WHAT IS THE FIRM’S OBJECTIVE?

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Introduction

This chapter considers the most fundamental question facing anyone trying to make decisions within an organization – what is the objective of the business? Without clarity on this point it is very difficult to run a business in a purposeful and effective manner. Unless we know what our objective is we cannot make sensible financial decisions, so it is essential we tackle what at first seems a fairly trivial question early in the book. As you will see the answers to this question are far from easy or trivial. They can be uncomfortable for many managers. They are also vital for the success of the business.

A common purpose

Cadbury Schweppes (CS), widely regarded as one of the best-managed companies in the world, has a clear statement of its objective in the 2002 Annual Report – see Case study 1.1. Notice that CS does not confuse the objective with the strategy to be employed to attain the objective. It first states the aim and then states the means to achieve the end. Many firms seem to believe that their objective is to operate in a particular market or take particular actions. They seem unable to distinguish market positions or actions from the ultimate purpose of the existence of the organization. This will not only lead to poor strategic decisions but frequently makes intelligent financial decisions impossible.

Case study 1.1

Cadbury Schweppes

‘Cadbury Schweppes’ governing objective is growth in shareowner value. In pursuit of this the Group’s strategy is to create robust and sustainable regional positions in its core categories of confectionery and beverages...

....The business process by which the strategy is pursued is Managing for Value (‘MFV’). Introduced into the Group in 1997, MFV is a holistic approach to value creation. It includes setting stretching financial targets; adopting value based management principles in our business processes, both operational and strategic; raising capabilities at all levels of the organisation and aligning management incentive schemes with the interests of shareowners.’

[We consider value-based management in Section II of the book]


This book is about practical decision-making in the real world. When people need to make choices in the harsh environment in which modern businesses have to operate, it is necessary to be clear about the purpose of the organization; to be clear about what objective is set for management to achieve. A multitude of small decisions are made every day; more importantly, every now
and then major strategic commitments of resources are made. It is imperative that the management teams are aware of, respect and contribute to the fundamental objective of the firm in all these large and small decisions. Imagine the chaos and confusion that could result from the opposite situation where there is no clear, accepted objective. The outcome of each decision will frequently conflict with others and the direction of the firm will become random and rudderless. One manager on one occasion will decide to grant long holidays and a shorter working week, believing that the purpose of the institution’s existence is to benefit employees; while on another occasion a different manager sacks ‘surplus’ staff and imposes lower wages, seeing the need to look after the owner’s interests as a first priority. So, before we can make decisions in the field of finance we need to establish what it is we are trying to achieve.

You have probably encountered elsewhere the question, ‘In whose interests is the firm run?’ This is largely a political and philosophical question and many books have been written on the subject. Here we will provide a brief overview of the debate because of its central importance to making choices in finance. The list of interested parties in Figure 1.1 could be extended, but no doubt you can accept the point from this shortened version that there are a number of claimants on a firm.

**Who gets any surplus?**

Sound financial management is necessary for the survival of the firm and for its growth. Therefore all of these stakeholders, to some extent, have an interest in seeing sensible financial decisions being taken. Many business decisions do not involve a conflict between the objectives of each of the stakeholders. However, there are occasions when someone has to decide which claimants are to have their objectives maximized, and which are merely to be satisficed – that is, given just enough of a return to make their contributions. There are some strong views held on this subject:

**FIGURE 1.1**

*A company has responsibilities to a number of interested parties*
Shareholder supremacy. The pro-capitalist economists, such as Friedrich Hayek and Milton Friedman, believe that making shareholders’ interests the paramount objective will benefit both the firm and society at large. This approach is not quite as extreme as it sounds because these thinkers generally accept that unbridled pursuit of shareholder returns, to the point of widespread pollution, murder and extortion, will not be in society’s best interest and so add the proviso that maximizing shareholder wealth is the desired objective provided that firms remain within ‘the rules of the game’.

Workers supremacy. At the opposite end of the political or philosophical spectrum are the left-wing advocates of the primacy of workers’ rights and rewards. The belief here is that labor should have its rewards maximized. The employees should have all that is left over, after the other parties have been satisfied. Shareholders are given just enough of a return to provide capital, suppliers are given just enough to supply raw materials and so on.

