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Shareholders' Versus Management's Interest: A Review

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ABSTRAK

Pemegang saham adalah pemilik firma perniagaan yang melantik lembaga pengarah (pembuat polisi) dan menggaji pihak pengurusan firma (yang melaksanakan polisi tersebut). Di dalam dunia perniagaan yang serba moden, oleh kerana bilangan pemegang saham adalah besar dan taburannya luas, kawalan biasanya dikuasai oleh pengurus-pengurus profesional yang berkemungkinan bertindak untuk kepentingan peribadi daripada kepentingan pemegang saham. Kajian ini mengulas kembali pelbagai tindakan pengurus-pengurus yang boleh diterjemahkan sebagai terpesong dari objektif memaksimumkan kekayaan pemegang saham dan membincangkan kaedah-kaedah serta had-had untuk mengimbangi kepentingan pihak pengurusan dan pemegang saham. Kewujudan jangka panjang firma dan pihak pengurusan bergantung kepada tindak-tanduk pihak pengurusan yang selari dengan kepentingan pemegang saham.

ABSTRACT

Shareholders are basically owners of their corporations who elect corporate directors (who are policy makers) and employed corporate management (who implement corporate policies). In modern businesses, due to the large number and dispersion of shareholders, control is normally vested to professional managers who may pursue actions in their own self-interest rather than those of the shareholders. This paper reviews various ways managers are perceived to deviate from the shareholders' wealth maximisation objective, and the possible methods and constraints involved of aligning management's and shareholders' interests. In the final analysis, the long-term survival of the firm and the management depends upon the management's actions being congruous with shareholders' interest.

INTRODUCTION

Economics of the late 19th and early 20th centuries was based on the premise that entrepreneurs sought to maximise profits (Berle,1962; Manne, 1962), which in modern financial literature is equivalent to maximising the value of the firm, where value represents the discounted value of the future stream of earnings. The profit maximisation motive of these entrepreneurs was based on the identity of ownership and control by the entrepreneur.

In most modern businesses, however, ownership is vested in the hands of the shareholders and control is vested in the hands of professional managers (Berle ,1968). These managers however, have a negligible interest in the firm, it is questionable as to what motivates them to make corporate decisions in congruence with the shareholders' interest. For example, there is evidence that managers' personal goals of security, power, prestige, advancement and personal income take precedence over corporate profits (Kaysen ,1960; Gordon , 1961; Marris ,1964; Murphy ,1985).

In theory, shareholders elect corporate directors, who have the right to appoint or dismiss corporate managers. Since the operations of the business are in the hands of the corporate managers rather than directors (who are policy makers), managers may pursue a course of action which relate to their preceived

interests or their perceptions of corporate self-interest rather than those of the shareholders. Management would be tempted to take this view, if they perceived shareholders as short-term investors rather than long-term owners of the firm (Rappaport , 1978).

Managers may pursue second- to- best investments given the constraints of the business, legal and regulatory framework they have to comply with. They may take considerable discretion in providing themselves with perquisites such as large expense accounts, plush offices, and higher salaries at the expense of the shareholders. Managers may also make large contributions to charities (Manne, 1962), or even spend large sums of money on improving their conditions of work (Berle, 1962)), which could have been invested to generate more earnings.

Diamond and Verrecchia (1982) suggest that, assuming the full consequences of managerial actions are not measurable at the end of the contract period, and it is costly to recontract, managers may pursue investments which increase their expected utility, rather than that of their shareholders. This is achieved by investing in less risky investments relative to more risky investments with higher returns, or consuming more perquisites than that agreed upon, or even just being incompetent.

