EUROPEAN BUSINESS SCHOOL
International University Schloss Reichartshausen

**Course Essay**

*International Corporate Governance*
*Fall Term 2008*

# *Topic 1:*

The shareholder approach to corporate governance reduces complexity by focusing on financial variables and short-term time perspective. By this, the shareholder value approach allows for more complex organizations to be governed with a given amount of resources. Please discuss whether and if, how the shareholder approach is one of the reasons why corporate governance did not prevent from the actual financial crises.

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The age of industrialization was fueled by constant advancements in technology, which increased productive efficiency. More complex and bigger machines began to substitute labor, thus the production factor capital, to afford this machinery, became more and more important. The possibility to exploit seemingly endless economies of scale, simply by increasing the capital stock, pushed firms to grow. The capital market was created to satisfy the incredible demand of investment capital, which could no longer be satisfied by single investors like banks or the entrepreneurial families themselves. The firm was taken public, opening up to a vast group of participators. As the individual, the entrepreneur was substituted by a collective of shareholders, the firm began to live a life on its own and the corporation was born. Today, the leader of the corporation is not the firm anymore, but merely became an agent to the shareholder, an employee of the corporation. But neither is the single shareholder the firm, as to his limited influence. The corporation has to be seen as an aggregate of many individual shareholders, resembling something like a democratic state, the CEO being its minister. The difference being that shareholders are solely bound to the faith of the corporation by a piece of paper they acquired on the capital market. The moment the shareholder perceives his personal interest is not satisfied by the corporation anymore, he is free to untie himself by simply selling the piece of paper - without having to move and leave friends and home behind, if we stick to the metaphor.

This mentioned personal interest of the shareholder is easy to identify: return on his investment, which is dividend, which is cash flow. So the aggregate - and therefore the interest of the corporation - must be: Maximum Cash Flow to the shareholders. Alfred Rappaport formulated exactly this in his famous 1986 shareholder value approach, defining the value of a company as nothing more than the discounted cash flows it provides to its shareholders.

This in mind, the formulation of a single objective for a CEO, as a good agent to the shareholders, is quite simple: Lead the corporation in a way it creates the maximum possible cash flow. So the prime tasks of this CEO would be to increase efficiency. The clear advantage of the shareholder value approach lies herein; it breaks down the complexity of a huge organization to a single number, the cash flow bottom line. On the other hand its disadvantage becomes obvious: It abstracts from the complex impacts of the actions of a corporation on the world it acts in. Even if it is important to anticipate future cash flows for the calculation of shareholder value, the time horizon of these estimations usually do not exceed 5 years. Some actions carried out by the company to increase the cash flow today, or within the next 2-5 years, however might have a dramatic impact on the performance of the company in the long run, let's say 10 years. The CEO on the other hand, who is threatened to be replaced by the shareholders (represented through the board of directors) the latest within 5 years (at least according to German legislation, see §84 I AktG), is pressured to deliver the maximum possible cash flows as soon as possible in order to keep shareholder value high.

The shareholder value approach follows the idea that as long as everyone strives to maximize his own interest, the aggregate also reflects the optimum output. So the individual shareholder focuses only on his personal return, and the CEO only focuses on delivering those returns constantly in order to keep his job. But as it has been extensively proven in game theory, this thesis does not always hold true. The problem of the shareholder value lies - as we did identify - in the time horizon. As neither the shareholder, nor the CEO is bound to the faith of the company in the long run.

This aspect, however, is taken care of by corporate governance. The corporation is put in the context of the environment it acts in. It is treated as an actor, who affects his surroundings and is himself affected by the environment. Corporate governance mechanisms provide the CEO with knowledge about the impact of his actions on the environment - be it the market for example - and therefore, the feedback of those actions on his own company at a later stage. But if, due to effective corporate governance mechanisms, the CEO is well aware of the negative impact of his behavior in the long run, he faces a dilemma: The incentives of corporate governance countervail his incentives set out by the shareholder value.

This is why the shareholder value approach hindered corporate governance from preventing major crisis, as we face one today. Corporate governance and shareholder value provide opposing incentives to the CEO (sustainable development vs. today's cash flows). Unfortunately, the shareholder value is very likely to prevail, as it directly threatens the personal interest of the CEO, which is keeping his position. Violation of rules set out by corporate governance may also be punished by the shareholder, but he has – as we learned - according to shareholder value a sole interest, cash flow. If those cash flows are high (as it is usually the case before a crisis) and his interest is satisfied, the shareholder is unlikely to question the behavior of the CEO. If the cash flow drops however - due to overexploitation of assets for example - it is usually too late.

The hypothesis might even be extended in a way that the shareholder value did not only hinder the prevention of a crisis, but is at least partly responsible for the very crisis. The argument might be based on the freedom of the shareholder, and/or the CEO, to untie himself from the faith of the corporation at any time.