the company.

A is incorrect. It is possible that a retired company employee could be receiving a pension or healthcare benefits from the company, so this would not be the *least likely* answer.

B is incorrect. The USDOT is one of the agencies that regulates US auto producers. It establishes safety, efficiency, and other rules and guidelines that ensure that the vehicles produced by the company adhere to its standards and protect public safety and well-being. It is therefore a stakeholder.