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Shareholder Theory/ Shareholder Value

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Synonyms

Shareholder primacy theory; Shareholder value creation; Shareholder value maximization; Shareholder wealth maximization; Shareholder-centric approach

Definition/Description

Shareholder theory states that the primary objective of management is to maximize shareholder value. This objective ranks in front of the interests of other corporate stakeholders, such as employees, suppliers, customers, and society. Shareholder theory argues that shareholders are the ultimate owners of a corporate's assets, and thus, the priority for managers and boards is to protect and grow these assets for the benefit of shareholders. Shareholder theory assumes that shareholders value corporate assets with two measurable metrics, dividends and share price. Therefore, management should make decisions that maximize the combined value of dividends and share price increases. However, shareholder theory fails to consider that shareholders and corporates may have other objectives that are not based on financial performance. For example, as early as 1932, Berle and Means argued that corporations have a variety of purposes and interests including encouraging entrepreneurship, innovation, and building communities. This wider view is gaining more traction in recent decades as evidenced by an increased interest in ethical investment funds. This suggests that shareholders and potential shareholders are not only interested in financial gains but are also interested in corporates being socially responsible (Kyriakou 2018). Therefore shareholder value creation is important; however, it needs to be balanced with other stakeholders' interests. This is referred to as an enlightened approach to shareholder value maximization.

This entry outlines the origins of shareholder value theory, provides a rationale for prioritizing shareholder value theory, documents arguments for taking a wider view beyond shareholder value, and explains enlightened shareholder value.

The Origins of Shareholder Value Theory

The origin of shareholder value maximization as the primary objective of corporates was influenced by changes in the structure of businesses, the economic environment, and

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financialization of the markets. These are now outlined in brief.

Business structure and the economic environment: The roots of shareholder value theory can be traced to the late eighteenth century when the capital investment required to finance innovative manufacturing businesses during the industrial revolution led to a change in the structure of businesses, from traditional small family-run corporates to large publicly owned corporates with dispersed shareholders and professional managers. This change in governance, called managerialism, led to new modes of coordinating enterprise, technology, and planning. From the 1970s, the focus on managerialism gave way to a growing focus on shareholder value maximization. The economic environment is considered to have contributed to this change in focus. The 1970s was a challenging time for US corporates as they experienced a decline in competitiveness due to the rise of foreign corporates. The result was decreases in their share prices. Questions were being asked about the performance of management in this era. The widespread reduction in the value of corporate stocks led to a focus by business leaders, policy makers, regulators, and politicians throughout the 1980s and 1990s on the role of the board and their duty and relationship to shareholders. In particular, agency theory, an economic theory that argues that humans are inherently self-serving, was deemed to provide an appropriate explanation for the poor performance of corporates. The view being that boards were taking decisions that benefited directors, not shareholders. This resulted in the widespread promotion of shareholder wealth maximization as the primary goal of corporates. Directors were not opposed to this approach as they believed that by focusing on wealth maximization, they could avoid their corporate being the target of a takeover bid. This reason was particularly pertinent in the 1980s as a wave of merger activity was sweeping through major stock markets. In addition to being a defense against takeover, a focus on wealth maximization also led to calls for the alignment of director and shareholder incentives. The result was a higher executive director pay that was typically linked to share price increases. This further motivated management to focus on shareholder wealth maximization. However, it is also argued to have fueled a focus on short-term gains that benefit transient investors and directors, to the detriment of long-term shareholders and other stakeholders that are interested in the sustainability of the corporate (Clarke and Friedman 2016; Englander and Kaufman 2004).

Financialization: During the 1980s financial institutions became substantial investors in corporate shares. Financial institutions pursue wealth maximization as their primary investment objective. This increased attention from well-informed investors and led to pressure on directors to deliver high returns on their tangible assets. If high returns are not reported, then corporates faced the risk of being taken over and broken up. This shifted the priorities of corporates to cost-cutting, divesture, outsourcing, and offshoring as managers did whatever was necessary to meet the earnings expectations of the market (Dallas 2017). Improvements in information technology in the 1980s and 1990s also resulted in easier access to information on corporates, increased interest from a wider range of investors and hence greater liquidity in the stock market. In particular, it enabled more trading by transient shareholders whose main focus is liquidating short-term abnormal gains. The shift in focus to reporting short-term gains is argued to conflict with the long-term sustainability of corporates.

