Debate

The Debate over the Shareholder Model of Corporate Governance

ISSUE: Is the shareholder model the best strategy of corporate governance in managing a public company?

It has long been the view that shareholders are a company's most important stakeholder. If a business's goal is to make a profit, and if the firm's owners and investors have the most to lose when a firm closes, then businesses must create value to survive and provide returns for owners. Managers who adopt the view of maximizing shareholder value advocate for a shareholder model of corporate governance. Corporate governance refers to formal systems of accountability, oversight, and control within an organization. The shareholder model of corporate governance therefore is centered on the shareholder as the most important stakeholder, with the goal of maximizing wealth for investors and owners.

From an economic perspective, such a viewpoint makes sense. Businesses cannot survive with making a profit. Even highly visionary companies such as Apple and Procter & Gamble cannot pursue their mission and goals if they do not earn money to turn these goals into a reality. The debate over which stakeholder should be given precedence in an organization has been raging since the 1930s. Early theories advocated for managerial strategies that would take into account a variety of stakeholders, including shareholders, consumers, and employees. Businesses would therefore adopt multiple goals to meet the needs of these different stakeholders. The problem with this idea is that different stakeholders have different needs, some of which may conflict. Environmental activists, for instance, might want a business to adopt more sustainable materials for its products. Yet shareholders might balk at the idea due to the high costs involved. Critics claimed that pursuing multiple goals increases complacency and muddles the organization's identity.

In 1970 famous economist Milton Friedman argued that a business manager's responsibility is to maximize profit for shareholders while conforming to the laws and ethical customs of society. Friedman believes that while individuals may have social responsibilities, corporations are artificial people that do not have these responsibilities. In his argument Friedman differentiates between agency and principal. For instance, if a manager decides to quit his job to join the armed forces, he is acting as a principal, not as an agent for the organization. Friedman also points out that managers who choose to use their capacity as an agent to pursue social responsibilities at the expense of the organization are basically using the money of shareholders to pursue goals that will not help them financially. In so doing, the manager is neglecting his or her responsibility toward the owners, which is unethical and disadvantageous to the organization.

The shareholder model of corporate governance has gained much traction among corporations. Managers began to be offered stock in the company in order to align their objectives (increasing their own wealth) with those of the firm. To help shareholders keep track of whether management was pursuing the best interests of the company, public corporations report quarterly earnings to provide shareholders with a snapshot of how the organization is doing financially. If managers are not increasing profits, they may be terminated for being unable to maximize

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shareholder value. Advocates of the shareholder model believe having this one goal helps a business become more competitive, helps managers prioritize their responsibilities, and helps create transparency in allowing investors to monitor the company's performance.

However, there is a significant downside to the shareholder model. Due to the pressures to meet performance expectations, managers are often tempted to take a short-term perspective of the organization. In other words, managers might focus on maximizing value in the short-term rather than in the long-term. This can have negative repercussions on the firm. For instance, if the manager acts unethically to achieve superior results in the short-term, the organization may end up facing fines and reputational harm in the long-term. Studies have supported the idea that a short-term emphasis on shareholder value harms long-term value creation. Critics of the shareholder model claim that ethical conduct is placed in a silo as managers are more concerned with increasing market share and profitability than anything else.

An alternative to the shareholder model is the stakeholder model of corporate governance. Managers that adopt a stakeholder model of corporate governance recognize that they must answer to other stakeholders, including consumers, employees, communities, regulatory authorities, and so on. However, while managers with this viewpoint acknowledge the importance of all stakeholders, they also recognize that firms must prioritize these stakeholders. For instance, some firms may choose to prioritize employees, while others could choose to focus on customers. This allows the firm to tailor its goals to best meet the needs of its chosen stakeholder rather than trying to meet the needs of every stakeholder.

The stakeholder model has received widespread support from many successful managers over the years. For example, Steve Jobs of Apple emphasized the customer first. This emphasis helped Apple focus on developing quality products that would "delight" customers, best meeting their needs for quality technological products. According to Jobs, when customers came first, "benefits to other stakeholders, including shareholders, followed." Even Jack Welch, who appeared to be an early role model for the shareholder value theory, has criticized shareholder value as a strategy. While Welch strongly supports creating wealth for shareholders, he claims that a good manager will be able to manage both short-term results—creating wealth for shareholders—while considering the long-term well-being of the firm.

There are two sides to every issue:

1. *The shareholder model is the best strategy for corporate governance because maximizing shareholder value will ensure the survival of the company.*

2. *The shareholder model is not the best strategy for corporate governance because it promotes short-term results over the long-term profitability of the company.*

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