Janne Ala-Ketola

The Broad Effects of Shareholder Value Maximization Theory

Metropolia University of Applied Sciences
Bachelor of Business and Administration
International Business and Logistics
Thesis
29.10.2021

Abstract

Author(s):	Janne Ala-Ketola
Title:	The Broad Effects of Shareholder Value Maximization Theory
Number of Pages:	35 pages + 1 appendices
Date:	29 October 2021
Degree:	Bachelor of Business and Administration
Degree Programme:	International Business and Logistics
Specialisation option:	Finance
Instructor(s):	Michael Keaney, Senior Lecturer

The thesis is written about shareholder value maximization theory, and its effects on organizations in the US. The theory has had an impact with the support of regulatory changes on companies' ways of management. Changes enforced by the theory have made companies in the US more focused on creating short-term value, with the emphasis on shareholders' interests particularly. Shareholders' interests often differ from what is the best for companies' long-term success. The conflict between interests between long-term and short-term value seeking has been "fixed" by aligning executives' salaries to the stock price. However, the change in aligning the interests between stakeholders has made the issue in companies arguably worse. Executives are more incentivized to create short-term value due to their own interests and see their companies' assets, such as employees, factories, and R&D, as expenses. The issue is especially meaningful in industries such as pharmaceuticals where the performance depends on R&D. In the pharmaceutical industry, where creating cures for diseases and saving human lives is at the very core of business, the focus on short-term investments harms the future. It is illustrative of a widespread problem in the US economy where companies are focusing on creating impressive expectations regarding the stock market, yet little improvements in the real market performance.

Keywords: Shareholders, Stakeholders, Shareholder value

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1 Introduction

The purpose of this thesis is to study the impact of shareholder value maximization theory. My thesis aims to bring out multiple perspectives of authors with the support of present and past sources. Additionally, I try to bring out valid arguments and questions regarding authors' viewpoints. My goal is to answer the question: is shareholder value maximization a value that companies should reach for first and foremost? Before starting broad research of the topic, my assumption is that fulfilling the demands of only one group of stakeholders makes companies neglect their other responsibilities.

The theory has had a significant impact on how companies are managed. While the theory addresses how companies are managed, it has a wide range of influence. Economies, societies, and citizens are influenced by how companies are managed. Therefore, it is essential for companies to strengthen economies, and help with issues which the world faces. Issues such as wealth inequality, climate change and employment status have all been affected by companies that have endorsed the theory of shareholder value maximization. The theory was introduced in late 19^{th} century, and a wide range of literature has been written on the topic. After decades of application of the theory, there are in-practice examples of how it has affected companies' performance. The topic provides debate-worthy discussion of how companies are managed, and what kind of other problems have emerged out of maximising shareholder value. The theory is controversial, yet it is still widely applied in the management of companies.

The theory has its supporters and those who are against it. However, the general view of authors is that companies should focus less on maximizing shareholders' value, and more on a wider range of values. The focus on shareholder value maximization has made companies short-sighted, and therefore harmed their performance. Executives of companies are highly motivated to maximize shareholder value due to their incentives relating to salary and remuneration. The incomes of executives depend largely on stock performance, which in return encourages them to go for guaranteed returns which increase stock price, and then reduce the amount invested in long-term investments such as R&D. Such short-term growth seeking has made investments such as buy backs of companies' own stock a popular "investment" across industries. The changes, however, have made economies more volatile. Employees of companies are seen as expenses rather than assets; meanwhile stock markets react more radically because short-term investments lose their value over time. The future does not look so bright because of reductions in investments over the long-term. The result is that companies in the US are less eager to innovate and make long-term investments, which reduces the global competitiveness of both US companies and the US economy.

The centre of attention for authors regards what changes should be made to the current system of management to benefit the wider economy. Authors have pointed out that the issue is not simple, and changes need to be made in many areas. Governments should motivate companies more to invest into R&D, executive pay should not be so strongly linked to stock price, the overall ideology of companies creating value should be changed, just to name a few changes proposed by authors.

The purpose of researching shareholder value maximization theory is important for the future because it undoubtedly has created harm to companies supported by research and should not be valued as much as it has been. Because the topic is broad and touches many views of companies, the research is solely conducted to shareholder value maximization and its effects on the economy.

2 Literature review

This chapter focuses on questioning the validity of shareholder value maximization theory and bringing the thoughts of some of the most relevant authors who have written about it. The research focuses mainly on the United States since it is the leading economy globally and tends to show the way to the rest of the world. The size of its capital markets also means that it has significant structural power with respect to rules-setting and the global application of these. This is reinforced by the globalization of finance, which has greatly reduced national boundaries such that investment capital flows are drawn to those countries whose regulatory regimes are closest to that of the United States, if not even more liberal (as with Britain's efforts to promote London as a financial centre via "light-touch" regulation prior to the 2008 banking crisis).