The arguments for and against the pursuit of shareholder wealth maximization are now outlined in brief.

The Rationale for Prioritizing Shareholder Value

Four main arguments in support of the primacy of shareholders over other stakeholders are forwarded in the literature; the agency perspective, the control perspective, the residual claims perspective, and congruence with social wealth.

The agency perspective: The first view, the agency perspective, is that directors have a contractual obligation to prioritize shareholder value maximization over other stakeholder claims.

Under agency theory the corporate is seen as a "nexus of contracts" (Alchian and Demsetz 1973). Shareholders are the owners. They are external to the corporate and hence cannot manage the corporate. Therefore, shareholders hire agents (managing boards) to protect their interests and to run the corporate on their behalf (Jensen and Meckling 1976). To fulfill their contractual obligation, boards should take decisions that promote the long-term sustainability of the corporate. The traditional view is that long-term sustainability is synonymous with financial prowess. Therefore, the focus should be on financial decision-making that maximizes shareholder value in terms of dividend returns and increases in share price. This traditional view is captured by Friedman when he stated: "Few trends could so thoroughly undermine the foundations of our free society as the acceptance by corporate officials of a social responsibility other than to make as much money for their stockholders as possible" (Friedman 1970, p. 113). Friedman went on to explain that catering for multiple stakeholders with multiple objectives increases the risk of managerial mismanagement and may even conflict with shareholder wealth. Therefore, the role of the board is to manage, grow, and protect shareholder assets. This can be achieved by a focus on sustainable development.

Control: Under the control view, shareholders are the controlling influence and hence the most important stakeholder. Each share has voting rights and though shareholders transfer their control rights to the governing board to run the corporate on their behalf, they have influence over the board. They can attend annual general meetings and remove individual directors, and they can influence board decision-making through their voting rights at meetings. Therefore, though they have transferred operational decision-making control to the board, shareholders retain ultimate control. As a result, shareholders are the most important stakeholder, and the governing board, managers, and employees should act to maximize shareholder wealth. The maximization of shareholder wealth is achievable when long-term sustainability is achieved.

Residual claims: Shareholders provide funds to the corporate for investment. The corporate invests these funds in assets. Therefore, any assets purchased with shareholders' funds are the property of the shareholders. However, under law, the contractual rights of other claimants, such as employees and suppliers, rank in front of shareholders' contractual claims. This means that shareholders are only entitled to the residual value when the corporate is wound up after all other contractual claimants have been satisfied. Consequentially, shareholders bear more risk and hence have a greater interest in the corporate's long-term sustainability relative to other stakeholders. Each decision made by the board has a direct impact on shareholder wealth, whereas all other stakeholder claims are typically fixed. Therefore, governing boards should focus on maximizing equity shareholder wealth as this will ensure the long-term sustainability of the corporate.

Congruence with social wealth: A fourth argument in support of shareholder value maximization is that it has value for the wider society. When governing boards focus on shareholder wealth maximization, this results in benefits for other stakeholders. For example, to increase sales revenues, policies may be introduced that improve customer service or provide a wider product range. This will lead to additional profits for shareholders as customers return more often. However, it also benefits customers who experience higher quality service and have access to a wider range of products. Similarly, to reduce staff recruitment costs, a corporate might invest in staff training or introduce flexible working hours. This will cut costs due to lower staff turnover, lower sick rates, and improved productivity from happier workers. The changes are also beneficial for workers who increase their human capital by gaining new skills and can better manage their work-life balance. In addition, financial gains to shareholders will also have a societal impact as in modern developed economies, a majority of the population have investment in stock markets. This investment may be direct, through the purchase of shares, or indirect, through their pension funds. Thus a focus on shareholder value is argued to be

beneficial for society at large. Politicians in several jurisdictions have equated the performance of the stock market with the interests of their voting public (Cioffi and Höpner 2006).

