

Helping Finance Students Think About the Shareholder Value Maximization Objective

Steven T. Jones

One of the most contentious debates in the field of financial management involves the relative merits of a “shareholder” versus a “stakeholder” focus. While there are often-overlooked common elements in the “shareholder” and “stakeholder” arguments, clearly there are sharp differences between the two as well. Business school professors have the often-difficult task of describing these differences for their students. This paper describes possible approaches to this issue, both at a surface level for an introductory finance course, and in a more applied manner for an advanced course.

The author proposes an approach of enlightened self-interest, in which corporate management observes its fiduciary responsibility to shareholders by pursuing long-term shareholder value maximization, and at the same time realizes that this pursuit is likely to be fruitless if other constituencies are neglected. However, it is hoped that the teaching suggestions offered in this paper will be helpful, both to those who agree with this approach, and to those who hold a different view.

INTRODUCTION

Traditionally, corporate finance texts have taught that the ultimate objective of financial management – or indeed, of corporate management in general – is to maximize shareholder wealth or “shareholder value.” Over time, this view has been challenged by the argument that a focus on shareholders is too narrow, and should be replaced by an emphasis on serving the interests of a broader group of “stakeholders.”

This debate has, as one might expect, created more questions than answers. What constitutes ethical behavior on the part of a corporation and its managers and directors? Do corporate managers owe their primary allegiance to the interests of the shareholders; or do they instead have equal responsibilities to all of the stakeholders in a firm? How can finance professors (who have widely varied views on this subject) best introduce their students to the topic of shareholder value maximization?

In the next section of the paper, I discuss a means of clarifying the implications of the shareholder value maximization objective for students taking their first finance course. These students, hearing for perhaps the first time the idea that the objective of a firm’s managers should be to maximize shareholder value, may very naturally wonder what types of behavior are advisable or permissible under this objective. Does the idea that the priority is maximizing shareholder value mean that a firm’s managers can safely ignore other constituents? Does it perhaps even imply that a fiduciary duty to the firm’s owners overrides all other ethical considerations? If those interpretations of the shareholder value maximization objective are not accurate, then what does the objective actually mean?

In the following section, I discuss how a case study can be used to examine the “shareholders vs. stakeholders” debate in more depth in an advanced finance course. Students in such a course are likely to have examined in previous coursework the theoretical arguments, pro and con, regarding the shareholder value maximization objective, although a review

of those arguments is not necessarily unwarranted. But, what if the issue is examined in a more applied manner? Suppose that students are asked to compare a firm that appears to have stronger financial results to a firm that appears to have better relationships with its customers and employees. Which is the better firm? An in-depth discussion of this issue can help to illustrate the idea that in the long term, shareholders’ interests may be advanced by careful attention to the firm’s relationships with other constituents.

A final section offers conclusions, and contemplates how research into this area might be extended.

SHAREHOLDER WEALTH MAXIMIZATION IN AN INTRODUCTORY FINANCE COURSE

In financial management courses, “shareholder wealth maximization” (or “shareholder value maximization”) is generally introduced as a more accurate alternative to the naive but somewhat instinctive idea that the objective of financial managers might be to maximize profits. One seeming advantage of this approach is that discussing the inadequacies of a profit-maximization objective allows the professor to lay the groundwork for several critical concepts that students will have to grapple with later. For instance, the distinction between profits and cash flows can help set the stage for later discussions of sources and uses of cash. The importance of not just absolute dollar values, but also timing, provides a nice preview of the time value of money topic. In addition, the need to look beyond point estimates of future cash flows to the degree of uncertainty regarding those estimates can serve as a precursor to the topic of risk and return.

However, as useful as it can be to describe these distinctions, ending the discussion there could amount to giving short shrift to the concerns that have evolved over the years regarding whether the objective of maximizing shareholder wealth is sufficiently broad. One approach to this issue is to provide students with a description of what the acceptance of this objective would and would not imply.

What the Shareholder Wealth Objective Does Not Mean

I have found the following two issues to be critical in explaining to introductory finance students what the shareholder wealth objective does not (or, at least, should not) mean. First, it is important to note that pursuing the objective of maximizing shareholder value does not give managers carte blanche to ignore legal and/or ethical considerations.