Marris (1964) and Murphy (1985) have suggested that managers tend to be more interested in maximising corporate size rather than shareholders' wealth. Beyond achieving a certain satisfactory level of profits, managers pursue a size maximisation strategy, which is positively related to financial (i.e. salaries, stock options, bonuses) and non-financial (i.e. prestige and authority) they enjoy. Size is also viewed as a defence against takeover as it is more difficult and expensive for the bidder to acquire control over the target's resources and hence provides more avenue for the target managers to pursue their own goals (Ball ,1987)). These actions by managers are perceived as deviations from the objectives of maximising shareholders' wealth.

Possible Ways to Align Management and Shareholders' Interests.

In theory, there are ways to motivate managers to maximise the shareholders' wealth. A competitive takeover market can be an essential means of disciplining corporate managers who might choose to pursue personal ambitions at the expense of their shareholders (Jensen & Ruback ,1983). The competitive takeover market argument is based on the assumption that management teams compete for the right to manage corporate assets. Any form of exploitation by incumbent management will be reflected in the share price of their firms. The low share price relative to what it should be with more efficient management becomes an attractive opportunity for other firms to replace incumbent management.

However, the threat of takeover does not provide a complete assurance against the incumbent managerial actions as defensive measures are available for targets against predators, such as corporate charter amendments, going private, engaging in standstill agreements, repurchasing shares, restructuring its assets and other related measures.

How effectively the incumbents can use these defensive measures will depend on the time and resourses available, the reputation of the bidder, the regulatory framework, and the attitude of the institutional investors towards the takeover. These defensive measures, even if not successfully employed, will at least make it difficult and expensive for the bidder. Whatever the limitations, competitive markets for corporate control do provide a self-regulatory monitoring mechanism which ensures that the interests of management cannot diverge too far from that of its shareholders.

A competitive managerial labour market is also important for motivating management to act in the best interests of their shareholders (Fama , 1980). In a competitive managerial labour market, the incumbent management are disciplined by the threat of being replaced by an equally qualified and experienced management team without much higher remunerations. Assuming the market prices the services of managers according to their past performance, the value of the services offered by replaced managers would be adversely affected.

However, there are at least three conditions that need to be satisfied in the managerial labour market to effectively discipline corporate managers.

First, the managerial labour market must be able to recognise the managers' talents and

their tastes for consumption on the job which is discounted ex-ante in the contract. Second, the managerial labour market is strong from efficiency in the sense that is is able to use current and past information to revise future wages, in other words the human capital and the human capital rental rates of managers reflect all information concerning management performance whether publicly available or not. Third, the managerial labour market imposes greater importance on the wage revision than any other factor when evaluating or reviewing the managerial contract.

In reality, however, the managerial labour markets cannot be expected to be strong from efficiency and cannot be totally relied upon to effectively discipline corporate managers. Managers by virtue of their position within the firm, not only enjoy valuable inside information concerning the firm's investment options and performance but also have prior knowledge of valuable information concerning managerial performance and are able to cover-up any shortcomings from outside detection.

Fama (1980) also suggests that management face both opportunities and discipline of external and internal labour markets. Shareholders have an ownership interest in the firm's performance which constitutes the best available indicator of management's economic productivity whose price in the managerial labour market depends on the success or failure of the firm. Since a firm's performance is determined at least partly by the performance of the entire management team, each manager has a stake in the performance of managers above and below him and will actively engage in two-way monitoring.

The opportunity cost wages signalled by the external labour market and the two-way managerial monitoring of internal labour market work together to discipline managerial performance and eliminate the agency costs. Theoretically, two-way managerial monitoring in the firm has a potential to ensure efficiency in the face of asymmetric information between insiders and outsiders. In practice, however, when managers within an organisation are classified according to rank or authority, the efficiency of internal two-way monitoring becomes ineffective. Top managers are presumed to be relatively more talented and efficient than lowly placed managers in the management of a firm's assets and information. Hence they dominate the decision - making process, which is against the notion of perfect monitoring symmetry.