Why Take a Wider View Beyond Shareholder Value

As early as 1992, Michael Porter claimed that economic instability and insecurity results from a focus on shareholder value maximization. More recently Clarke (2015) argued that the relentless search for returns, regardless of the consequences, and the self-interest and irresponsibility embodied in the pursuit of shareholder value, was at the heart of corporate scandals, such as Enron and WorldCom in the early 2000s, and the reckless excesses leading to the global financial crisis of 2008. Moreover, government bailouts of banking corporations in the aftermath of the financial crisis, with the associated short- and long-term costs to taxpayers, indicate that an excessive focus on maximizing shareholder wealth not only damages shareholders but also has a negative impact on society.

Some opposing arguments for the rationale forwarded under agency theory, control, residual claims, and congruence with social welfare are now outlined.

Agency theory: Agency theory identifies that directors could be self-serving at the expense of shareholders and that this can have negative consequences for the long-run sustainability of a corporate. It argues that monitoring directors and incentive alignment that leads to decision-making that is congruent with shareholder value maximization should result in director decision-making that is consistent with shareholder value maximization. However, the empirical literature is inconclusive as to whether methods used to reduce agency, lead to better outcomes for shareholders (Pargendler 2016). There are plenty of examples of corporate failures despite clean audit reports by auditors, for example, Enron. In addition, it is claimed that techniques used to align board decision-making, for example, share options, have not curbed dysfunctional decision-making, for example, Nortel. It would seem that agency theory is an oversimplification of the complexity and heterogeneity of financial and corporate reality. Economics is not the only driver of human interactions; it is also shared by politics, ideologies, legal systems, social conventions, modes of thought, etc. (Letza et al. 2008). Therefore, a focus on shareholder wealth is appealing for its simplicity but fails to take into account the complexity of the corporate world.

Control: While shareholders own shares in corporations, they are defined under law as separate legal entities. They exist separate to their aggregate members, with their own rights and duties that do not derive from the rights of their shareholders (Letza et al. 2008). Therefore, as distinct social entities, the directors' duty is to each distinct entity, not the aggregate shareholders.

Residual claims: Though shareholders are not guaranteed a return, they are not the only stakeholder to invest in corporations without a guaranteed return. Taxpayers, through government agencies, and employees, also invest in corporations without a guaranteed return. Government agencies provide infrastructure that corporations use and may even directly provide grants or subsidies to corporations. The return is tax revenues and societal gain. Employees make investments in "corporation-specific" human capital and unpaid hours of input with the expectation that they will reap returns (wages) from that corporation in the future. When the role is specialized, or the employee is older, their mobility is impaired and the potential loss in terms of future returns (wages) is greater. Employees cannot diversify their investment as easily as shareholders can. In addition, shareholders can exit at any time. This is not as easy for taxpayer investment or for some employees. Therefore, it could be argued that shareholders are not the key risk takers, as other stakeholders such as taxpayers and employees also face considerable risk. Indeed, their loss when a corporation fails may be even greater than shareholders' losses.

Congruence with social wealth: Pargendler (2016) suggests that there is little congruence between focusing on shareholder value and social

wealth. They find that share price increases do not benefit society equally, that the wealthiest 10% of the population own 81% of the stock, whereas the bottom 80% of the population hold 9% of shares. Moreover, given this skewed concentration of ownership, shareholders have few incentives to act as stewards for the public good. Thus, there is little overlap between the interests of shareholders and those of wider society. Pargendler's (2016) conclusion focused on the outcome of the pursuit of financial objectives, where the output is dividends and share price increases; however, there are other beneficial outcomes from corporate sustainability that benefit the wider stakeholder body. Recognition of these benefits has led to calls for an approach termed "enlightened shareholder value."