An analogy that I have found helpful is the following. One of my few memories from my terrifying excursion into Operations Management, as an MBA student, is the topic of linear programming. In writing a linear program, one sets an objective of maximizing or minimizing a particular outcome, such as product life span or customer wait times. However, pursuit of the objective is limited by certain constraints that must be observed without fail. For instance, there may be a constraint that variable X must be no less than 3 times variable Y, another constraint that the sum of 5 times variable Y and 2.7 times variable Z must be no more than 12, etc.

Importantly, the constraints always trump the objective. For example, while we would like to cut customer wait times closer to zero, we must abide by the various constraints regarding the variables that ultimately work together to determine those wait times. This requirement holds true even though complying with the constraints inflates customer wait times relative to what they otherwise would be. The existence of the constraints does not change the fact that the objective is to minimize wait time. However, the constraints do create strict limits on the actions we can take in pursuing that objective.

The analogy to the shareholder wealth maximization objective is that there are legal and ethical constraints that must be observed, even if these constraints hinder the pursuit of the objective itself. I often use the deliberately extreme example of a firm having the opportunity to enrich its shareholders by laundering money for a crime syndicate. Virtually all students will quickly agree that this behavior simply would not be acceptable, regardless of its potential to assist in maximizing shareholder value. Said another way, the phrase “maximize shareholder wealth” is not followed by the words “even if you have to lie, cheat, and steal to do so.”¹

Second, saying that shareholder wealth maximization is the objective does not mean that managers can safely ignore other measures of firm performance, nor that it is wise for them to overlook other constituencies. For instance, as noted above shareholder wealth maximization most often is introduced as an alternative to profit maximization as the objective of financial management. However, a company that reports no profits for thirty years is highly unlikely to succeed at adding value to its shareholders.

Further, I have found it productive to extend this concept from comparisons of alternative financial measures to the importance of various constituencies to the firm’s success. For instance, it is difficult to see how a corporation can continue to maximize shareholder value if there are ongoing problems with customer loyalty or with employee satisfaction

and retention. If we continually alienate our customers to the point that they leave us for our competitors, or if our employees are constantly out on strike (or departing for greener pastures, or marking time until retirement), then it is going to be exceedingly difficult for us to provide our shareholders with a healthy return on their investment. Indeed, a corporation can have the most talented Chief Financial Officer in the world, and still fail to attain the financial objective of maximizing shareholder value, if the other pieces of the puzzle are not in place.

What the Shareholder Wealth Objective Does Mean

Having laid out two of the more important caveats regarding the shareholder wealth maximization objective, I then proceed to explain what this objective does imply. The key point to recognize is that, from the perspective of a stockholder, issues such as profitability are critically important; however, their importance is a means to an end. The statement that seems to resonate with my students is that, forced to choose, an investor prefers a fat wallet over a pretty income statement.

Said another way, if a given student purchases shares of a company’s stock today, he or she likely expects that all else being equal, greater profitability (or market share, or employee satisfaction) will improve the likelihood of receiving a strong return on investment. However, suppose that this student purchases shares in two companies today, and holds those shares for forty years. Suppose further that over that forty-year holding period, Company A produces slightly higher average growth in earnings per share, but Company B produces a slightly higher cumulative return on the student’s investment. It is virtually certain that, when all is said and done, the student will regard Company B as having been a more successful investment than Company A.

Thus, the shareholder value maximization objective simply means that maximization of their own wealth is the yardstick by which most owners are likely to measure success. Said another way, the shareholder value maximization objective holds out no expectation that the owners of the firm will be altruistic; rather, it assumes that the owners expect the managers, as their agents, to look out for the owners’ best interests. However, a perspective of enlightened self-interest may very well allow for the idea that the best interests of the owners include the pursuit of customer loyalty, employee satisfaction, and other priorities that enhance the firm’s long-term value.

SHAREHOLDER VS. STAKEHOLDER FOCUS IN AN UPPER-LEVEL COURSE

While the issues discussed above hopefully represent a meaningful advance over simply asserting the validity of the shareholder wealth objective, they are almost certainly not sufficient for an upper-level financial management course.

Even if the professor holds the more traditional view that a manager's fiduciary duty is to the shareholders, he or she should attempt to expose students to the notion that the observance of this duty may not be as straightforward as it might appear. Suppose, for instance, that we compare two firms. The first firm has, to date, produced stronger financial results. The second firm appears to have distinguished itself better in its dealings with customers, employees, etc. Which firm's managers have done a better job?