Watts (1988) suggests that product markets are also important in disciplining all parties to the firm including the managers. Firms that deliver products demanded by customers at the lowest price, while covering costs, survive (Fama & Jensen, 1983), and this provides parties to the firm with a strong incentive to control costs, including contracting costs. Contracting costs are the costs of the firm's contracts and include the agency costs that still remain under the contract.

If managers have relatively large ownership positions in their firm, they are expected to be more empathic towards their shareholders and would be motivated to act more closely with shareholders' interest (Easterbrook & Fischel , 1983; Shleifer & Vishney ,1986; Rappaport ,1986). Managers are then expected to bear a share of the wealth effect of their decisions.

Leland and Pyle's signalling model (1977) and Jensen and Meckling's agency theory (1976) suggest that takeovers financed through common stock exchanges (assuming no change in the absolute managerial shareholdings) result in a decrease in the managerial ownership position, which is positively related to the negative price reaction of the bidding firms. The market interprets the decline of managerial ownership position as negative news for shareholders.

Benston's (1985) study on managers of 29 large conglomorates concluded that managers of these firms individually did not own more than a small percentage of the total shares outstanding but the amount they owned yielded annual gains and losses which exceeded their remuneration. These gains and losses provided a considerable incentive to make decisions that are in congruence with their shareholders' interest.

Lewellen, Loderer and Rosenfield's (1985) study evaluated the hypothesis that managers with large personal holdings in their firms are less likely than managers with small holdings to engage in acquisitions that reduce shareholders' wealth. They found that there was consistent positive and statistically significant relation-

ship between abnormal returns from mergers and the percentage of acquiring firm's shares held by senior management. This implies that substantial amount of own firm's share ownership helps to align the interest of shareholders and managers.

However, the ownership position of managers is not a complete assurance for shareholders because although most top managers do have relatively large ownership positions, this may not necessarily be true for divisional managers. In large decentralised firms, most resource allocation decisions are made at divisional levels.

Furthermore, the threshold for risk-tolerance differs between managers and shareholders (Amihud & Levi, 1981; Diamond & Verrecchia; 1982). Managers are assumed to be more risk-averse than shareholders because shareholders can trade-off the risk in their risky investments against other risk in their presumably diversified portfolios, whereas managers can trade-off an investment failure only against other investments of the firm or the divisions, which suggests that the opportunity costs of capital relevant to managers is likely to be a function of total risk of the investment instead of its systematic risk. Thus, it is not surprising that managers are motivated to reduce their risk by investing in low - risk investments, for example, acquiring firms with unrelated cashflows even when alternative strategies with higher returns and risk are available. Studies by Kamarchen ,1968; Monsen & Dawn ,1965; Radice , 1971, Boudreaux, 1973 and Amihud & Levi , 1981) show that management-controlled firms are associated with lower systematic risk than owner-controlled firms. To a large degree, the explanation for their findings was consistent with the presumed desire of managers of management-controlled firms to exhibit lower risk preference.

Management could also be motivated to act in the interests of their shareholders by having their compensation (especially their perquisites) tied partly to market returns realised by the shareholders (Coughlan & Schmidt, 1985). However, a compensation contract which relies wholly on the market returns can be unfair because share price movements are partially influenced by factors beyond the management control. Also, there is a problem of management being able to manipulate the performance indicators of the firm, for example, accounting measure of performance such as price-earning ratio.

Financial statements audited by independent auditors could also attentuate the managers' preference to deviate from the wealth maximising objective. Benston (1979-80) suggests that audited financial reports are a valuable device for monitoring managerial bahaviour because external auditors provide independent assurance of financial report credibility.

Audited financial reports also facilitate alignment of manager and shareholder interests through their impact on executive compensation and managers' opportunity wage rates (Larcker , 1983; Healy , 1985). However, compensation plans that linked managerial pay to accounting measures of performance provide incentives for managers to manipulate the content of corporate financial reports.

Johnson and Revsine (1988, p.95) report that "... managers retain considerable discretion over firms' accounting policies ... which enables them to alter the content of financial statements through selection of accounting procedures and estimates or through other more subtle manipulations of the reporting system..."