Stakeholder approach. Standing somewhere in the middle are those keen on a balanced stakeholder approach. Here the (often conflicting) interests of each of the claimants is somehow maximized but within the constraints set by the necessity to compromise to provide a fair return to the other stakeholders.

Variety of objectives: those admitted to (and those kept quiet)

A firm can choose from an infinitely long list of possible objectives. Some of these will appear noble and easily justified, others remain hidden, implicit, embarrassing, even subconscious. The following represent some of the most frequently encountered.

Achieving a target market share

In some industrial sectors to achieve a high share of the market gives high rewards. These may be in the form of improved profitability, survival chances or status. Quite often the winning of a particular market share is set as an objective because it acts as a proxy for other, more profound objectives, such as generating the maximum returns to shareholders. On other occasions matters can get out of hand and there is an obsessive pursuit of market share with only a thin veneer of shareholder wealth espousement – see Exhibit 1.1.

Keeping employee agitation to a minimum

Here, return to the organization’s owners is kept to the minimum level necessary. All surplus resources are directed to mollifying employees. Managers would be very reluctant to admit publicly that they place a high priority on reducing workplace tension, encouraging peace by appeasement and thereby, it is hoped, reducing their own stress levels, but actions tend to speak louder than words. An example of this kind of prioritization was evident in a number of state-owned UK
industries in the 1960s and 1970s. Unemployment levels were low, workers were in a strong bargaining position and there were, generally, state funds available to bail out a loss-making firm. In these circumstances it was easier to buy peace by acquiescing to union demands than to fight on the picket lines. Some companies have tried to reduce workplace tension by giving workers a large proportion of the shares, i.e. making them part-owners. But, as the example of United Airlines shows, ‘differences in expectations’ can destroy the business. UA ended up with ever more extreme demands from the unions, followed by bankruptcy – see Exhibit 1.2.

EXHIBIT 1.1 Profits fall on scheduled flights
Source: Financial Times 5 April 2000

Survival
There are circumstances where the overriding objective becomes the survival of the firm. Severe economic or market shock may force managers to focus purely on short-term issues to ensure the continuance of the business. In fire fighting they pay little attention to long-term growth and return to owners. However this focus is clearly inadequate in the long run – there must be other goals. If survival were the only objective then putting all the firm’s cash reserves into a bank savings account might be the best option. When managers say that their objective is survival what they generally mean is the avoidance of large risks that endanger the firm’s future. This may lead to a greater aversion to risk, and a rejection of activities that shareholders might wish the firm to undertake. Shareholders are in a position to diversify their investments: if one firm goes bankrupt they may be disappointed but they have other companies’ shares to fall back on. However the managers of that one firm may have the majority of their income, prestige and security linked to the continuing existence of that firm. These managers may deliberately avoid high-risk/high-return investments and so deprive the owners of the possibility of large gains.
United Airlines: the experiment that fell to earth

The carrier’s bankruptcy has raised serious doubts about the viability of workers controlling the companies they work for, write Caroline Daniel and Simon London

Three months ago the world’s second largest airline filed for bankruptcy amid spiralling losses. Last week, after nine years of 55 per cent employee ownership, workers at last dumped enough stock to push their stake below 20 per cent, triggering so-called ‘sunset clauses’. The experiment was finally declared dead.

Differences in expectations emerged quickly, says one former employee. ‘The silliest of all was when John Edwardson, [then number two] had a meeting with the pilots’ union early on and the union said: “Now we are owners, we have the right to fire one officer every year” and John just looked at him and understood it wasn’t a joke. It was a tense moment. And he replied: “I suppose then that officers can fire one pilots’ union leader every year.” Then the light went on.’

Moreover, it was hard to get employees to think like owners. Middle managers in particular were uneasy about giving up precious power. ‘We started to say: “We are all owners now, instead of just bosses and employees, so bosses needed to learn quickly how to supervise as coaches, cajolers, advisers – but not with a whip.” But some supervisors didn’t get it and said: “If I criticise one of my people, and they write to the chief executive, I’ll be in trouble.”’...

Along with restrictions over which aircraft would fly certain routes, the absurdity of some of the arcane work rules was underscored by the fact that the pilots’ contract included a promise that the company would pick up the tab if a pilot moved city and his piano needed re-turning, ... employees were given just three out of 12 board seats. But they were also granted the ability to veto chief executives and strategic decisions, such as acquisitions.