In Case Studies in Finance: Managing for Corporate Value Creation, Bruner, Eades, and Schill (2014) offer what appears, on the surface, to be a stark contrast between operational excellence and financial excellence. This contrast is provided by an examination of the competition between Federal Express and United Parcel Service (UPS), as of the 2004 opening of the Chinese market to more of the services provided by these two firms.

At the risk of over-simplifying the case, Federal Express is portrayed as a company that is widely admired as a paragon of operational excellence and positive employee relations, but also as a firm that has produced relatively modest financial results. UPS, on the other hand, is portrayed as a company that has provided strong returns for its owners, but also as a staid, bureaucratic organization that has had a contentious relationship with its workforce. The teaching notes that accompany the case encourage the instructor to request in advance that students come to class prepared to discuss which of these two companies best embodies the concept of "excellence" in business.

After discussing numerous financial, operational, and historical details regarding the two firms, I like to spend the latter portion of the class discussion of this case with a careful focus on this issue. I remind the students that they were asked to consider which company is the "better" firm. I then take a vote, and after tallying the results I ask the students on each side of the question to articulate the reasons that they voted as they did.

Interestingly (and to me, encouragingly), in my classes no clear pattern has emerged over time in the student responses to this question. On several occasions, there has been a strong consensus in favor of Federal Express; in at least one semester, there was a nearly unanimous vote for UPS. Frequently, however, the class splits very nearly down the middle, and an interesting and informative debate ensues. After the students indicate that they feel as though they have had their say, I describe my own reaction to the issue, beginning with an acknowledgement of what I see as the strong points in both sets of arguments.

I then attempt to show the students that the choice of UPS or Federal Express as the "more excellent company" may involve considerations that are not apparent from the question posed by the publishers, because the situation in which the more operationally excellent firm is also the financially weaker firm will not necessarily persist indefinitely. If long term shareholder value creation depends in part on customer satisfaction, and/or on the ability to attract, retain, and

motivate good employees, then a firm's up-front investment in operational excellence might initially lead to less impressive financial statement results, but might ultimately lead to higher returns to the shareholders.

This is, in a sense, analogous to the idea that a capital budgeting decision involving an up-front investment in fixed assets may initially depress financial measures such as return on assets; but, this investment will nonetheless be in the long-term interest of the shareholders if it turns out to be a positive net present value decision. Along somewhat similar lines, the firm that initially appears to be operationally superior, but financially inferior, may ultimately become the firm that serves its shareholders better, as it reaps the rewards of its investments in operational excellence.

As it turns out, the case comparing Federal Express to UPS provides an excellent opportunity for illustrating this point: it turns out that long term shareholder returns have actually been better for investors in Federal Express, than they have been for investors in UPS. To demonstrate that, I provide the students with a handout that documents returns to date to shareholders in the two companies. I update these numbers each time I teach this case, and Exhibit 1 shows this handout as it would appear going into Memorial Day weekend of 2018. Please note that in order to avoid the appearance of "cherry-picking" data, holding period returns are calculated using three different start dates. One of these is the date on which UPS went public, which is the earliest feasible start date for an apples-to-apples comparison of the returns of outside shareholders.

So, one might be highly sympathetic to the argument of those students who have voted for UPS, on the basis of the notion that managers' fiduciary duty is to the owners of the firm, yet still conclude that Federal Express has been the better-performing firm because its actions up to the date of the case laid the groundwork for stronger shareholder returns. Said another way, one might endorse the opinion that Federal Express has been the more excellent firm without believing that it is safe for managers to ignore financial results, and without necessarily rejecting the appropriateness of shareholder value maximization as a firm's ultimate objective.

This examination of the aftermath of the case neither proves nor disproves the validity of the shareholder value maximization objective, which arguably is a philosophical rather than empirical question. What it potentially does do is to provide anecdotal evidence that careful attention to serving multiple stakeholders, such as employees and customers, can produce significant benefits to the shareholders down the road.

Thus, as in the above description of how this issue can be addressed in an introductory course, a perspective of enlightened self-interest may lead the owners of the firm to insist that the firm's managers prioritize shareholder value, but also may lead the owners to allow managers to sacrifice short-term financial results in order to take actions that enhance long-term returns.

CONCLUSIONS AND FUTURE RESEARCH

The tension between the traditional “shareholder” focus and the argument that corporate managers owe consideration to the interests of all of a firm’s “stakeholders” is real, and this paper makes no attempt to prove one approach superior to the other. However, this paper has proposed some ideas for improving students’ understanding of the issues involved.

