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Shareholder Value Maximization

"Virtue is more to be feared than vice, because its excesses are not subject to the regulation of conscience."

—Adam Smith

Aran enjoys the thunder of his music and the thrill of shaving seconds off his courier route almost as much as he enjoys the still-new, risky thrill of starting his own delivery service. During fleeting moments of thought – just short of contemplation -- Aran sometimes realizes that he is also fortunate to be living in what his brother-in-law calls a "free market environment", a place where he is able to own and operate his own business, to make a go of it based almost entirely on his own gumption.

It has been just half a year since Aran purchased the second- (or probably sixth-) hand minivan he uses for his dashes about town, and already the number of daily deliveries that speed their way through the city as temporary (thankfully) passengers inside Aran's hippity-hoppity courier-mobile has exceeded by at least half the probable numbers his stodgy brother-in-law predicted in his so-called *pro forma* (whatever that is), allowing Aran to purchase another small van and to hire a part time delivery person.

Blue smoke and thumping bass notes in his wake, and with a bow wave of pedestrian-shoving horn blasts, Aran spends his days in a frenzied whorl of package, parcel and post relocation. No time for lunch, no time for any of that roses-smelling stuff, no time to get that nasty engine knock looked after (just pump up the bass a bit more and the knock isn't nearly so obvious). The objective, after all, is to make the business profitable.

He had promised his new, expectant (in more ways than one) bride, as well as his sharpened-pencil brother-in-law that he would, "Without any doubt What-So-Ever!" make a go of this venture. "They are my shareholders", Aran reminds himself, using the term that his B-I-L constantly peppers his lectures with, while lowering the tip of that graphite lance in Aran's direction.

"I must exceed my shareholders expectations", has become Aran's mantra. "I must go faster!" is his credo.

Whether one believes that Aran's befouling of the environment and the peril in which he places both himself and others around him is unethical or immoral might be predicated on the

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mores of the culture in which Aran lives. If, for example, he resides in Bremerton, Washington, his disregard for the air and for the safety of those around him would be considered improper, at least, and probably illegal; whereas, if in Bangkok, Thailand, his horn-honking impatience and lack of vehicle maintenance might be thought of as perfectly normal, and certainly not in violation of either custom or code. Stakeholders include everyone affected by the decisions of corporations -- the environment, society, employees, other drivers, pedestrians, etc.. The decision, therefore, whether the needs of not just *share*holders, but also other *stake*holders should be incorporated into the conduct of business, and the extent to which it should be considered, cannot always be universally or uniformly applied, based solely on philosophical grounds.

There are, however, certain economic truths that transcend philosophy, that are immutable, and that, if adhered to, can favor the maximization of both shareholder and other stakeholder interests. One of those truths is that the mitigation or elimination of risk is a fundamental way of helping secure a company's economic viability. Conversely, decisions which disregard all but immediate gains for shareholders, to the exclusion of other stakeholders, might place shareholder value at great financial risk. Certainly, a traffic ticket or two will increase Aran's insurance rates to the point of offsetting whatever gains an extra delivery or two each day would bring him. Similarly, failing to maintain his vehicle will undoubtedly cost him considerably more in future repairs than will taking it in for periodic servicing. Further, it seems unlikely that Aran has factored in elevated gas costs that result from speeding, or the outlay that a lawsuit by an injured pedestrian might be. A poignant example of the potential costs of attempting to maximize profits by ignoring the stakeholders of safety, maintenance, the environment, or the populace is the Bhopal, India, disaster of 1984, which

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destroyed lives, land and property, and eradicated years of profits for shareholders in a matter of minutes, producing negative effects on the business of Union Carbide for decades.[1]

In his monograph, entitled "Corporate Governance and Value Creation"[2], Jean-Paul Page (2005) states: "The ultimate power in a company must rest with the shareholders." echoing a common thread observable in the works of some of the most influential proponents of free market economics – beginning with Adam Smith (1723-1790), who expressed skepticism of "those who affected to trade for the public good" and furthered by the likes of Nobel Prize-winning economist Milton Freidman -- perhaps best summarized by Mr. Friedman in his 1970 paper, "The Social Responsibility of Business is to Increase Its Profits", in which he writes:

> "There is one and only one social responsibility of business – to use its resources and engage in activities designed to increase its profits..."[3]

Taken out of context, Messr's Smith, Page and Friedman's remarks (as well as those of Aran's brother-in-law) could be interpreted as indicating that the monetary remuneration to the shareholders must concurrently ignore the interests of all other persons or entities. If that were so, then the noise and air pollution caused by Aran's van, along with the risk at which he places himself, other drivers and pedestrians, would seemingly be of no consideration to Aran or to his "shareholders". Such an interpretation could be extended to rationalize the dumping of toxins into a river by a major manufacturer; or to the continued distribution of a pain-killing drug known by its maker to cause heart problems; or even to the raking off of profits by major shareholders through creative bookkeeping practices. Taken to the extreme, *a la* the Bhopal example, Robert Almeder (1980) attempts to equate Friedman's position with the killing of another human for financial reward.[4] Of course, neither Smith, nor Page nor Friedman advocated violating the law in their works. On the contrary, "…so long as it stays

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within the rules of the game, which is to say, engages in open and free competition without deception or fraud." is the concluding clause of Mr. Friedman's statement. In fact, a thorough study of Friedman's writings, such as those conducted by James Madison University Professor Scott Gallagher (2005) and summarized in his paper "A Strategic Response to Friedman's Critique of Business Ethics"[5], postulates that Friedman advocated that managers who do not align their actions with society's broader view of ethical behavior place their entire organizations at risk. Further, contends Dr. Gallagher, Friedman taught that a firm can lower costs by insulating itself from radical shifts away from the norms of society. It follows, then, that a firm that is acting in accordance with the cultural ethics – the norms of society -- reduces its risks, and is therefore "…better able to gain a sustainable competitive advantage, since their conduct and behavior are tied more closely to the social macro environmental force." Considering the interests of a broader range of stakeholders beyond just shareholders will also prevent the need for additional mandated behavior designed to protect public interests.

Additional works, such as the 2002 study[6] conducted by Messr's Omran, Atrill and Pointon, as well as the 2005 monograph[7] of Franck Amalric and Jason Hauser, use case studies and statistical analysis to bolster the contentions that there is no significant difference in shareholder-oriented versus stakeholder-oriented companies, but that companies can increase their shareholder value through the development and implementation of activities that contribute to society beyond the goods and services they produce, the employment it provides, and the returns on investments it generates.

What this memo demonstrates is that the rationale for a manager being accountable only to the shareholder, irrespective of other stakeholders' needs, is not only poor fiscal policy in that

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it increases risk, but is also antithesis to the teachings of several influential economists who advocate corporate responsibility to society at large, within a free market system. The worth of a business is measured by a combination of financial success, usefulness to society, and satisfaction of employees, the priorities determined by the makeup of the individuals and corporations that together own the shares and direct the company. This is sometimes referred to as stakeholder analysis, which concludes that the least risky and therefore potentially most profitable strategy for a company is to abide by both the laws, as well as the culturally-acceptable behavior of the environment in which it is located.

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