Wielding that power required enlightened union leaders. Instead, unions exploited it, denying Mr Edwardson the chief executive’s post and later ousting Jim Goodwin, their own appointee, when he warned United would perish without wage cuts. ... Pilots’ wages soared an immediate 29 per cent, with 4.5 per cent rises scheduled to follow.

Mr Dubinsky, then head of United’s pilots’ union, gloated that he intended to choke the golden goose ‘by its neck until it gives us every last egg’.

A senior pilot recalls: ‘... From 2000 to 2002, labour costs rose $1.4bn (£886m) but at the same time revenues fell $5.5bn.’

The pilot continues: ‘The problem was that United was employee-owned but union-controlled. Union leaders needed to satisfy their members who were concerned about work rules and wages, rather than valuation issues. There was a corrupting influence of politics on decision-making ... the equity culture never caught on.’

... the implications of union control over time led to the bleeding of management talent.

EXHIBIT 1.2

Source: Financial Times 18 March 2003
Creating an ever-expanding empire

This is an objective that is rarely openly discussed, but it seems reasonable to propose that some managers drive a firm forward, via organic growth or mergers, because of a desire to run an ever-larger enterprise. Often these motives become clearer with hindsight; when, for instance, a firm meets a calamitous end the *post mortem* often reveals that profit and efficiency were given second place to growth. The volume of sales, number of employees or overall stock market value of the firm have a much closer correlation with senior executive salaries, perks and status than do returns to shareholder funds. This may motivate some individuals to promote growth.

Maximization of profit

This is a much more acceptable objective, although not everyone would agree that maximization of profit should be the firm’s purpose.

Maximization of long-term shareholder wealth

While many commentators concentrate on profit maximization, finance experts are aware of a number of drawbacks of profit. The maximization of the returns to shareholders in the long term is considered to be a superior goal. We look at the differences between profit maximization and wealth maximization later.

This list of possible objectives can easily be extended but it is not possible within the scope of this book to examine each of them. Suffice it to say, there can be an enormous variety of objectives and a large potential for conflict and confusion. Some sort of order must be introduced.

The assumed objective for finance

The company should make investment and financing decisions with the aim of maximizing long-term shareholder wealth.

Throughout the remainder of this book it is assumed that the firm gives primacy of purpose to the wealth of shareholders. This assumption is made mainly on practical grounds, but there are respectable theoretical justifications too.

The practical reasons

If one may assume that the decision-making agents of the firm (managers) are acting in the best interests of shareholders then decisions on such matters as which investment projects to undertake, or which method of financing to use, can be made much more simply. If the firm has a multiplicity of objectives, imagine the
difficulty in deciding whether to introduce a new, more efficient machine to produce the firm’s widgets, where the new machine both will be more labor efficient (thereby creating redundancies), and will eliminate the need to buy from one-half of the firm’s suppliers. If one focusses solely on the benefits to shareholders a clear decision can be made. This entire book is about decision-making tools to aid those choices. These range from whether to produce a component in-house, to whether to buy another company. If for each decision scenario we have to contemplate a number of different objectives or some vague balance of stakeholder interests, the task is going to be much more complex. Once the basic decision-making frameworks are understood within the tight confines of shareholder wealth maximization, we can allow for complications caused by the modification of this assumption. For instance, shareholder wealth maximization is clearly not the only consideration motivating actions of organizations such as Body Shop or the Co-operative Bank, each with publicly stated ethical principles. Drugs companies are coming under pressure from shareholders to be more generous to AIDS victims – see Exhibit 1.3. Just how generous should they be and still be shareholder wealth maximizers? Real-world decision-making can be agonizingly hard.

**Investors warn drugs industry of backlash over health crises**

Geoff Dyer

The pharmaceuticals industry could suffer serious damage to its profitability and end up with a reputation similar to that of the tobacco industry if it does not do more to resolve health crises in poor countries, a group of Europe’s leading investors will warn today.

The institutional investors will take the unusual step of issuing a statement on how companies should respond to events such as the Aids pandemic. They fear a popular backlash could limit the prices the industry is able to charge in wealthy countries.

The group of investors, which together have £600bn of funds under management, also caution that failure to reach a deal on drug patents in the developing world could harm the industry’s reputation.