Enlightened Shareholder Value

Under shareholder value theory, the corporate is viewed as a body of shareholders with the board's duty to the shareholders. Shareholder value theory also assumes there is a single, common and uniform measure of shareholder value, dividends and share price increases, and that shareholders are only interested in financial returns. However, this may not be an appropriate assumption. As early as the 1970s, activist shareholders have submitted proposals on social issues at annual general meetings. This suggests that shareholders have interests other than financial returns and that by catering for other stakeholder interests, boards are in fact catering for shareholder interests. Moreover, furthering shareholder value is not mandated under corporate law (Stout 2012), and the law has imposed duties on boards to other stakeholders, such as to employees and suppliers. For example, in the UK (Companies Act 2006) and Ireland (Companies Act 2014), directors have a duty to promote the success of the corporate for the benefit of its shareholders while having regard to the interests of employees and to creditors generally, particularly in times of threatened insolvency. A stakeholder-orientated approach to governance is evident in continental Europe and Japan where shareholder value and stakeholder interests are not separate and isolated from each other but interdependent, mutually influential, and reciprocally supportive (Letza et al. 2008). More widely, investors in many markets reported that even where a primary duty to shareholders is accepted, this does not exclude engagement and action on sustainability issues (Sullivan et al. 2015). This approach is referred to as the "enlightened shareholder value" approach.

The enlightened shareholder value approach focuses on long-term value creation and the interests of various stakeholders, in advancing shareholder value. Shareholder interests are predominant; however, the promotion of their interests does not require ignoring the interests of other groups deemed to be important to the success of the corporate. Boards are permitted to take different stakeholder interests into account if deemed to be congruent with long-term shareholder wealth maximization. It would be hard for boards to make decisions that treat the well-being of employees or the environment as the primary cause for action (unless based on other legal obligations under employment or environmental law). An enlightened approach does not extend to additional rights for stakeholders, nor does the approach prioritize other stakeholders at the expense of shareholders. However, it argues that all stakeholders benefit from a long-term view and hence the sustainability of the corporate. As with any corporate investment, investment in a corporate stakeholder group should earn a return for the whole corporate, and there is some tangential evidence to suggest that this is the case. For example, De Klerk et al. (2015) report higher share prices in corporates with higher levels of sustainability disclosures. Thus it would seem that sustainability and value maximization have the potential to be complementary undertakings that result in a virtuous circle in which "doing good" helps companies do well, and doing well provides the wherewithal to do more good (Martin et al. 2009). Policy makers also are promoting a more enlightened approach. There are increasing legal requirements on corporates to publish on social and environmental matters, for example, the EU Non-Financial Reporting Directive 2014/95/EU. In addition, stock exchanges have started to require their members to comply with Corporate Governance Codes that contain requirements on

disclosures of social and environmental matters (KPMG 2017a).

A refocus to enlightened shareholder value is consistent with the growing numbers of institutional investors who include sustainability criteria and metrics when developing and assessing portfolios of shares (Chen and Scholtens 2018; Miralles-Quiros et al. 2017; Sullivan et al. 2015). Even Michael Jensen, the champion of agency theory, has conceded that in order to maximize value, managers must not only satisfy but enlist the support of all corporate stakeholders (Jensen 2002).

Summary

Taking an enlightened shareholder value approach is not as clear cut as pursuing financial objectives that result in stronger financial ratios, higher dividends, and increases in share price. Setting non-financial objectives is difficult as there are measurement and reporting issues with limited guidance from policy makers. However, financial performance and sustainability are not divorced from each other. Share price is a vital indicator of corporate performance. It reflects the underlying value of the corporate, including potential future sustainability. Financial performance is important not only for shareholders but also for other stakeholders. For example, without financial sustainability, employees' future income stream is at risk, suppliers' future income stream is at risk, customers' access to products is at risk, and the public cannot benefit from the infrastructure funded by tax and direct investment by corporates.

Conflict typically arises between shareholders and other stakeholders, not because of the pursuit of financial objectives, but due to agency issues, wherein self-serving boards make decisions that focus on short-term gains that put the long-term sustainability of the corporation at risk. This approach only benefits short-term transitional shareholders who trade for quick speculative gains. This behavior does not serve the interests of long-term shareholders, who are interested in the sustainability of the corporate. As a result of agency behavior, legislative and regulatory intervention is required to ensure corporations respond to the growing public demand, that they recognize their wider social and environmental responsibilities and avoid a singular focus on short-term financial shareholder wealth maximization.

Cross-References

- ► Accountability
- ► Agency Theory
- ► Corporate Activism
- ► Executive Remuneration and CSR
- ► Governance
- ► Stakeholder
- ► Transaction Cost Economics

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