Shareholder intervention mechanism can help to align the interests of managers and shareholders by either facilitating recovery of past losses or preventing future losses, and acting as a deterrent to opportunistic manipulative behaviour of managers. Johnson and Revsine (1988) reports the corporate charter and by-law amendments, litigation and control contests as three common forms of shareholder intervention.

The purpose corporate charter and by-law amendments initiated by shareholders is to restrict future managerial discretion by explicitly prohibiting certain activities or by requiring formal shareholder approval of planned activities. These amendments become subject to shareholder ratification at the annual meeting.

Shareholder litigation is initiated by individual or a class of shareholders against directors and managers, who are alleged to cause damages (reduction in common stock values) to shareholders arising from their actions.

Sometimes, the corporation itself sues the managers and directors for breaching their duties to the corporation, inflicting injury to

the corporation and thereby indirectly decreasing shareholder wealth.

Control contests are represented by proxy fights and cash takeovers. A proxy contest is initiated by dissident shareholders who group to wrest control from incumbent management. The aim is to gain support from holders of majority shareholdings to elect their own representative to the board and consequently gain control over the future policies of the firm. In cash takeovers, insurgents gain control of the firm through acquisition of a substantial number of shares directly from the target shareholders, at a premium over the prevailing market price.

However, direct shareholder intervention is a costly alternative to align managerial and shareholders' interests (Dodd & Warner ,1983), and should only be utilised when the expected benefits from the intervention are commensurately high.

Weidenbaum and Vogt (1987) and Hogan (1989) suggest that since high transaction and information costs in the market for corporate control limit the extent to which shareholders can monitor management activities, the board directors should assume the responsibility for doing so. A more assertive board willing to take stand against actions not in the best interest of their shareholders will ensure stronger internal checks on management.

Constraints on Shareholders' Action Against Management

Shareholders may try to take action against the management, but this effort is usually constrained (Jensen & Meckling ,1983 ; Johnson & Revsine , 1988). First, ownership of shares tends to be diffused and it is costly to monitor the activities of the management. Except for large institutional investors, individual shareholders are neither influential nor interested in the business operations. Furthermore, the benefits from monitoring management's activities would be dispersed among all shareholders according to their investments and not according to their monitoring efforts. This free-rider problem motivates shareholders to be passive and resort to shift capital out of the firm if they are dissatisfied.

Easterbrook and Fischel (1983) argue that if the benefits accruing to an individual shareholder are proportional to the fraction of shares held, intervention is individually rational only when the expected proportional benefits accruing to the shareholder exceed the shareholder's share of intervention costs.

Efforts to share intervention expenses across a class of shareholders are subject to the potentially considerable costs of identifying and coordinating the operation of a shareholder group and free - rider incentives. Consequently, an individual shareholder may have to bear the entire intervention cost and realise only a proportionate share of the benefits. This problem becomes more serious when a large portion of the intervention costs are fixed and unrelated to the expected benefits, which favours intervention by individual shareholders with large shareholdings.

However, though it is costly for small shareholders to intervene, there have been cases in the U.K. of their attempts to uproot management by setting up shareholders' action groups to turn their individual small holdings into significant blocks of shares. For example, Chloride small shareholders at one time believed that their firm was not properly managed and attempted to oust the management. Though they were not successful, the bad publicity forced the chairman to speak to their leader (Fallon & Strodes ,1988). In this respect, even institutional investors prefer shares with voting rights so they can vote to put pressure on the management.

Fama (1980) suggested that the concept of ownership of a firm is an irrelevant concept in modern business. The shareholders being residual claimants do suffer from the failure of the firm, but they have capital markets which allow them to shift among firms with relatively low cost and hedge against the failure of any firm by diversifying their shareholdings across firms. Broad diversification implies that an individual shareholder will have no special interest in personally supervising the detailed activities of any individual firm in his portfolio.