The statement, sent to 20 leading companies, makes a number of recommendations. It urges them to provide more scope to poorer countries to override drug patents. It also asks them to set prices in different countries that take into account what they can afford and to make more information available to purchasers.

**EXHIBIT 1.3 Investors warn of backlash**

Source: Financial Times 24 March 2003
The theoretical reasons

The risk bearers take the prize
The ‘contractual theory’ views the firm as a network of contracts, actual and implicit, which specify the roles to be played by various participants in the organization. For instance, the workers make both an explicit (employment contract) and an implicit (show initiative, reliability, etc.) deal with the firm to provide their services in return for salary and other benefits, and suppliers deliver necessary inputs in return for a known payment. Each party has well-defined rights and pay-offs. Most of the participants bargain for a limited risk and a fixed pay-off. Banks, for example, when they lend to a firm, often strenuously try to reduce risk by making sure that the firm is generating sufficient cash flow to repay, that there are assets that can be seized if the loan is not repaid and so on. The bankers’ bargain, like that of many of the parties, is a low-risk one and so, the argument goes, they should be rewarded with just the bare minimum for them to provide their service to the firm. Shareholders, on the other hand, are asked to put money into the business at high risk. The deal here is: ‘You give us your £10,000 nest egg that you need for your retirement and we, the directors of the firm, do not promise that you will receive a dividend or even see your capital again. We will try our hardest to produce a return on your money but we cannot give any guarantees. Sorry.’ Thus the firm’s owners are exposed to the possibilities that the firm may go bankrupt and all will be lost. Because of this unfair balance of risk between the different potential claimants on a firm’s resources it seems only reasonable that the owners should be entitled to any surplus returns which result after all the other parties have been satisfied.

Alternatives can be bad for all stakeholders (in the long run)
Another theoretical reason hinges on the practicalities of operating in a free market system. In such a capitalist system, it is argued, if a firm chooses to reduce returns to shareholders because, say, it wishes to direct more of the firm’s surplus to the workers, then this firm will find it difficult to survive. Some shareholders will sell their shares and invest in other firms more oriented towards their benefit (United Airlines? Where even the workers sold their shares). In the long run those individuals who do retain their shares may be amenable to a takeover bid from a firm that does concentrate on shareholder wealth creation. The acquirer will anticipate being able to cut costs, not least by lowering the returns to labor. In the absence of a takeover the company would be unable to raise more finance from shareholders and this might result in slow growth and liquidity problems and possibly corporate death, throwing all employees out of work. For over 200 years it has been argued that society is best served by businesses focussing on returns to the owner. Adam Smith (1776) expressed the argument very effectively:
The businessman by directing . . . industry in such a manner as its produce may be of the greatest value, intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. Nor is it always the worse for society that it was no part of it. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it. I have never known much good done by those who affected to trade for the public good. It is an affectation, indeed, not very common among merchants.

Source: Adam Smith, *The Wealth of Nations*, 1776, p. 400

In an interview in 2003, Milton Friedman focussed on the main benefit of encouraging businesses to pursue high returns for owners. He said that this results in the best allocation of investment capital among competing industries and product lines. ‘The self-interest of employees in retaining their jobs will often conflict with this overriding objective.’ He went on:

The best system of corporate governance is one that provides the best incentives to use capital efficiently. ... You want control ... in the hands of those who are residual recipients [i.e. shareholders bear the residual risk when a company fails] because they are the ones with the direct interest in using the capital of the firm efficiently.


**Rights of ownership**

One final, and powerful reason for advancing shareholders’ interests above all others (subject to the rules of the game) is very simple: they own the firm, and therefore deserve any surplus it produces.

This is not the place to advocate one philosophical approach or another which is applicable to all organizations at all times. Many organizations are clearly not shareholder wealth maximizers and are quite comfortable with that.

Charities, government departments and other non-profit organizations are fully justified in emphasizing a different set of values to those espoused by the commercial firm. The reader is asked to be prepared for two levels of thought when using this book. While it focuses on corporate shareholder wealth decision-making, it may be necessary to make small or large modifications to be able to apply the same frameworks and theories to organizations with different goals.

Football clubs are organizations that often have different objectives from commercial organizations. As Exhibit 1.4 shows, many fans of Newcastle United believe that the objectives of their club changed for the worse when it became a company quoted on the London Stock Exchange. A confusion of objectives can make decision-making complex and suspect.
What is shareholder value?

