



# International Journal of Multidisciplinary Research and Development



IJMRD 2015; 2(2): 100-103  
www.allsubjectjournal.com  
Received: 13-01-2015  
Accepted: 01-02-2015  
E-ISSN: 2349-4182  
P-ISSN: 2349-5979  
Impact factor: 3.762

**Rajesh Kumar Nigah**  
*Faculty: Accountancy and  
Finance Academy of Commerce  
Satyaniketan, Dhoulakuan,  
New Delhi, India*

## “To create a customer or serve the shareholder”? What drives the corporate board rooms to act upon?

**Rajesh Kumar Nigah**

### Abstract

Global corporate board rooms have been witnessing hot debates over the ‘nerve centre’ of any successful business model. An obvious distinction occurred between the ‘customer-centric’ vis-à-vis ‘shareholder-centric’ perspectives on the merits of arguments so put-forth. Perhaps those deliberations led to the existence of ‘profit-centre’ and ‘cost-centre’ philosophies to describe the corporate culture in short. Nevertheless, academicians still try to be skewed on the pursuit of ‘shareholder value’ to that of ‘valuing customer’ for a niggling corporate world, viz, management and investors are obsessed with faster outcomes; dismally inclined towards long term investment portfolios; and scant eyed on the accounting mishaps that grab headlines and the like censures. On the contrary, the doctrine of shareholder value has supported the management and shareholders as well as customers in the same spirit with no signs of betrayal. Under this corporate fiasco the centre question remains - what companies have to do if they are to be serious about creating value? This paper attempts to shed light on the vital insights of this corporate dilemma and draw a set of ‘guidelines to govern’ the concept of ‘value creation’ that goes hand-in-hand with company’s sound business model as well as realizing the potential for creating value and strike a happy balance between shareholders and customers perspective.

**Keywords:** Modern Capitalism, Value Creation, Professional Management, Real and Expectations Market

### 1. Introduction

#### Folklore of Modern Capitalism

Capitalism of the post depression era saw the first modern capitalistic era in 1932 where professional management steered the corporate world. The second era labeled as ‘shareholder value capitalism’, began in 1976 with a fundamental premise of every corporation to “maximize shareholders’ wealth”. If firms pursue this goal, the thinking goes, both shareholders and society will benefit. The third era began during 1990’s with a new dimension and thought to bring arpeggio between all the stakeholders, labeled as ‘**customer-driven capitalism**’

As Jack Welch commented that the idea of maximizing shareholder value is the dumbest in this world, where CEOs and his clout that are blessed with huge incentives to focus most on the market future-casting, and ironically expect results out of real products and services. The ‘expectations market’ is the world in which company’s shares are traded between investors — in other words, the stock market. In this market, investors assess the real market activities of a company today and, on the basis of that assessment anticipate the future course of business performance. While the “real market,” is the world in which industries operate to produce output as pre-designed and services are rendered, and revenues are earned, expenses are paid, and profits are derived. The consensus view of all investors and potential investors as to expectations of future performance shapes the stock price of the company.

Jensen and Meckling emphasized on singular goal of a company as ‘to maximize the shareholders returns’, and Drucker’s ideology being ignored grossly. It was being vehemently barbed that the companies should give executives a compelling reason to place shareholder value maximization ahead of their own nest-feathering. Perhaps the big-idea had a mirror effect as the proponents of shareholder value maximization and stock-based executive compensation hoped that their theories would force executives improve the real performance of their companies and increase shareholder value over time but proved fatal.

However reminiscent the concept of shareholder value maximization may be, it’s a walk-the-moon task for the management to make it.

**Correspondence:**  
**Rajesh Kumar Nigah**  
*Faculty: Accountancy and  
Finance Academy of  
Commerce Satyaniketan,  
Dhoulakuan, New Delhi, India*

This is so because the value is believed to be a left-over part of the funds received by a company viz, total revenues less all manufacturing and admin expenses (salaries, bonus, overheads, taxes and debts etc). It is therefore believed that the value of their shares becomes the discounted value of all future cash flows minus those payments. In a way share prices are subjected to unpredictable future flows and could result into promising leads or end up with heart-throbbing news. This means that shareholder value has almost nothing to do with the present. Indeed, present earnings tend to be a small fraction of the value of common shares.

Indeed, shareholder primacy rose from arcane academic theory in the 1970s to dominant business practice today. Shareholder primacy is a managerial choice – not a legal requirement. The business judgment doctrine ensures that, contrary to popular belief, the managers of public companies have no enforceable legal duty to maximize shareholder value. Certainly they can choose to maximize profits; but they can also choose to pursue any other objective that is not unlawful, including taking care of employees and suppliers, pleasing customers, benefiting the community and the broader society, and preserving and protecting the corporate entity itself.

