Don't play – Why stakeholder value does not work

Companies are a network of interest groups, who are struggling for influence and control. The employees, the management, the investors and more have expectations and interest in how the company is managed. Employees demand fair and good payment, the investors want a stable business plan and good profits and the management has to delegate all interests.
The discussion within the Business Ethics about the focus of companies in the stock exchange is in essence the question for whose advantage the company is working. The theory divides between the stakeholders, who are either harmed or benefitted by the company and the shareholder who own shares on the company. This differentiation is between the people who live and work for a company, who are actually involved in the daily business and the people who invest money in a company from the outside. The shareholders are one of many stakeholder groups, but one that accumulates most power and most decisive potential in dealing with company policy.
The interests of the shareholder are not bound to any ethics, but solely on the profit optimization of the company. Often this is to detriment to other shareholder groups like trade partners or most visually to employees and the environment. Theoretical approaches to move away from the current Shareholder Value Model towards a Stakeholder Value Model have not been successfully implemented. The following paper will summarize shortly why this change in Business Ethics in the Stock Exchange can't happen in the current system.

Value of a company

Capitalism demands a certain growth for any company in business. The goal is to find a niche in which to prosper and expand. This expansion requires equity money to invest. At first this can come from a bank or a Venture Capitalist who acts as investor and becomes creditor. By giving up shares to external shareholders the owner of the company also gives up influence and power in decision making in his company as his company becomes partially owned by the investors.
For steady expansion more equity is required meaning more external parties need to invest. An efficient way to allocate capital for a company is to take part in the Stock exchange. Shares of this public listed company are sold, yielding equity money and again giving outsiders influence in company policy. In order to allow for the company to grow, the management sells influence in the management process to anonymous external shareholders. By buying a share they buy a part of the company, they invest in the future growth and they receive power to influence the company's policy.
For investors to be interested in shares, the return-of-investment is most important. If they invest money into a company, they expect growth and profit from their investment. This profit has to more than the Safe Interest Rate the investor would get by leaving his money at the bank.
Investment has always the risk of losing money, therefore a risk analysis is very important. The more risky an investment is, the higher the expected profits must be, otherwise the return-of-investment would be uninteresting. Important for analyzing the return of investment is to determine the Market

Value, or in simpler terms the worth of the company today and in the future.
Therefore for considering investment the market value is important and needs to be calculated. The market value is always based on expectations on how the companies value will develop in the future. The market value needs to grow for investors to be interesting.
Different formulas can be used to determine the future market value. One definition describes the Market Value as the "sum of discounted future cash flow". The Cash flow is the difference between the sell and the purchase price of a share adding dividend. In this model the Net Preset Value is calculated by comparing the amount of profit gained from the expected cash flow of a company with the money gained from an alternative investment. In other words it is calculated how much profit is made, considering a specific amount of money is invested and how much cash flow is expected from the company in the following years. If this profit exceeds the money gained in an alternative investment, for example saving the money at a bank with a certain interest rate, then the investment has agreeable terms. A negative Net Present Value would equally mean, you would lose money in this investment. Based on this model investors can also determine at which Net Present Value an investment becomes affordable and can thereby recalculate which expected cash flows need to be achieved in the future. The expected cash flows are a speculative factor in this regard. Based on the future market value and the risk taken in an investment the Fair value is calculated determining the reasonable share price for an investment.
The future market value of a company determines whether an investment deal is sold or not. Therefore it is the most important index for evaluating the potential and the undertaking risk for this investment.

Of Stakeholders and Shareholders

As mentioned in the introduction, a company is heavily influenced by a power struggle of different interest groups. The stakeholders are all groups who are interacting with the organization and can either be harmed (eg environment) or benefitted (employees) by this interactions. Depending on their position each faction tries to negotiate its value and its influence, often stakeholders have a rather weak position in this virtual negotiation as they are misrepresented or do not have any means to backup their claims. The group of shareholders has the biggest advantage as they are the one who invest their money to make company business and expansion at all possible. Thereby they are keeping the company running. In return they gain influence, but the responsibility remains with the management. This influence can be passive or active.
Passive influence are the expectations shareholders and potential investors have in a companies future market value. To keep the investors a company has, it must meet the profit expectations of their shareholders, otherwise it's value gets downrated, which equals to a financial loss for the investors. The same time for new investors who base their investment decision on the future market value, which needs to be of a certain minimum value to be an profitable investment. The market value is monitored closely by the companies management and by the shareholders and thereby the shareholders have a strong passive influence on the managements business decisions.

Active influence can be taken by the shareholders. A public listed company is managed by a Board of Directors. These are appointed in an Annual General Meeting by the Shareholders. By choosing the Board members they have major influence in the course and the policy of the company. The Board members for example decide on the CEO of the company. However even though the influence that can be gathered this way can be big, the effort among the various shareholders to coordinate such change is high. Also most companies try to keep election majorities in the Board of Directors by keeping shares on their own company.
It is important to realize, that the company is stuck in the situation, in which they require the support of their shareholders. Otherwise they would lose investors and in the end losing equity to act with. At the same time they are at risk of being governed from the outside by shareholders replacing Board members working solely for the shareholder's agenda.

