

How to maximise shareholder wealth



“ Governance helps us do the right thing, the right way – for our shareholders and our customers, employees, suppliers, local communities and the environment. Our governance is focused on how to get it right, not only in the board room but also across the business...” (Page 46)

Statement 2

“ Our aim is to build a sustainable business through consistent, profitable growth and to make sure that our customers and wider stakeholders can always trust us to do the right thing. We recognise that creating shareholder value is the reward for taking acceptable risks.” (page 54)

Required

From a finance perspective the main objective of a firm is to maximise shareholder wealth. However from the two statements above it appears that in reality companies don't just focus on shareholders.

To what extent do you agree that shareholder wealth maximisation should be a superior objective over stakeholder interest? Discuss your answer with relevant supporting literature. You may also back up your discussion with relevant real life examples from any where in the world.

(40 marks)

“ Maximizing shareholder wealth is the most superior objective of the company, is not it?”. It is the difficult question which a lot of businesses need to clear up. In the world, there are a great number of companies which pursuit the policy “ shareholder wealth maximization”. They think that shareholders are the investors who contribute capital for the businesses. Although shareholders do not directly manage the company, they are the

holding company ownership. So they believe that maximizing shareholder value is the main objective of their enterprises. On the contrary, other companies are not interested much in shareholders. According to them, a company needs to consider more important objectives because a sustainable enterprise does business for society and for itself. In my opinion, I disagree with the statement that shareholder value maximization is a superior objective over stakeholder interest.

Firstly, a company has many different objectives. There is profit maximization, maximization of business value, maximization of shareholder value assets, maximization of share price, etc. My own point of view is that the most important goal of a company is increasing the business value in the market.

Professor Michael C. Jensen thought that: “ Value maximization is not a vision or a strategy or even a purpose, it is the scorecard for the organization” (Jensen, Michael C., 2001, Value Maximization, Stakeholder Theory, and the Corporate Objective Function, p. 245)

“ Rappaport, (1986), suggested seven drives within a business that can be managed to create value:

A growth in sales;

An increase in the operating profit margin;

A reduction in the cash tax rates;

A reduction in the working capital investment;

A reduction in the fixed asset investment;

A reduction in the weighted average cost of capital (WACC);

An increase in the competitive advantage period.

Rappaport argued that improvements in these value drivers (by actively managing them) would lead to an increase in shareholder value”.

(Shareholder Value: An Analysis of Current Corporate Reporting Practices, <http://www.ukessays.com/essays/accounting/corporate-reporting-practices.php>)

Standing on the vision of creating value, maximizing profit is the main objective of the company. This objective constantly increases the value of assets for business owners. The target of maximizing profit is concretized and evaluated by the following norms:

Maximizing earning after tax.

Maximizing earning per share.

Maximizing market price per share.

“ Anthony (1960) argued that most economics texts and college classrooms install the belief that the objective of a business is to maximise profits.

Similarly, Doyle (1994) stated that profitability measures are also familiar benchmarks in academic studies of organisational renewal, turnaround and corporate failure” (Shareholder Value: An Analysis of Current Corporate

Reporting Practices, <http://www.ukessays.com/essays/accounting/corporate-reporting-practices.php>)

<https://assignbuster.com/how-to-maximise-shareholder-wealth/>

In short, the companies should focus on maximizing their profit. It helps the companies to maximizing their business value which will maximize other worth.

Besides, many enterprises cannot pursue the policy that maximizing the shareholder wealth because this also depends on the company's model. For example, the average dividend rate of the large companies exceeds 40 percent, while the average dividend rate of the small companies is fewer than 3 percent. What is the reason of the serious difference in the dividend rate between the large companies and the small companies? The reason is that most of the small companies are on the increased period of their business cycles; so the companies need more capital which to develop their production and business activities. They cannot pay the high dividend rate for their shareholders. They are allowed to determine the dividend rate and keep the profit which to turn over their business activities. Therefore, each company has a different superior objective; it depends on the company's model, frame, etc.

Moreover, in business operation, the enterprise objective is maximizing profits in certain conditions. Companies are always looking for ways that how to sell as many goods as possible. However, in the process of developing economics, in all countries, the society requires the companies to operate not only for profit but also for social responsibility. Implementing social responsibility to help entrepreneurs build goodwill and reputation with their partners, thereby promoting the production and business activities of the enterprise. For example, the Panasonic Group which is operated by Matsushita is crowned with success because they consider the auxiliary

interests as the main objective in their merchandising. These targets connect closely the company activities and improve the life's quality, social welfare of Japanese. Professor Richard Ellsworth asked a question: " How do the companies determine their viable goal?" In Japan and the other countries, it serves their customers and workers.

By contrast, some companies have behaviors that cause environmental pollution or use hazardous materials which harm to consumers. These companies will be boycotted by customers. For instance, Vedan Company discharged wastewater into the Thi Vai River which causes environmental pollution; so most of the supermarkets and consumers ostracized Vedan Company's products. Although Vedan Company performed compensation, it has lost a great reputation. In the business, the reputation is very important. It also brings the visible profit for the company. Management should not ignore the question of social responsibility. " As related to business firms, social responsibility concerns such things as protecting the consumer, and becoming actively involved in environmental issues like clean air and water. Many people feel that a firm has no choice but to act in socially responsible ways; they argue that the corporations vary existence depends upon its being socially responsible" (James C. Van Horne, 1974, Financial Management and Policy, Prentice – Hall, <http://oz.plymouth.edu/~harding/Fin/objective.html>).