To start with, relatively short vesting periods, combined with a belief that short-term earnings fuel stock prices, encouraged executives to manage earnings, exercise their options early, and cash out opportunistically. Of course, these shortcomings were obscured during much of that decade, and corporate governance took a backseat as investors watched stock prices rise at a double-digit clip. The climate changed dramatically in the new millennium, however, as accounting scandals and a steep stock market decline triggered a rash of corporate collapses. The ensuing erosion of public trust prompted a swift regulatory response which requires companies to institute elaborate internal controls and makes corporate executives directly accountable for the accuracy of financial statements.

Ironically, some executives contend that they have no choice but to adopt a short-term orientation, given that the average holding period for stocks in professionally managed funds has dropped from about seven years in the 1960s to less than one year today. Why consider the interests of long-term shareholders when there are none? This reasoning is deeply flawed. What matters is not investor holding periods but rather the market's valuation horizon—the number of years of expected cash flows required to justify the stock price. While investors may focus unduly on near-term goals and hold shares for a relatively short time, stock prices reflect the market's long view. Studies suggest that it takes more than ten years of value-creating cash flows to justify the stock prices of most companies. Management's responsibility, therefore, is to deliver those flows—that is, to pursue long-term value maximization regardless of the mix of high- and low-turnover shareholders. And no one could reasonably argue that an absence of long-term shareholders gives management the license to maximize short-term performance and risk endangering the company's future. The competitive landscape, not the shareholder list, should shape business strategies.

## 2. 'Value Creation'- Five Sentinels to Safeguard

### 1) Do not advise shareholders on the potential earnings nor dare to manage it.

It would be like “scratching one's head with fire” if shareholders are constantly advised on their potential earnings or take the onus to manage them. In one of the surveys of 254 companies conducted during 2013, around 60% companies were found guiding regularly on the profit scenarios and another study stunningly revealed that companies used to take care of managing the earnings beyond accounting camouflage. Those who disagree with this logic would probably fail to go a long way with the rest. Perhaps there is another way of putting it as:

- the accountant's bottom line approximates neither a company's value nor its change in value over the reporting period.
- organizations compromise value when they invest at rates below the cost of capital or forgo investment in value-creating.
- the practice of reporting rosy earnings via value-destroying operating decisions or by stretching permissible accounting to the limit eventually catches up with companies. Those that can no longer meet investor expectations end up destroying a substantial portion, if not all, of their market value.

### 2) Emphasize strategic decision making than focusing onshore-cuts.

Indeed, most companies evaluate and compare strategic decisions in terms of the estimated impact on reported earnings when they should be measuring against the expected incremental value of future cash flows instead. Expected value is the weighted average value for a range of plausible scenarios.

At the corporate level, financial advisors need to ensure:

- the operating units will have sufficient potential to add value that can restrict additional capital inflows
- those units having limited potential should be only targeted for restructuring or divestiture
- an appropriate mix of investments will likely to increase the overall value

### 3) Focus on mergers and acquisitions that mean long term gains.

It is a well known fact that most of the value (actual and virtual) gets added through routine operations and typically a merger or an acquisition could turn into a major turnaround strategy. Corporates usually resort to such catastrophic decisions only with magnificent cash flows and low debts, to boost up their competitive situations. M&A announcements worldwide exceeded \$2 trillion in 2014, while Indian companies signed deals worth \$48 billion in the year 2014. Management and other investment advisors usually rely upon earnings per share (EPS) to assess the crux of any deal. Sound decisions about M&A deals are based on their prospects for creating value, rather than their immediate EPS impact. It would be ideal for management to identify the time, place and method to accomplish real performance gains by estimating the present value of the resulting incremental cash flows and then subtracting the acquisition premium. CEO's and management have to carefully evaluate the risk-return trade-offs so that efforts prove effective while anticipating a synergistic impact. The post-merger

integration increases the challenges of competition and thus forces the corporate honchos to develop new synergies to cope with. Usually companies will exhibit confidence through good pay offs to their shareholder's and encourages them to retain forecasted gains. In case of any uncertainty on financial viability, shareholders will be offered additional stocks as incentives. This reduces potential losses for the acquiring company's shareholders by diluting their ownership interest in the post-merger company.