2.1 The beginning of shareholder value ideology

Modern shareholder value maximization ideology started from an article published by Milton Friedman in 1970. According to Friedman "an entity's greatest responsibility lies in the satisfaction of the shareholders". He states in his article that managers of a company work for the shareholders, not for the organization. Therefore, shareholders are the real decision-makers of a company, not managers or directors. The company's greatest social responsibility is to create as much profit, and that way provide employment, money to economies and products. Companies should not take part in social responsibility actions because the shareholders' money would be then used in the wrong way when it is not used to increase profits. If the organization would use funds of the company without the approval of shareholders, the shareholders' money would be wasted. Above all, Friedman argues that the social responsibility of the company is to make "as much money as possible while conforming to the basic rules of society". (Friedman, 1970)

Shareholder value maximization theory has had a great influence on how organizations have and are being run currently. This was at least partly because people were not happy with how the US economy was performing in the 1970s. (Denning, 2013) For the first time, there was real competition against the US, and people wanted a method to outperform the rest of the world. Secondly, the largest companies in the US were growing too big to be managed efficiently. At that time, there was an article published by Milton Friedman, who proposed an answer which was hoped to give the solution. However, the solution was not directing companies to the right direction. At the same time when the world became more financialized, the companies became profit maximisers. That means, companies in some cases ignore their core business idea to perform better to reach profit goals and at the same time taking higher risks for example by purchasing financial market instruments such as hedge funds. As an example, one of the world's largest companies by market share in the early 20th century, General Electric received 40% of its profits from a financial subsidiary called GE Capital when Jack Welch was in the charge of the company. (Plender, 2019) The result was in the end that the company was in a bail-out during the 2008 financial crisis. General Electric as an example shows that companies seeking additional profits from the financial markets often pose a risk for the company if the investments fail. Companies which enter the financial markets would be safer if they would stay with their core business products but the temptation to seek increases in profit are often too big.

The transformation was exacerbated by the new political leaders: Ronald Reagan for the US and Margaret Thatcher in Britain. Both promoted free markets and financialization of companies. Governments have played a significant role in the changes in management style. The banking sector was deregulated, beginning in the 1970's, which created more freedoms, and banks at that time started to enter the speculative investment possibilities. The deregulation of banking industry was harmful because banks were not focusing anymore only on providing investment capital and attracting savings. Banking should be a sector which creates security to societies and banks should not therefore be taking risks themselves in investing. According to Foroohar, the deregulation of banking industry also "paved the way to the so-called shareholder revolution". The changes in capital usage have resulted in money being directed into less useful purposes for the wider society. While the change in capital usage has been harmful for wider society, the changes have benefitted greatly the wealthiest population of the world. (Foroohar, 2016: 33)

While the theory of shareholder value maximization has been ingrained to the companies of the US, the theory is not so widely adopted globally. Yet in the US, the theory became a core value of businesses in the early 20th century. (Foroohar, 2016: 107)

2.2 When values of companies are re-organized, other stakeholders suffer

William Lazonick & Mary O'Sullivan state that shareholder value has dominated the corporate governance of companies now for decades in the US and Britain. The emphasis with creating shareholder value is to cut costs to increase return on equity. The result of shareholder value maximization was that there were significant decreases in employment in the US. At the same time when staff costs were reduced, the companies were using more money on investments that increase stock price. Therefore, the money was being reallocated by organizations to more valuable purposes for the shareholders rather than creating additional value for the company itself. The methods with which companies started to manipulate stock price are mainly dividends and stock buybacks. The investments which went to increasing to stock price, were reallocated from long-term value creating investments. According to Lazonick & O'Sullivan: "For many major US corporations stock repurchases have now become a systematic feature of the way in which they allocate revenues…". (Lazonick & O'Sullivan, 2010) The deregulation of the late 20th century and the influence gained by institutional investors pressured managers to align their interests with those of shareholders. At the same time, the stock-based pay of managers increased, which made it easier for them to transfer their interest from serving the company to shareholders.

Shareholder value ideology has increased unemployment and job insecurity in the US. Additionally, income differences between managerial positions and shop-level workers pose a larger scale issue that the wealth differences in the US will continue to worsen. Inequality will increase so the rich will become richer, while the poor will be poorer. The inequality also extends to the investment in employees' expertise. Lazonick & O'Sullivan claim that US companies are investing into a narrow base of their employees and neglect a large proportion of staff who are working in the less demanding positions. The lack of efforts to invest into the entire staff reduces the capabilities of companies to then succeed against international competition. Additionally, the US has little interest to provide equal education for all citizens which would give equal opportunities for every citizen.

The authors argue that the prosperity of the stock market can end suddenly, as the success from companies from the era of "retain & reinvest" does not affect anymore. The result may be that younger generations do not enjoy such stock booms and may face difficulties when companies have been focusing only to milk out value out of companies instead of creating additional value for the future. They believe that shareholder value is not a way to create successful companies or an economy, rather to create a downfall. The authors state that there should be found a new kind of value to reach. (Lazonick & O'Sullivan, 2000)

2.3 Issues in competitivity of the US

The problems of the US economy as shown in the 1970's have resulted in worse performance against international competition. According to Pisano & Shih, the problems which became concerning in the 1970's regarding competitiveness of US companies have not disappeared. The issue has been put aside due to multiple economic crises which have been harming the US economy. However, the belief in the US is that the problems have passed. Research shows otherwise, as the demand of US high-tech products has been gradually decreasing between from 2000 to 2007. The starting point of US trade balance of 2000 was + $27.8 billion, and in 2007 the trade was - $53,6 billion. The issues with competitiveness also are related to employees' circumstances. Research shows that employee wages have not increased since the late 19th century. Essentially, there has not been a rise in citizens' standards of living since then, which is also underlined by authors such as Lazonick & O'Sullivan. (Pisano & Shih, 2009)