Maximizing wealth can be defined as maximizing purchasing power. The way in which an enterprise enables its owners to indulge in the pleasures of purchasing and consumption is by paying them a dividend. The promise of a flow of cash in the form of dividends is what prompts investors to sacrifice immediate consumption and hand over their savings to a management team through the purchase of shares. Shareholders are interested in a flow of dividends over a long time horizon and not necessarily in a quick payback. Take the pharmaceuticals giant GlaxoSmithKline: it could release vast sums for short-term dividend...
payouts by ceasing all research and development (R&D) and selling off surplus sites. But this would not maximize shareholder wealth because, by retaining funds within the business, it is believed that new products and ideas, springing from the R&D programme, will produce much higher dividends in the future. Maximizing shareholder wealth means maximizing the flow of dividends to shareholders through time – there is a long-term perspective.

**Profit maximization is not the same as shareholder wealth-maximization**

Profit is a concept developed by accountants to aid decision-making, one decision being to judge the quality of stewardship shown over the owner’s funds. The accountant has to take what is a continuous process, a business activity stretching over many years, and split this into accounting periods of say, a year, or six months. To some extent this exercise is bound to be artificial and fraught with problems. There are many reasons why accounting profit may not be a good proxy for shareholder wealth. Here are five:

- **Prospects** Imagine that there are two firms that have reported identical profits but one firm is more highly valued by its shareholders than the other. One possible reason for this is that recent profit figures fail to reflect the relative potential of the two firms. The stock market will give a higher share value to the company that shows the greater future growth outlook. Perhaps one set of managers chose a short-term approach and raised their profits in the near term but have sacrificed long-term prospects. One way of achieving this is to raise prices and slash marketing spend – over the subsequent year profits might be boosted as customers are unable to switch suppliers immediately. Over the long term, however, competitors will respond and profits will fall.

- **Risk** Again two firms could report identical historic profit figures and have future prospects which indicate that they will produce the same average annual returns. However, one firm’s returns are subject to much greater variability and so there will be years of losses and, in a particularly bad year, the possibility of bankruptcy. Figure 1.2 shows two firms with identical average profit, but Volatile Joe’s profit is subject to much greater risk than that of Steady Eddie. Shareholders are likely to value the firm with stable income flows more highly than one with high risk.

- **Accounting problems** Drawing up a set of accounts is not as scientific and objective as some people try to make out. There is plenty of scope for judgment, guesswork or even cynical manipulation. Imagine the difficulty facing the company accountant and auditors of a clothes retailer when trying to
value a dress which has been on sale for six months. Let us suppose the dress cost the firm £50. Perhaps this should go into the balance sheet and then the profit and loss account will not be affected. But what if the store manager says that he can only sell that dress if it is reduced to £30, and contradicting him the managing director says that if a little more effort was made £40 could be achieved? Which figure is the person who drafts the financial accounts going to take? Profits can vary significantly depending on a multitude of small judgments like this. Another difficult accounting issue is demonstrated in Exhibit 1.5 – just when does a sale add to profits?

**FIGURE 1.2**
Two firms with identical average profits but different risk levels

**EXHIBIT 1.5** When does a sale add to profits?

Source: Financial Times 14 March 2002
Communication Investors realize and accept that buying a share is risky. However they like to reduce their uncertainty and nervousness by finding out as much as they can about the firm. If the firm is reluctant to tell shareholders about such matters as the origin of reported profits, then investors generally will tend to avoid those shares. Fears are likely to arise in the minds of poorly informed investors: did the profits come from the most risky activities and might they therefore disappear next year? Is the company being used to run guns to unsavoury regimes abroad? The senior executives of large quoted firms spend a great deal of time explaining their strategies, sources of income and future investment plans to the large institutional shareholders to make sure that these investors are aware of the quality of the firm and its prospects. Firms that ignore the importance of communication and image in the investment community may be doing their shareholders a disservice as the share price might fall. Barclays seems to be aware of its responsibilities in this respect – see Exhibit 1.6.

The London Stock Exchange encourages companies to improve their communication with shareholders – see Exhibit 1.7.

Barclays to separate its revenue sources

John Copper

Barclays plans to disclose significantly more information about earnings from different operations this year in an effort to improve its stock market valuation.

Mr Martin Taylor, chief executive, intends to publish revenues and costs from operations within investment banking and UK retail banking.