#### **4) Maintain only assets with maximum appreciation leaving all sentiments.**

Top Management have to judiciously assess the buyers ability and interest to pay a premium for its physical infrastructure, both visible as well as invisible assets like patents, goodwill, plant and machinery, furnishings etc detachable ones before they bargain good. This analysis clearly becomes a minefield for business that fares well compared to its projections and or competitors and could fetch good dividends while bidding. While looking into the optimum shell-out during competitive market conditions, management may strategically apply twin techniques to increase value by decreasing the capital employed thus:

- by focusing on R and D, innovation, exploring new markets, etc. high-end value enhancing activities to enjoy a competitive advantage
- by outsourcing manufacturing, packaging, distribution, etc. routine activities that may be performed by others at low cost

Fit-in-the best examples are Apple Computers whose iPod got designed at Cupertino, California, and manufactured in Taiwan, and hotel companies such as Hilton Hospitality and Marriott International, which manage hotels without owning them. Dell Computers' well-chronicled customized PCs and Laptop business model, which minimizes sales and distribution costs and inventory maintenance costs etc. overheads, are spared for.

#### **5) Increase dividends while no special strategies to gain value.**

The top management with credentials of handling value-focused strategies usually distributes the excess through dividends to shareholders when they are unable to find a suitable investment option to bank on. This will rejuvenate the spirits of shareholders by giving good returns as well as safeguarding the company's long term investment propositions by slipping away from unexposed investments. Often, companies resort to snoopy technique of 'buy back' arrangement of shares to lure the market and enhance the value, while it's a well know fact that it's a futile boondoggle for any financial wizard to grasp the economic purpose. The top management of a value-focused company would buy-back shares when the estimated investment options elsewhere will indicate lesser returns over stock trading. Company adhering to this guideline serves the interests of the non-tendering shareholders, who would gain at the expense of the tendering, if such assessment does not go haywire. When a company's shares are expensive and there's no good long-term value addition to be had from such

investment, distributing dividends is the best strategic option for the management.

### **3. Epilogue**

However, following these guidelines ensure streamline long-term prospects for a majority of the companies, a few might still reel under the uncertainty if investors remain hooked to short-term earnings, as a dwindling stock price can actually affect operating performance. The risk goes overboard specially for companies such as high-tech start-ups, which depend heavily on a healthy stock price to finance growth and send positive signals to employees, customers, and suppliers. When share prices are depressed, selling new shares either prohibitively dilutes current shareholders' stakes or, in some cases, makes the company unattractive to prospective investors. As a consequence, management may have to defer or scrap its value-creating growth plans. Then, as investors become aware of the situation, the stock price continues to slide, possibly leading to a takeover at a fire-sale price or to bankruptcy.

### **4. References**

1. Jesse Eisinger, "Challenging The Long-Held Belief in 'Shareholder Value'", *New York Times* (June 27, 2012); Joe Nocera, "Down With Shareholder Value," *New York Times* (August 10, 2012); Andrew Ross Sorkin, "Shareholder Democracy Can Mask Abuses," *New York Times* (February 25, 2013).
2. Edward A. Rock, "Adapting to the New Shareholder-Centric Reality," *University of Pennsylvania Law Review* (forthcoming 2013).
3. Lynn A. Stout, "Toxic Side Effects of Shareholder Primacy," *University Pennsylvania Law Review* (forthcoming 2013).
4. *The Economist*, "The Endangered Public Company," (May 19, 2012), available at [www.economist.com/node/21555562](http://www.economist.com/node/21555562).
5. Steven Denning, "Why Did IBM Survive?," *Forbes.com* (July 10, 2011), available at <http://www.forbes.com/sites/stevedenning/2011/07/10/why-did-ibm-survive>.
6. Stout, *The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public* (2012).
7. Gerald F. Davis, *Managed by the Markets: How Finance Reshaped America* 59-101 (2009)
8. Henry Hansmann and Mariana Pargendler, "The Evolution of Shareholder Voting Rights: Separation of Ownership and Consumption" (February 15, 2013), available at <http://ssrn.com/abstract=2219865>.
9. Milton Friedman, "The Social Responsibility of Business is to Increase Its Profits," *New York Times Magazine* 32 (September 13, 1970).
10. Michael C. Jensen and William H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure," *Journal of Financial Economics* 305 (1976).

11. Roger Martin, *Fixing the Game: Bubbles, Crashes, and What Capitalism Can Learn from the NFL* 11 (2011).
12. Hayak, *The Fatal Conceit: The Errors of Socialism* (1991).
13. Rock, *supra* note 2 and Stout, *supra* note 3.
14. Stout, *supra* note 6, at 37-44.
15. Bebchuk, "The Myth of the Shareholder Franchise," 93 *Virginia Law Review* 675 (2005).
16. Clay Christensen and Michael Raynor, "The Innovator's Solution: Creating and Sustaining Successful Growth", Harvard Business School Press (2003).