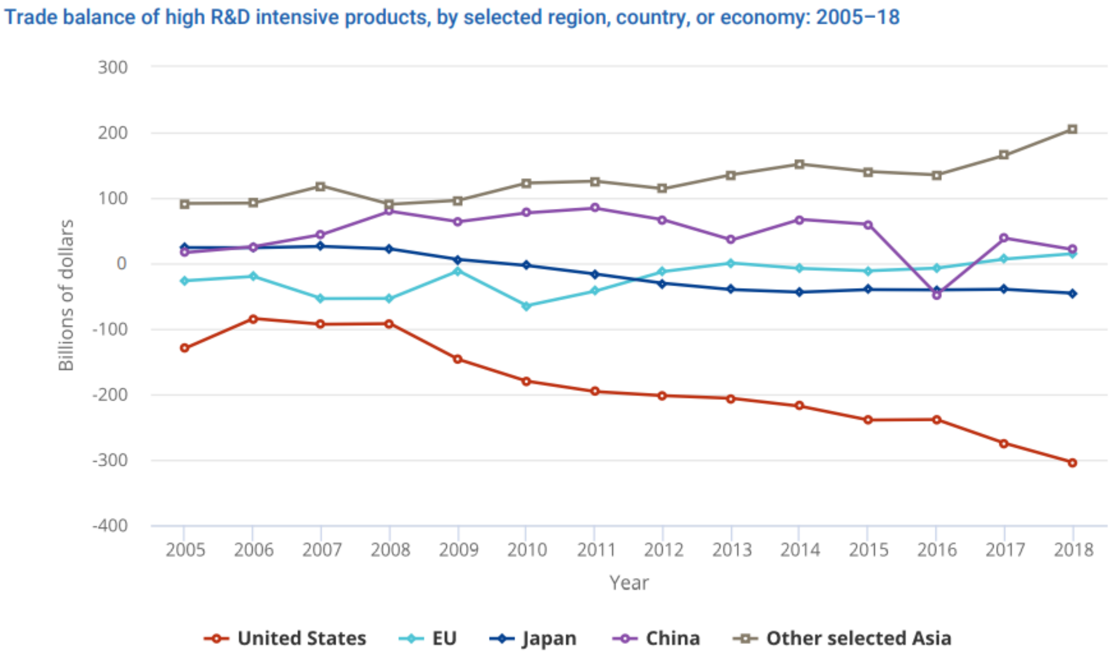

Figure 1. Trade Balance 2005-2018

The figure 1. above shows recent data of the trade balance in the US and how it has evolved between 2005 – 2018 in R&D intensive products. R&D intensive products include industries such as pharmaceuticals, computers, and electronics. (NSB, 2020)

The more recent figures show that the trade balance in the US has been decreasing over time. In 2018, trade balance of US R&D intensive products was – 300 billion dollars. The changes are especially concerning when comparing to EU, Japan, China, and other selected Asian countries which are outperforming the US by a large margin. Whereas the US has the most recent figures approximately 300 billion dollars in negative trade balance. None of US competitors shown in the figure have such negative numbers, and the difference between US and its competitors is significant, ranging from approximately 200 to 400 billion dollars. The figure shows that the direction has been similar as what Pisano & Shih point out in their data with US high-tech products.

When companies which have the largest market shares decide to outsource their operations, it is likely that their competitors do the same. Companies which decide to outsource receive short-term gains at the expense of long-term growth. Additionally, when operations are transferred to, for example, another country, employment opportunities in the domestic economy are reduced. A reaction to the change is naturally that the experienced workforce also follows the demand of an industry. The issues regarding competition have been hidden behind reducing costs from valuable resources such as local expertise and factories. Expertise has been outsourced to cheaper countries such as India to bring coding skills, and almost every company which focuses on manufacturing phones and laptops has outsourced manufacturing to Asia. The costs are reduced by these methods, but they have drawbacks. When expertise is outsourced, the expertise does not reach the US, it stays in foreign countries. Then, US-based companies have a harder time to innovate themselves because the expertise does not come from within the company. Additionally, research shows proximity between knowledge centres enhances the flow of it. Information is also transferred effectively when people switch jobs. It can be said that outsourcing has a wide range of negative effects to the competitiveness of companies. This is especially true in those industries where new technology is essential to remain competitive in a world where innovations are discovered all the time. (Pisano & Shih, 2009)

The government has had a significant role in the R&D of the US. Therefore, the government should create a foundation for companies to seek increasing amounts of R&D and long-term investments. Companies should take risks with R&D to possibly find long-term prosperity. Looking for short-term investments with lesser risk should not be how companies are managed. According to Pisano & Shih, companies are focusing too much on creating brands, and not enough on developing products. They state that the company’s products make the brand, not heavy investments into marketing. Companies should stop blaming Wall Street for the emphasis on short-term profits. Companies are themselves responsible for the expectations they are promising to Wall Street, so the expectations set up by companies should be lower. Wall Street should not be taking the blame for companies cutting costs from areas they are not supposed to. The expectations set by companies however is affected greatly by the executive pay compensations, and the impact what stock market has in todays' companies. Thus, companies have pressure to create meet and create high expectations for themselves. As an example, Amazon has clearly stated that their strategy is to create long-term value. The company is more focused in executing its strategy than satisfying investors demands for short-term growth. Companies should realise that analytical tools recognizing investment opportunities are not effective in identifying what R&D can create. Because analytical tools can identify short-term investments that have foreseeable outcomes, these projects often get funded. However, companies should realise that R&D for a new product in the market can create a breakthrough in sales. Pisano & Shih state that R&D should be one of the core functions of companies. To both develop products to meet customers' needs but also to discover innovations. The R&D should not be done alone, companies need to work together to innovate with the support of government. (Pisano & Shih, 2009)

Boards of companies should be restructured. Companies have heavy emphasis on hiring financial and law experts to the boards, but what about the core business ideas? Financial experts are professionals in creating effective balance sheets and meeting analysts' expectations but lack the industrial expertise. Boards should be included too with people who are experts in the field and can understand the importance of innovation and product development. With a diverse board with expertise from various perspectives of managing a company, greater prosperity can be achieved. Pisano & Shih state that the issues raised in the late 20th century have not been fixed yet, but it is not too late. US can become competitive internationally once again when companies start to seek sustainable growth. (Pisano & Shih, 2009)