Until now, the bank has only given the overall figures for these divisions.

In its interim results announcement later this summer, the bank is likely to list separately revenues from investment banking, asset management, UK personal retail banking, and small and medium-sized business banking in the UK.

Mr Taylor hopes investors will be able to value the bank’s earnings more accurately from these figures. Asset management earnings are relatively high quality because they tend to be more consistent than those in investment banking.

Barclays also hopes that by showing the exact extent of its small business lending it will be able to reassure investors. Three-quarters of its earnings volatility in the past 15 years have come from bad debts on this lending.

A split between personal and small business banking would put Barclays among the leading banks in terms of disclosure.

EXHIBIT 1.6 More information leads to higher shareholder value ...

Source: Financial Times 14 May 1996
Additional capital  Profits can be increased simply by making use of more shareholders’ money. If shareholders inject more money into the company or the firm merely retains profits (which belong to shareholders) their future profits can rise, but the return on shareholders’ money may fall to less than that which is available elsewhere for the same level of risk. This is shareholder wealth destructive.

Getting manager’s objectives aligned with those of shareholders

The problem
In theory the shareholders, being the owners of the firm, control its activities. In practice, the large modern corporation has a very diffuse and fragmented set of shareholders and control often lies in the hands of directors. It is extremely difficult to marshall thousands of shareholders, each with a small stake in the business, to push for change. Thus, in many firms we have what is called a separation, or a divorce, of ownership and control. In times past the directors would usually have been the owners. Today, however, less than 1 percent of the shares of most of the UK’s 100 largest quoted firms are owned by the directors.

The separation of ownership and control raises worries that the management team may pursue objectives attractive to them, but which are not necessarily beneficial to the shareholders – this is termed ‘managerialism’ or ‘managementism’. This conflict is an example of the principal–agent problem. The principals (the shareholders) have to find ways of ensuring that their agents (the managers) act in their interests. This means incurring costs, ‘agency costs’ to: (a) monitor

EXHIBIT 1.7  Stock exchange in shareholder relations advice
Source: Financial Times 8 February 1999

- The Stock Exchange is today sending every listed small company a guide to improving relations with shareholders. Its main recommendation is for a Statement of Prospects to be published in the annual report. It also urges companies to explore the internet and other ways of making available information that will enable potential investors to make value judgments more easily.

The move follows the increasing pressure on small companies as they fall off investors’ radar screens. They are becoming less important to institutions that are increasing in size as the financial services industry consolidates.
managers’ behavior, and (b) create incentive schemes and controls for managers to encourage the pursuit of shareholders’ wealth maximization. These costs arise in addition to the agency cost of the loss of wealth caused by the extent to which prevention measures do not work and managers continue to pursue non-shareholder wealth goals.

**Some solutions?**

Various methods have been used to try to align the actions of senior management with the interests of shareholders, that is, to achieve ‘goal congruence’. These follow:

**Linking rewards to shareholder wealth improvements**

A technique widely employed in UK industry is to grant directors and other senior managers share options. These permit managers to purchase shares at some date in the future at a price that is fixed now. If the share price rises significantly between the date when the option was granted and the date when the shares can be bought the manager can make a fortune by buying at the pre-arranged price and then selling in the market-place. For example, in 2004 managers might be granted the right to buy shares in 2007 at a price of £1.50. If the market price moves to say £2.30 in 2007 the managers can buy and then sell the shares, making a gain of 80p. The managers under such a scheme have a clear interest in achieving a rise in share price, so congruence comes about to some extent. However, as Exhibit 1.8 makes clear share (stock) options are not always the best way of motivating employees (‘Restricted stock’ means the ownership of shares when there are constraints, e.g. the owner cannot sell for a few years).

An alternative method is to allot shares to managers if they achieve certain performance targets, for example, growth in earnings per share or return on assets. In 2003 Luc Vandevelde, chairman of Marks and Spencer, opted to be paid entirely in M&S shares (13,500 shares a month). He will no longer receive pension contributions, nor be eligible for a bonus. He said ‘It is a vote of confidence in the team that my remuneration is closely tied to the value which we create for our shareholders’ (*Financial Times*, 9 July 2003).