Thus we can see that the companies do business not only for themselves but also for social benefits.

As a final point, “ In recent years, a wider variety of goals have been suggested for a business. These include the traditional objective of profit maximization. However, they also include goals relating to earnings per share, total sales, numbers employed, measures of employee welfare, manager satisfaction, environmental protection and many others”. (Business stakeholders, http://tutor2u.net/business/accounts/stakeholder_theory.htm)

Shareholders are the real owners of the company; but the company does not only focus on the shareholders value, they also interested in profit, sales, staffs, etc. They should concentrate on finding new strategies which to develop their companies. Increasing the enterprise value would satisfy the other objectives. The business value grows up which means assets, capital, profit of the company put up. Maximization the company value is maximization the different objectives indirectly. The invested purpose of the shareholders does not take back their capital immediately; they want to ensure safeness for their invested capital and develop the production, service controlling the market. The long term growth is the obvious benefit of the shareholders which the companies need to take interest in.

According to Professor Eric de Keuleneer, alternative model is given as “ stakeholder value maximization”. (Professor Eric de Keuleneer, 2005, The origins and purpose of Corporate Governance)

“ A major reason for increasing adoption of a Stakeholder Concept in setting the business objectives is the recognition that businesses are affected by the “ environment” in which they operate. Businesses come into regular contact with customers, suppliers, government agencies, families of employees,

special interest groups. Decisions made by a business are likely to affect one or more of these “ stakeholder groups”... The stakeholder concept suggests that the managers of a business should take into account their responsibilities to other groups – not just the shareholder group – when making decisions. The concept suggests that businesses can benefit significantly from cooperating with stakeholder groups, incorporating their needs in the decision – making process.” (Business stakeholders, http://tutor2u.net/business/accounts/stakeholder_theory.htm).

Professor Michael C. Jensen notes: “ Stakeholders include not only the financial claimants, but also employees, customers, communities, and governmental officials, and under some interpretations, the environment, terrorists, blackmailers, and thieves” (Jensen, Michael C., 2001, Value Maximization, Stakeholder Theory, and the Corporate Objective Function, p. 236).

Stakeholders are defined by CIMA as: “ Those persons and organisations that have an interest in the strategy of the organisation. Stakeholders normally include shareholders, customers, staff and the local community.” (CIMA: Management Accounting: Official Terminology, 2005, p. 53).

“ Examples of Stated Business Objectives that Incorporate the Stakeholder Concept”:

Company

Stakeholder Statement

“ British Telecom”

“ We aim to be at the heart of the information society – a communications – rich world in which everyone, irrespective of nationality, culture, ethnicity, class, creed or education, has access to the benefits of information and communications technology (ICT).

In practical terms, that means we are committed to doing business in a way that:

- maximizes the benefits of information and communications technology for individuals.
- contributes to the communities in which we operate.
- minimizes any adverse impact that we might have on the environment.
- It means doing business in a way that will persuade customers to buy from us, investors to back us, the best people to work for us and communities to have us around.

If we had to say what we believe in a single sentence, it would be this: better communications help create a better world.”

“ Marks and Spencer”

“ Our commitment to society is nothing new. We’ve always known that as well as providing the right products, a sustainable retail business needs the support of healthy communities and a high quality environment. Since the 1930s, Marks & Spencer has been actively involved in improving the quality of life for a wide range of communities. We’ve always tried to make an active

contribution to the needs of our stakeholders, whether as customers, employees, investors, suppliers, partners or neighbours.

Entering the 21st century our commitment remains as strong as ever, but the world is changing. Business is becoming global, society more diverse and our environment is under greater threat than at any time before. Companies have to consider how their actions impact on an increasingly connected set of issues.

We aim to be the most trusted retailer wherever we trade by demonstrating a clear sense of social responsibility and consistency in our decision making and behaviour.”

“ GlaxoSmithKline”

“ GlaxoSmithKline is one of the world’s leading pharmaceutical companies. Its global quest is to improve the quality of human life by enabling people to do more, feel better and live longer. GSK’s strategic intent is to become the indisputable leader in its industry – not simply in terms of size, but in how it uses that size to achieve its mission. Through its Global Community Partnerships function and Corporate Donations Committee, GSK partners with and supports organisations whose goals and objectives reflect its mission of improving the quality of human life.”

(Business Stakeholders, http://tutor2u.net/business/accounts/stakeholder_theory.htm)

From the above examples, it can be seen that nowadays the companies focus on not only their business value, profit but also customers, staffs,

social community, etc. The enterprise targets are not in the range of their business activities; they extend on the world scale. The companies operate for themselves and the society which improves the quality of human life.

In conclusion, maximizing the shareholder value is not the supervisor objective of the company. The business objective is putting up the enterprise value which satisfies stakeholders such as shareholders, customers, staffs, local community, etc. The increasing of business value and the satisfaction of the stakeholders will maximize the shareholder wealth. A sustainable company is a company which operates for itself and society.