Second, managing a business is normally done on a team basis where no single manager expects to identify the full benefits of his work as there is no performance yardstick to measure the individual manager's contribution and offer reward commensurate with the contribution. Managers are aware of this fact and can exploit

the situation by pursuing actions which are in their best interest.

Third, managers are also protected by the 'Business Judgement Rule' in courts of law, which states that courts will not second guess the decisions of management or board of directors unless there is clear evidence of conflict of interest provided by the shareholders.

Fourth, if the value change suffered by shareholders due to managers' actions are comparatively small relative to the aggregate firm value, the high costs of intervention will allow managers to pursue actions with relative impunity.

Fifth, skilful timing by managers to pursue actions that enrich themselves at the expense of their shareholders is also a constraint of shareholder intervention. For example, manipulative activities might be timed to coincide with predicted bull markets in the hope that the general upward drift will swamp the share price impact of manipulation and thereby preclude the loss measurement by investors.

Why Managers Should Pursue the Wealth Maximisation Objective?

Some managerial actions may seem to diverge from the wealth maximisation objective, but could be in the direct short-term interest of the shareholders and or for the long-term stability of the firm. For example, charity contributions by firms could be a profitable advertising campaign, and could be tax deductible. Foregoing high profits in time of shortage, could be a strategy to create market loyalty, and improving the wages and conditions of work could be an indirect attempt to improve efficiency in production in the long term.

However, managers should realise that any action on their part that seems to diverge from what is expected by the shareholders, can only benefit them in the short-term. Any deviation from shareholders wealth maximising objective will disturb the balance of the financial relationship between the various components of the firm and consequently jeopardise the existence of the firm in the long-run. Managers should pursue the objective of maximising their shareholders wealth because in the long-term, no matter how powerful or independent they are, any divergence from the stated objective would certainly work against their them.

Managers are referees who harmoniously balance the interests of various parties such as employees, creditors, suppliers, customers and shareholders. The very existence of the firm and the managers depends on the managerial ability to balance the financial relationship between the firm and each of its constituents. For example, customers need high quality products and services at competitive prices, employees need competitive wages, creditors and suppliers require money due to them to be settled on time, and shareholders require cash dividends and appreciation in the share price. If the firm fails to satisfy these claims, it will cease to exist in the long run. To fulfil its obligation, the firm requires cash which can best be generated through its business activities or through loans and share issues. Generating cash through business activities means to pursue investments that maximise the net cash flows (i.e. maximise Net Present Value), and not just maximise size. A high price-earning ratio with no real cash growth potential may fool the shareholders for a short period, but certainly not the creditors and suppliers.

Even when the managers do generate enough cash to fulfil its obligations to the various components through business activities, it is always open to question as to whether they could have generated more cash, or did they pursue the most optimal investments subject to the constraints? If they did not, then they are still diverging from the objective of maximising shareholders' wealth.

External sources of cash are loans and share issues. The amount of loans that a firm can take will depend on its cash generating ability. However, if firms resort to equity financing, for a given level of funds required the higher the share price the less dilution will be borne by current shareholders. Thus the amount of external resources that the firm can resort to depends upon its cash generating ability.

CONCLUSION

In modern businesses, ownership is vested in the hands of the shareholders and control is in the hands of professional managers. To the extent that the ownership is widely dispersed

and managers have a negligible ownership in the firm, it is questionable that managers make business decisions in congruence with shareholders' interests. This paper reviews the ways managers are perceived to deviate from shareholders wealth maximisation objective and the possible ways to align managers and shareholders' interest. However, there is no absolutes measure of wealth of shareholders and the practical surrogate is the total market value of the firm. In the final analysis, the long term survival of the firm will depend upon its corporate managers to pursue investments that maximise the net cash flows and therefore maximise the market value of their firm's outstanding shares.

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