For students in an introductory course, it is critical that professors clearly lay out what the shareholder value maximization objective does and does not imply. Students will arrive at their own opinions regarding the desirability of this objective, and it is important that those judgments be directed at the actual objective, rather than a straw man version of the objective. So, finance professors should be careful to note that the idea that managers should pursue shareholder value does not imply an absence of ethical constraints that must be observed in this pursuit. Further, it is useful to note that long-term shareholder value maximization is unlikely to be achieved if the firm’s executives do a poor job of managing relationships with customers, employees, and other constituencies.

Students in a more advanced course are likely to be better prepared to examine a more nuanced situation in which a firm’s emphasis on serving various non-owner stakeholders appears to have detracted from shareholder value. If one does agree with the notion that the managers’ fiduciary duty is to the stockholders, then by definition it is the stockholders whose interests the managers must ultimately pursue. At the same time, a firm’s investments in its employees, customers, and other constituencies may in some instances advance the long-term interests of the stockholders, even if the firm’s financial measures are initially lowered by these investments. Thus, in some instances a managerial focus on these other constituencies may augment, rather than impede, pursuit of the shareholder value objective.

The ultimate goal of each of these types of discussions is to advance student understanding of the fiduciary

responsibilities of a firm’s managers, which is a key (if often unstated) objective of a course in financial management. One fruitful area for future research would be the development of a rubric for measuring student understanding of this issue. Here again, we should acknowledge that different students will reach different conclusions regarding the desirability of the shareholder value maximization objective. What is most important here is that students have a clear understanding of the idea that they are accepting or rejecting, and of what that idea actually represents.

REFERENCES

- Bruner, Robert F., Kenneth M. Eades, and Michael J. Schill. *Case Studies in Finance: Managing for Corporate Value Creation*. 2014. 7th Edition. New York: McGraw-Hill/Irwin
- Norman, Wayne, and Chris MacDonald. April 2004. “Getting to the Bottom of ‘Triple Bottom Line.’” *Business Ethics Quarterly* 14(2): 243-262.

ENDNOTES

- ¹ Norman and MacDonald (2004) offer a thought-provoking example of a situation in which an attempt to balance competing interests in the service of net social benefit may undermine, rather than enhance, ethical decision-making. Taking their observations a step further, in the situation that they describe the aforementioned idea of a shareholder value objective, constrained by specific ethical requirements, would seem to impose a stricter standard of behavior on the firm than would a multiple-stakeholders model, as typically defined.

Steven T. Jones is a Professor of Finance at Samford University.

EXHIBIT 1: SHAREHOLDER RETURNS

SINCE UPS WENT PUBLIC

Date	UPS Adjusted Close	Federal Express Adjusted Close	S & P 500 Adjusted Close
5/25/2018	115.49	251.50	2,721.33
11/10/1999	43.77	39.64	1,373.46
years elapsed	18.54	18.54	18.54
FV of a \$1 investment	2.6386	6.3446	1.9814
Cumulative return	163.86%	534.46%	98.14%
Average annually compounded return	5.37%	10.48%	3.76%

SINCE END OF CALENDAR YEAR 2003

(i.e., since the end date of the full-year financial results information provided in case)

Date	UPS Adjusted Close	Federal Express Adjusted Close	S & P 500 Adjusted Close
5/25/2018	115.49	251.50	2,721.33
12/31/2003	50.59	62.26	1,111.92
Years elapsed	14.40	14.40	14.40
FV of a \$1 investment	2.2829	4.0395	2.4474
Cumulative return	128.29%	303.95%	144.74%
Average annually compounded return	5.90%	10.18%	6.41%

SINCE JUNE 18, 2004

(i.e., since the end date of the range shown in Case Exhibit # 1)

Date	UPS Adjusted Close	Federal Express Adjusted Close	S & P 500 Adjusted Close
5/25/2018	115.49	251.50	2,721.33
6/18/2004	50.22	72.28	1,135.02
Years elapsed	13.93	13.93	13.93
FV of a \$1 investment	2.2997	3.4795	2.3976
Cumulative return	129.97%	247.95%	139.76%
Average annually compounded return	6.16%	9.36%	6.48%

ALL PRICE DATA FROM YAHOO! FINANCE WEBSITE (<http://finance.yahoo.com>)