2.4 Share buybacks as a method to increase short-term value

Share buybacks means that companies are buying their own shares from the stock market, and that way increasing the value of existing shares. This method of investing has been increasing significantly over the years because of multiple factors. Shareholder value maximization theory has increased the amount of buybacks conducted because it increases the value of the remaining shareholders' investments value. The legal changes in the late 20th century where share buybacks were no longer seen as stock price manipulation enabled companies to invest into buybacks. Share buybacks also have tax advantages for shareholders when comparing to dividends. When dividends are paid, shareholders profits are taxed immediately, whereas with share buybacks by companies the share price increases and taxes are paid only when shareholders sell the shares. Additionally, executives of companies have their own interests to invest into buybacks because it increases their salaries which are dependent on metrics such as Earnings Per Share. Share buybacks reduce the amount of shares publicly traded, and therefore increase the earnings per share of a company. Share buybacks are widely criticized actions by companies as a method to use capital.

According to William Lazonick companies are creating "profits without prosperity". (Lazonick, 2014) He argues that the top management of companies are the only ones greatly benefitting from the stock market growth and corporate profit growths. The reason for this is because the growth is a result of stock buybacks to create short-term growth, and that way promote top-executives' performance-based salaries higher. The highest paid executives received in the US in total 42% of compensation from stock options, and 41% from stock awards. Lazonick claims that short-term value maximization later does not create any additional value for companies. At the same time when money is used to create short-term results, they are taken from long-term investments such as R&D and recruitment. As Figure 1 shows, the trade balance of US companies has been in a decline since 2005 in those industries which have a heavy emphasis on R&D. The results shown in Figure 1, can be related to the idea of seeking for short-term results. The argument is also supported by Foroohar who says that the ideology of shareholder value maximization is not so popular worldwide, when comparing to the US. The result is that from the stock price growth the real beneficiaries are the company executives, not the investors. Additionally, the growth does not reward long-term investors; the benefits only reach those who are seeking short-term profits. Therefore, dividends can be considered as a better alternative to reward all the shareholders of the company since dividends distribute cash directly to the investors whereas buybacks generate short-term rises in stock price.

The amount of share buybacks has increased significantly after share buybacks were deregulated and no longer seen as stock price manipulation. The result was according to Lazonick & O'Sullivan that companies shifted from a model from "retain and reinvest" to "downsize and distribute". What it meant in practice was that there were no longer increases in employment; on the contrary the employment rates in the US were declining. At the same time, the wages of CEOs of companies have been increasing at a significant pace while average workers' wages have not. The changes are counterintuitive; when productivity increases, so should wages too. But the money was distributed unequally to the directors of companies. Suddenly, the core of businesses was to meet and exceed the expectations of shareholders, not to provide a service or a product for a customer. (Lazonick & O'Sullivan, 2010)

Lazonick states that companies often justify that share buybacks are done because the shares are undervalued and therefore it is reasonable to buy own shares away from the market. In theory, it does make sense however companies have been increasing share buybacks though stock markets are at record-high numbers and increasing all the time. (Lazonick, 2014) Additionally, there are multiple companies which have failed to invest in the right time to share buybacks which have resulted as money wasted by companies. As an example, General Electric's stock price has fallen from $32 in 2016 to $7 per share in 2018. While at the same time, General Electric invested in 2016-2017 $24 billion in buying back its own shares. For General Electric, the investments made to buybacks were poor during that time and arguably could have been used in better ways. (Krein, 2018)

Another reason for companies to perform share buybacks is that there are no other viable investment options to invest in. Therefore, share buybacks are considered as an efficient way to invest. Lazonick however believes that the main reason behind share buybacks are the incentives of top-executives' salaries because their pay is highly dependent on the share performance. Thus, it is reasonable for them to invest into buybacks which increase share price. He states that the shareholders of public companies are rarely interested in the long-term investment methods, rather they want to see the stock value rise. When shareholders and executives both benefit from stock price manipulation, there is little reason to not do so. (Lazonick, 2014)

Recently companies have also started to take increasing amounts of debt to finance share buybacks, which increases the risk what companies are taking for share buybacks. Share buybacks are not returning on the investment that companies are making, so why is it sensible to do so? According to Lazonick, Sakinc & Hopkins it might be sensible to take debt to investments which have the possibility to make returns over a long period of time. However, leveraging finance to buy back the company's own shares is considered as a bad way to manage a company. The buyback behaviour has been analysed by JPMorgan Chase and results were that buybacks made by debt have increased the risk that companies are taking. (Lazonick, Sakinc & Hopkins, 2020) Especially during uncertain periods when companies need flexibility and resilience in situations like the Covid pandemic, taking unnecessary debt may result in significant difficulties. The issue of financial instability has been raised also by John Plender. He points out that there are major drawbacks when companies aim to make their operations as efficient as possible, making them more vulnerable. Creating vulnerable company structures has been praised by Michael Jensen who believes that additional cash available is not an efficient way of allocating funds. The argument made by Jensen may be true that money laying in balance sheets could be used in ways which could create profits, but companies need to be prepared to respond in unpredictable events to avoid financial difficulties. When taking into consideration that companies are taking debt to finance share buybacks and similarly having increasingly efficient structures, the change poses a concerning sign for the future. (Plender, 2020)

According to Krein: "The country seems incapable of making the necessary investments to fuel future productivity and growth, or to ensure widespread prosperity." (Krein, 2018) The spending of both government and companies have been declining since 1980s with respect to long-term investments. The trend of share buybacks at the same time has been increasing at a yearly pace. In 2018, companies in the S&P 500 spent more in share buybacks than capital investments. Krein argues that the political changes for companies to enhance competitiveness of US companies such as deregulation and tax cuts have increased profits for companies, but the money has not been invested in value increasing ways.