**Sackings**

The threat of being sacked with the accompanying humiliation and financial loss may encourage managers not to diverge too far from the shareholders’ wealth path. However this method is employed in extreme circumstances only. It is sometimes difficult to implement because of difficulties of making a co-ordinated shareholder effort. However, shareholders really stirred themselves in the case of ITV plc – see Exhibit 1.9.
Selling shares and the takeover threat

Over 60 percent of the shares of the typical company quoted on the London Stock Exchange are owned by financial institutions such as pension and insurance funds, who are not prepared to put large resources into monitoring and controlling all the hundreds of firms of which they own a part. Quite often their first response, if they observe that management is not acting in what they regard as their best interest, is to sell the share rather than intervene. This will result in a lower share price, making the raising of funds more difficult. If this process continues the firm may become vulnerable to a merger bid by another group of managers, resulting in a loss of top management posts. Fear of being taken over can establish some sort of back-stop position to prevent shareholder wealth considerations being totally ignored.

Corporate governance regulations

There is a considerable range of legislation and other regulatory pressures designed to encourage directors to act in shareholders’ interests. The...
Companies Acts require certain minimum standards of behaviour, as does the Stock Exchange. There is the back-up of the Serious Fraud Office (SFO) and the financial industry regulators. Following a number of financial scandals guidelines of best practice in corporate governance were issued by the Cadbury, Greenbury, Hampel and Hicks Committees, now consolidated in the Combined Code of Corporate Governance. Directors have to state in the accounts how the principles of the code have been applied. If the principles have not been followed they have to state why. The principles include: transparency on directors’ remuneration requiring a remuneration committee consisting mainly of non-executive directors; directors retiring by rotation at least every three years; the chairman should not also be the chief executive officer to avoid domination by one person (in exception circumstances this may be ignored, if a written justification is presented to shareholders); the audit committee (responsible for validating financial figures, e.g. by appointing effective external auditors) should consist mainly of independent (i.e. not a customer or supplier, or a friend of the family or chief executive) non-executive directors and not by executive directors, otherwise the committee would not be able to act as a check and balance to the executive directors; at least half the members of the board, excluding the chairman, should be independent non-executive directors; the accounts must contain a statement by the directors that the company is a going concern, i.e. it will continue for at least one year; a senior independent director should be
appointed to listen to the views of a range of shareholders and communicate those views to the board.

**Information flow**

The accounting profession, the Stock Exchange and the investing institutions have conducted a continuous battle to encourage or force firms to release more accurate, timely and detailed information concerning their operations. The quality of corporate accounts and annual reports has generally improved, as has the availability of other forms of information flowing to investors and analysts, such as company briefings and press announcements. This all helps to monitor firms, and identify any wealth-destroying actions by wayward managers early, but as a number of recent scandals have shown, matters are still far from perfect.

**What happens if control over directors is weak?**

In some countries the interests of shareholders are often placed far below those of the controlling managers. In the absence of good corporate governance it is difficult for a firm to obtain funds for expansion – look at the trouble Russian companies are having.

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**S&P plans new type of rating for Russian groups**

Arkady Ostrovsky in Moscow

Standard & Poor’s, the international credit rating agency, will next month launch a product allowing the rating of Russian companies according to corporate governance standards.

Poor standards of corporate governance are among the most pressing issues in the Russian economy, which analysts say slow down foreign and domestic investment and undermine Russian growth.

The new product, whose launch will coincide with the OECD’s round table on corporate governance, will rank companies according to their compliance with standards of governance rather than their financial position.

Investors say any instrument allowing measurement of corporate governance risk could be of great value.

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Exhibit 1.10 S&P plans new type of rating for Russian groups

Source: Financial Times 11 October 2000
Conclusion

Readers will agree that all organizations need clarity of purpose. A multiplicity of objectives leads to confusion and contradictory decisions. While the single objective ‘shareholder wealth maximization’ is controversial and subject to much debate, for the purpose of the decision-making frameworks and techniques discussed in the rest of the book we will take it as the objective at all times. This allows much simpler and clearer decisions to be made. At the very least, this has the benefit of allowing easy understanding of financial concepts.

The reader is then free, once the basics of finance are absorbed, to modify the objective to suit the organizational context. However, for most commercial organizations in competitive market environments, you are unlikely to be justified in straying too far from the straight and narrow path of shareholder wealth maximization. Football clubs, building societies, co-ops, charities and government agencies however are a different story.