Being professional Stock broker

Who are investors? The group of shareholders is very diverse. Stock trading as it is performed on the big international Stock Exchanges is highly optimized and therefore done by specialized Stock brokers. Investors act as clients who commission brokers to handle their business transactions. Very simplified, the broker acts as intermediary and has to decide on investments, whether to purchase or sell shares of a company. Their experience and the perceived market situation at the Stock Exchanges fill the factors used in the calculation models for the market value. Based on current market data, analyzing trends and speculation they determine the market values of companies. This process is in constant change, improvement and optimization. Calculation models are enhanced to improve predictions and to produce more accurate results for future predictions. For the broker working with this models is his daily job and an important tool to achieve the efficiency required in this fast and ever changing job.
In the discussion of Stakeholder Value versus Shareholder value, it is easy for people to assume different factors for decision making than professionals to. Amateurs have the time to analyze business decisions and also ethical dilemmas more deeply. They don't have the stress of having to deal with the topic every day and did not develop a way to focus on the question at hand: buy or sell. Amateurs can effort to ask moral questions, where professionals learned to put those aside or otherwise they would have impeded the quick judgement needed for the job. Professional work is streamlined for efficiency especially in time time relevant and time constraint fields of work like the stock exchange.
Knowing this is important when analyzing this problem. The efficiency the job required prevents the broker from asking the ethical questions everybody should ask influencing people's lifes.
Secondly the broker is assessed by his performance. This performance needs to be evaluated and therefore numeric figures are required to calculate the effectiveness of his work. While it is not impossible to reason moral implications for business decisions, they are not quantifiable and require extra effort to explain. They are therefore inconvenient.
All these factors in the professional work as Stock broker are no absolution for ignoring ethical considerations, but they are part of the system and to enable to make these the system would need

deceleration.

Why stakeholder value does not work

After describing who the value of a company is determined, looking how the power situation in a company favors the shareholders and after seeing the fast-paced working conditions of the single Stock broker, we can conclude how this situation results in the lack of ethical company policy and the lack of focus on Stakeholder value.

The companies management is under pressure to maximize profits to keep equity in the company stable or to expand by gaining investors. Therefore if the CEO of this company decides to change the main focus away from the shareholders to other stakeholders like employees or environmental concerns, he risks loosing shareholders. The described struggle of influence in a company boils down to money. Fair wages for employees, investment in new environmental-friendly technologies, everything can be quantified in money that needs to be raised. Money that is spend by the company to support these stakeholders is money that is taken from the margin profit. This directly results in lower profit expectations and causes a long-tail of problems for the company in the current Stock exchange market.

The lowered Market Value expectations will mean that the current shareholders may have lost money, as other investment ventures may have resulted in a higher Net Present Value. Therefore the return of investment they did now does not pay off as expected and is to be considered a loss. Secondly new investors are alarmed by the resulting decrease of the Fair Value.

At this point the company, who tried to do the morally right thing of strengthening the position of their stakeholders is faced with the consequences of this decision. In the middle run this course of action can lead to two alternatives.

The first alternative is dictated by the company's current shareholders. They can demand the Board of Directors to reevaluate the new company policy in favor of a more profit orient one. After all, investors can always threaten to pull out and thereby have a very strong argument. If the Board of Directors does not agree, the shareholders have the power to reelect new Board members more inclined to their cause. In both cases the shareholder's aim is to get the focus back on their interests, namely making profit.

The second alternative is a threat from outside the current shareholders. By decreasing the Market Value and the Fair Value of the company, the worth of the company is diminished. It's price becomes cheaper, which enables competitors to invest into the company and overtake the management. After all buying the company is another way of investment and a good way of rid of competitors. Part of this take-over is the replacement of the current management and a reset of the strategy. After-all the potential for making higher profits is there and can be reenabled by once again ignoring stakeholders and focussing on profit maximization. Such a take-over requires to be in accordance to the current shareholders and can be in their best interest as the new management can refocus on the needs of the shareholders.

Both alternatives display how the company, who acts in well intention for their stakeholders is punished. The consequence in both cases is, that the new stakeholder-friendly policy is replaced by the old strategy to exploit as much profit as possible.
By looking at the people who are doing the business transactions it has to recognized that this is not by all means malicious acting. It is rather a result of competition, fast-pace market and a very sophisticated level of business optimization, that dictates the rules of the game. The system did not develop room for non-quantifiable business considerations, Shareholders have a too strong argument in business policy and at the moment everyone trying to act in a moral and ethical manner has to face disadvantage in the system. Ethical considerations are not impossible, but will be overruled as soon as shareholders feel threatened by profit cuts. Companies are stuck in a system in which ethical action is bound to be overruled by quarterly reports and performance analysis. Finding a leeway of balancing stakeholders and shareholders is the only way to play in the game of Stock Exchange. If a company values its ethical principles and does not want to risk losing it, it should not play this game.

Sources

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