The profits of companies have been invested in financial markets, rather than the company itself. Therefore, the US government failed to change companies' motives to invest into productivity increasing attributes. But when companies and the US government both are reducing investments in innovation, who should be creating it? As stated by Lazonick, the US government has played a significant role in creating innovation for the companies in the US. Additionally, companies are lobbying the US government to make more investments in innovation, while at the same time they are investing massive amounts in buybacks. As an example, Intel lobbied the US government to invest into nanotechnology research because the company itself was not capable to do it. Meanwhile Intel was spending four times the amount needed for nanotechnology innovation on share buybacks. (Lazonick, 2014)

Share buybacks are widely criticized, but not all research show that buybacks would be harmful for companies. Alex Edmans found from his research in the UK that none of the FTSE 350 companies invested in buybacks to reach an EPS goal. Additionally, another research found that those companies who have invested in buybacks, performed 12,1% better than its competitors in 1980s. Similar research was conducted recently in 31 countries and the same results applied to the more recent one too. Edmans states that those companies who invest in buyback, have already taken all other investment possibilities and then use the additional funds remaining for buybacks. Then, the buybacks made by companies do reach investors and that way is reallocated to companies which have more attractive investment possibilities. Further research shows that companies do buybacks when possibilities for growth are not looking optimistic in the short-term. Edmans claims that when buybacks are used to reach short-term goals, the problem is not buybacks, but rather the way of thinking by executives. The focus is then in reaching quarterly goals and short-term pay out. (Edmans, 2020)

The issues of share buybacks develops into a broader question: to what extent are companies responsible for the society? As Edmans claims, when a company has already taken up all the best investment options, then it is reasonable to invest in buybacks. But should companies then with the additional cash in the balance sheet invest in innovation, sustainability, and the wider economy? When comparing the influence of buybacks and social impact investments, the latter serves the greater good. Buybacks at their core serve investors, whereas social impact investments create benefits for everyone. In a country such as the US, where wealth inequality has increased over decades, only a small proportion of the population benefits from buybacks. Therefore, it should not be the directions that companies are taking with their additional cash, rather they should try to create wider good for everyone in the society. (Edmans, 2020)

As Lazonick points out, US companies do not feel obligated to invest in innovation. Companies believe that the government is responsible for creating innovation. The way companies think of innovation is not reasonable because companies themselves are specialized in their field and could use cash available to fund research for new products. Governments have much more responsibilities than companies. Research has also shown that companies do have the cash to make investments to R&D, but rather invest into shareholder value maximising investments. Therefore, the US government should pressure companies to make more value-creating investments.

Authors such as Foroohar and Lazonick point out that the shareholder value maximization ideology has increased the wealth inequality in the US. And the cause behind this are the companies, and the government is left with the task of fixing it. The US government should not be both doing R&D for companies, and repairing the inequalities resulted from shareholder centralized way of thinking. Companies should take more responsibility of the problems that they have initially created by prioritizing short-term value creation. The problems are rooted in the US government failing to incentivize companies to the right direction, and executives seeking short-term growth above taking into consideration its employees and the society. Lazonick argues that the US government should stand up against the short-term value seeking by companies. The starting point should be from managing executive pay, so that they would not be motivated to create short-term value; as research has shown, it damages the long-term prospects of companies. He adds that the taxation should be fixed so that it would not reward value extracting behaviour. (Lazonick, 2014)

2.5 In-practice the effect of shareholder value maximization theory

The change in management style has not been seen by all authors as a shift to the worse. Steven Kaplan claims that the reason for struggling companies in the 1960-1970s was the lack of shareholder value-focused way of thinking. He notes that companies which solely focus on reaching for shareholder value maximization perform better than those who do not. (Kaplan, 2020) The argument made by Kaplan is denied by the vast amount of evidence indicating that shareholder value maximization has not encouraged companies to work in better ways. On the contrary, companies have become more short-term focused to increase stock price. The issue is, stock price today can be and is manipulated by managers of companies to reach Earnings Per Share goals, or to increase their own bonus salaries based on stock performance.

According to Lynn Stout: "…when we look at macroeconomic data—overall investment returns, numbers of firms choosing to go or remain public, relative economic performance of "shareholder friendly" jurisdictions—it suggests shareholder value dogma may be economically counterproductive.” (Stout, 2012) The research into whether shareholder value maximization is good or bad for companies’ long-term performance shows that the ideology has made companies make worse investment decisions. The argument of Stout is supported by Foroohar’s research. Public companies are not so eager to make investments to long-term value seeking investments because it does not give certain returns for investments. Foroohar claims that privately held companies are investing approximately double the amount that public companies to long-term value creating investments such as R&D, expansions, or employee training.

