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Maximising shareholder value: an ethical responsibility?

Finance professors often get criticised by ethics professors because they tell their students that the goal of the firm is to maximise shareholder value. Financial scandals such as Enron, Tyco and others are regularly blamed on the excessive focus on shareholder value maximisation

Theo Vermaelen, Professor of Finance at INSEAD, says this critique is misplaced and reflects a lack of understanding of what we teach in finance courses.

“Shareholder value is defined as the present value of free cash flows from now until infinity, discounted at a rate that reflects the risks of these cash flows. So, maximising shareholder value is not the same thing as maximising short-term profits, earnings per share or manipulating stock prices through accounting fraud. The Enron disaster, in which all shareholders lost their money, has nothing to do with excessive focus on shareholder value," he says.

Another misunderstanding is that because anyone who evaluates decisions on the basis of consequences for shareholder value, does not care about other stakeholders.

“In a discounted cash flow spreadsheet, shareholder value is calculated by taking revenues and then subtracting labour costs, executive compensation, interest and taxes. This residual cash flow incorporates the interests of all stakeholders, not simply the shareholder. What we don’t do is 'balance' the interest of stakeholders as you can justify any decision by stakeholder maximisation theory. For example maximising stakeholder value could mean that I pay workers above-competitive salaries at the expense of shareholders. The problem is that if you do this in a competitive market, in the long run you will be driven out of business, as recently illustrated by the collapse of General Motors. Of course, in the short run a firm may make abnormal profits, but this will attract competitors, so that in the long run also shareholders will earn a competitive rate of return”.

While economists typically justify maximising shareholder value on the basis of economic efficiency arguments, Vermaelen wants to give an ethical twist to this. He proposes a new definition of ethical behaviour in business that is less tied to highly personal values: respect for implicit contracts. Once we embrace this definition, maximising shareholder value may well be an ethical responsibility.

Vermaelen adopts the view that a company should be considered as a nexus of contracts between various stakeholders. All contracts have explicit and implicit characteristics. For example, the debt contract has a large number of explicit terms such as maturity, interest rate, seniority, covenants, and so on. However, shareholders have a largely implicit contract. Apart from voting rights, which are relatively meaningless for small stockholders, shareholders have no explicit rights. Shareholders are not entitled to any dividends or can’t get their money back. As a company needs shareholders, the survival of a corporation with widely dispersed ownership depends on the survival of this implicit contract.

“In a capitalist economy it is reasonable to assume that shareholders have an implicit contract that the management will maximise their interests," Vermaelen says. "So, I believe that respect for such implicit contracts is an ethical responsibility. Hence, [illegible] ar[illegible]med at destroying va[illegible]l. Unless, of course, [illegible]y makes it clear in advance that it will [illegible]ter[illegible]r example, a [illegible]t r[illegible] states that it will start a corporate social responsibility policy that distributes five per cent of its profits to the poor behaves ethically because investors can incorporate the lower profits in the issue price of the stock. But implementing such policies when they were not announced in advance is, in my view, unethical.”

Proponents of CSR argue that many of these policies actually do create shareholder value. For example, giving money to the poor may create sympathy for the company, increase revenues and/or lower labour costs and may ultimately be value maximising.

“Obviously if CSR policies are simply PR or marketing exercises than obviously they are not inconsistent with value maximisation or unethical," Vermaelen says. "But it is up to the company to prove that this marketing strategy works.”

The fact that managers may not maximise shareholder value is generally described as an agency problem. Traditionally economists try to deal with this by designing compensation schemes that align the interest of stockholders and managers. Or, alternatively, appoint a board of directors that has the fiduciary duty to make sure managers maximise shareholder value.

”The problem is that it is difficult, if not impossible to solve the problem this way, as the current credit crisis indicates,” Vermaelen says. “Bonuses based on short-term profits led bankers to take risks that produced short-term profits and short-term stock price increases without creating long-term shareholder value. So besides designing better incentive schemes to align managerial and shareholder interests, there is a need to promote the ethical view that the right thing to do is to maximise shareholder value “

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