The difference shown in the research indicates that companies which are public and maximizing shareholder value are not outperforming their counterparts. As Foroohar argues: “It’s interesting to note that some of the deep-seated problems that have plagued the American auto industry for generations, such as unsustainable pay deals with unions, began after companies went public.” As an example, she points out that General Motors fired 74 000 employees and closed 21 plants to reach investors’ financial goals. The financialization of companies has led them to make unreasonable decisions at the expense of other valuable resources such as employees. Arguments made by Foroohar support the arguments of Lazonick & O’Sullivan, that job insecurity has increased after shareholder value has become the center of businesses. The example of General Motors shows as well that the ideology of shareholder value seeking affects wider societies in a substantial way. (Foroohar, 2016: 81)

The industry of automobiles is not the only one which has been widely affected by shareholder value maximization theory. Foroohar points out that the pharmaceutical industry is also affected by the theory. The change is concerning because as research has shown, shareholder value seeking has decreased investments in R&D. The pharmaceutical industry relies heavily on research and development so that diseases can be cured. Because of the reliance on R&D and without guarantees for returns, pharmaceutical companies are becoming less and less attractive for investors. Pharmaceutical companies which focus on R&D have their own risks for investors because of no guarantee for returns. The risks in these companies have made them unattractive for investors, consistent with business schools’ advice to avoid risks. The risks however to save human lives and make cures for diseases should be considered if they are worth taking. (Foroohar, 2016: 91)

These issues affect the industry-leading companies such as Pfizer. Pfizer has dozens of billions of dollars in its balance sheet which could be used to create possibly new life saving medicine, but it is rather used for actions which increase the stock price, and to avoid paying US corporate taxes. Another example of a company seeking value for shareholders is Valeant. Valeant has used mergers and acquisitions, controversial medicine pricing and accounting tricks to make their company's market value reach new highs; in other words, with methods that make the company only look better to shareholders. The way of managing business is not seen to be wrong by managers since the way of thinking in business schools is to "minimize the amount of cash at risk and increase shareholder value". The ideology taught by business schools have resulted in 150 000 lost jobs in the pharmaceutical industry from 2008 to 2013. Not only the way businesses are managed have been influenced by shareholder value maximization ideology, but also the education systems. Business schools are educating future managers and directors, and that is why they have an important role on how companies will be managed in the future. Will they be directed by the ideology of retain & reinvest, or downsize & distribute? (Foroohar, 2016: 92-93)

2.6 Flaws of the game

Milton Friedman argues: "there is one and only social responsibility of business—to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without fraud." (Friedman, 1970) The statements Friedman makes are controversial because he assumes that the governments and companies are working perfectly. On the contrary, governments are often failing to create laws that would aim for the society's best interests. (Admati, 2020) Additionally, managers of companies rather try the limits of those laws, than obey them as they are supposed to. The laws that governments have passed to direct companies to do the right things, are not doing their job well as white-collar crime is not so well revealed such as tax avoidances to tax havens. As an example of companies avoiding their due diligence as part of society, Apple was sued for tax avoidance in its office in Ireland. Essentially, Apple has avoided paying 13 billion euros in taxes in the EU because the company has its office in Ireland. (Regan, 2020)

Ireland's taxation regime is not only abused by Apple, but many other US companies also have their operations registered these to avoid taxation. The reason why companies have set up office in Ireland is because US companies have tax arrangements in Ireland which make it easier to avoid tax. The problem with Ireland is that the EU cannot affect the way Ireland has its taxation arranged. The way Ireland attracts US companies to avoid taxes in the EU has made Ireland a widely criticized country for taking tax profits away from the EU. In the lawsuit against Apple, the company was not forced to pay back taxes it was supposed to. The result was that Apple has paid 0,005% taxes in the EU. Apple states: "We're proud to be the largest taxpayer in the world, as we know the important role tax payments play in society." (BBC, 2020) The statement made by Apple is far from reality as seen from the lawsuit, and it shows just how large corporations want to avoid their responsibilities as a part of societies.

Though there is clear evidence that companies are not playing the "game" by the rules, Kaplan states that in the past 50 years shareholder value maximization is the reason why companies have been so successful. He reasons that companies should continue operating as they have, as long as they work by the rules of the "game". The research of companies doing illegal actions and leaving without consequences however does not promote trust to the "game" that it would be working properly. Especially for the largest companies in the world, as Brandon Garret states that companies are "too big to jail". Admati brings up in her article numerous examples where companies have been subject to minor charges in connection with significant crimes. (Admati, 2020) The trials of large corporations are often done in a discreet way, where the sentences are left unclear, as is how the decisions are made. The lack of information then makes it harder to understand if the legal systems are working in the right manner against those who are in power such as large corporations or government authorities. As an example, leading up to the financial crisis in 2008 multiple companies were working in disreputable ways, yet no one was sentenced. Even though companies were conducting business before the crisis in clearly wrong ways, no law was broken, supposedly.

2.7 A simplified way of seeing management performance

Michael C. Jensen has appraised the ideology of Friedman and has continued his work broadly on shareholder value maximization theory. He argues that it is difficult to measure performance of employees of companies with multiple scorecards, and he believes that employees can then seek their own benefit, neglecting the overall company's long-term success. Therefore, reaching for the long-term increase in market value is the best way to measure the success of a company. Jensen points out an important argument that potentially dozens of methods to measure performance can result in confusion and troublesome situations to measure efficiency in companies. The simple way that Jensen proposes regarding how companies can measure their efficiency has been one of the reasons why his theory is widely adopted. He acknowledges that there is short-term and long-term shareholder value, but companies should reach for the latter. (Jensen, 2001)

Jensen identifies in his work the theory of agency costs. The theory argues that there is an agent performing actions on behalf of the principal, but their interests are not aligned assuming that both parties are "utility maximisers". Therefore, the interests of the agent should be aligned with the principal to have same interests from both parties. The theory is relevant to shareholder maximization theory because it was made to support how companies will be directed to the same direction as shareholders. (Jensen & Meckling, 1976)

In the agency model of businesses, principals are shareholders who own shares of companies and agents are company executives. In business, directors of companies are not directly motivated to have similar goals as shareholders. The shareholders may, for example, be seeking short-term returns whereas a director wants to invest into R&D to possibly find a new product which would increase long-term growth and prospects of the business. The motives of shareholders may also require more risks to be taken to reach the wanted returns. The risks then may jeopardize the position of the director if the investments fail. The investment decisions and risk averseness are a few examples how directors and shareholders have different ideas of how companies should seek value. (Jensen & Meckling, 1976)

The agency theory has been applied to businesses so that directors have a significant proportion of their pay decided upon according to share price increase. With stock-based bonus systems directors are incentivized to seek ways to increase the share price of their company. Increasing the share price thus aligns the motives of both directors and shareholders. The change, however, has made reaching quarterly financial goals a key priority of directors. The quarterly goals are often manipulated by methods which only create short-term value. As Roger L. Martin points out, after directors became rewarded with money to reach quarterly results, they became better in reaching them. The change shows that directors can effectively manipulate their results. Agency theory was made to create similar goals between shareholders and executives and to stop executives from seeking their own interest. But the theory makes an argument against itself at the same time. Executives are seeking shareholder value via their own interests, which are in compensation. However, now both shareholders and executives are enjoying their compensations and the share price rises while at the same time the rest of society does not benefit to the same extent that shareholders and executives do. The problem is that companies are not rewarded for investing into long-term growth. If companies would seek for long-term value growth, the benefits would be enjoyed by both the economy and the company. The way agency theory works currently benefits only the few and the wealthiest. It can be also said that it works the best for executives as they can exit a company when stock price has risen the most before it plummets. A large part of investors suffers too by trusting the company to provide long-term growth and a safe investment. Additionally, citizens of the US invest their pensions to funds which are expected to rise in price for the long-term. Therefore, the focus on short-term goals can harm the future pensions of US citizens. (Martin, 2011: 29, 57)

As Jensen identified in his work companies' directors and shareholders have different objectives to pursue, but should they have similar goals? And should directors be obeying what shareholders want the companies to do? Shareholders are not legally the people who have the decision power of companies; directors and the board are. Shareholders are not committed to the company in any way for a long period, investors can sell their shares as soon as they are satisfied with the profits that a company has generated. Additionally, there are short-term and long-term shareholders. Short-term investors may as well be satisfied if a company merely creates value by stock buybacks and dividends whereas long-term investors would want the company to seek for long-term value creation.

According to Martin, directors of companies have become only interested to increasing short-term value maximization, because it is the only measure they can control. Additionally, the results which are demanded by analysts are often unreachable for companies, and force directors to reach the goals with methods that are not providing long-term growth. The short-term value maximization has made companies skyrocket their stock prices, and after a while the price has plummeted. As an example, Cisco Systems stock price was 80$ in 2000, and in 2010 the stock price was 20$. The reason for the decrease in stock price was simply the consequence of too high expectations from the company, and by any means to reach the expectations. The decrease in stock price was in total billions of dollars in market value of Cisco Systems. While the goal of Jensen's agency theory was to solve the differences between motives of directors and shareholders, it has actually worsened the issue. (Martin, 2011: 28-31)

Roger L. Martin agrees partly with the theory Jensen proposes, but states also that companies are always facing such issues to weigh which are the things that matter the most for a company. Therefore, it is not sensible to try to simplify the complicated nature of companies. Rather, why should the measurement method be solely shareholder value maximization? Martin states that if he would have to choose one variable to measure for performance, it would be customer satisfaction. But not only to focus on customer satisfaction should be important according to him, but companies should also focus on other important factor too, such as employees, environmental impact and obeying the law. Martin claims that shareholder value is not maximized by trying to reach it directly, rather it is achieved on the side when doing other meaningful things for the business. (Martin, 2016)

2.8 Theories that underly behind financial crises

The US economy has faced two crises in the 21st century: the dotcom bubble and the mortgage crisis. The authorities of the US fixed the problems behind the dotcom bubble and believed that future crises could be avoided by these methods. However, less than a decade after the dotcom crisis the US was facing a more severe crisis which struck the entire world by its magnitude. Why did not the changes made after dotcom crisis help to prevent future crises? According to Roger L. Martin: "Our theories about the fundamental goal of corporations and the optimal structure of executive compensation are fatally flawed and have created stock market upheavals." He states that the theories that are behind the current structures of corporations "threaten the future of American capitalism". (Martin, 2011: 1-10)

The theories which Martin refers to, are agency theory and shareholder maximization theory. The theories were supposed to enhance the performance of companies, but there has been little to no improvement. The total returns of S&P have declined by 1 percent from 1933-1976 to 1977-2010 from 7,5 percent to 6,5 percent. If the shift in management theory has not improved returns of companies, what has it done? It has made the companies more volatile. Additionally, companies have become shareholder focused, rather than customer focused, which should be the stakeholder at the center of a business. The difference between companies who have put shareholders first, and those who have not, does not look impressive for shareholder value maximization. As an example, the company J&J outperformed GE by 2,2% in annual returns. There has been little to no difference between shareholder value focused way of management to those who have valued, for example, customers first. Yet companies which value customers first are creating long-term value whereas shareholder value maximization companies are often creating short-term value. (Martin, 2011: 30, 65)

2.9 Expectation’s importance exceeding the reality

Martin adds that the shareholder value maximization theory has made the “real market” and the “expectations market” far too close to each other. Before the theory became mainstream, stock-based incentives in executive pay were less than 1 percent. The change is significant: as an example, in 2009 Larry Ellison CEO of Oracle received 97% of his paycheck from stock-based incentives. The combining of both markets has made executives of companies more focused on increasing the expectations of the company because when the stock rises, so does their stock values and compensations. The real market’s positive performance does not reflect in expectations always because the expectations of a company can always be a step higher than the company’s performance in the real market. (Martin, 2011: 12-14)

The expectation market is hard to beat. Because the expectations of the future are influenced by how well a company has performed in the past, it affects to the expectations what are set for the future. The more impressive rises have been in the past, the same will be expected for the future, and even better results. Martin compares the stock market with the NFL (American Football League) gambling. The difference in NFL and the stock market is that when authorities of NFL saw that the expectations market and the real market became close to each other, they were separated because it did not favour the nature of American football. Why similar measures have not been done with the stock market? Expectations market directs how companies are investing money, and that way affect negatively how the “game” is played in the US. US capitalism forces executives to align their interests with the expectations with compensation rewarded from stock price rising. The alignment of both markets can be seen in practice in how accurately companies have met expectations. In 1980s executives met the expectations of analysts by 50%, and in 1990s the percentage was 70%. (Martin, 2011: 14.21)

An argument could be made that the stock markets are efficient, and the market therefore has reacted to the real market value of the company. The reality however is different, and the stock markets are inefficient. The stock market can be easily manipulated by fixing accounting and doing short-term actions such as buybacks. Martin claims that the Dot-com bubble was an example showing that the reality is far from expectations. Additionally, improving the real market value of a company is not what investors are really looking for, because creating long-term value takes time and patience what investors often are lacking. On the contrary, the opposite has been happening since corporations have been given up on long-term value seeking investments to increase stock price. Such examples are seen in closing facilities, reducing R&D and dismissal of employees. The difference between stock market and the real market can be also seen in figures which illustrate steady increases in for example, profit, whereas the stock market often has its volatile jumps and drops.

2.10 Social impact of businesses

Regardless of what a company does, it has social impact via its employment, products, and emissions, among other factors. The question remains: who has the responsibility for companies' social impact? Governments create laws and societies have norms which companies need to follow to be identified as an attractive provider of products, or as an employer. In an increasing trend people are identifying social responsibility of companies as an important value to take into consideration. Therefore, companies should be motivated themselves to seek ways to create a positive impact to their environment. While it does not give companies direct value in numbers or share price increase, it is appreciated by citizens and shareholders, thus increasing long-term value of a company. Martin states that companies can follow the mainstream trends or try to create new initiatives into countries' civil foundations. By creating initiatives, other companies will be most likely to follow behind if the action was seen as a positive change for the better. Above all, companies themselves understand their industries and products the best, and that way they can see what could be changed first. After creating changes, governments will see the impact and develop new regulations to guide other companies to operate in the same way. (Martin, 2011: 206-207)

The pandemic has created issues for companies' current supply chains, where costs have been cut by outsourcing, for example by finding the cheapest options to get products or services delivered. Outsourcing has made companies like professional athletes in a single sport, they cannot adapt well to changes. Referring to the current issue with pandemic and restrictions in transportation, companies could make a positive initiative to start employing and creating factories in their home countries, thus, creating employment in their home countries with the expense of additional costs for their company. The change could have its strengths too: when supply chains would be brought from home country, during a pandemic or other restriction period operations of a company would not be harmed as much as during the Covid pandemic.

Rana Foroohar states that the current financial system should be re-modelled to provide sustainable growth for the world. The financial system should aim to provide equally wealth to everyone, not only to the wealthiest. There has been initiative on how to fix the problem in the US after the 2008 financial crisis. The Office of Financial Research was created to search for weak points in the financial system to predict future crisis. The office however needs the support of the US government. The Trump administration decreased the amount of funding the office had. The change should be the opposite since the system has its flaws. (Foroohar, 2016: 325)

3 Conclusion

Shareholder value maximization ideology proposed a solution for companies in the 1970s to how competitiveness of companies could be restored. However, the evidence has been otherwise. The theory has had an impact on how companies see their valuable resources. Resources such as employees and R&D capabilities have been seen as expenses when they are at the very core of companies' assets. Additionally, the ideology of maximizing shareholder value has flaws. The idea of only trying to maximize the shareholders' value leaves other stakeholders outside. Companies have multiple responsibilities in today's world such as social responsibility and sustainability. Reaching for shareholder value can be attained by not only by increasing the stock price, but also by increasing its value by actions which matter. Secondly, the argument that executives are responsible to the shareholders to make decisions does not make sense. Executives are not legally responsible for shareholders to create results according to what they want to be done. In addition, shareholders have different motives than what is the best for long-term for a company. Even major shareholders of companies can have only short-term incentives which encourages executives to take decisions which do not create long-term value.

The argument is raised by Martin, that shareholder value can be reached indirectly, that is by creating more meaningful products, serving wider society as an initiative for an industry, to name a few. When companies are proactive in their ways of creating wider good, everyone shares the benefits of prosperity. However, if companies only focus into creating value for the shareholders, only a small percentage of population benefits. Companies can create additional value for shareholders when meeting customers' needs and that way increasing its sales, and that way also increasing production and staff capabilities. The change has wider scale effects; more people get hired, more needs are fulfilled, more money is being consumed. Everyone benefits from creating shared prosperity.

One could argue that there is happening a shift regarding what shareholders value. Younger populations are more caring of the environment and what companies do besides their products, so currently and in the future creating a better future for everyone does ultimately serve the shareholders' interests too. There will be always those people who only seek short-term profits, but the general directions are that socially responsible companies are appreciated.

Actions such as share buybacks and other ways to manipulate the stock price should be controlled, and above all executive pays should not be directly compensated by the performance of stock. The agency theory at its core was intended to align the interests of shareholders and executives, but currently the executives are mainly serving their own benefit. When investors are starting to value more socially responsible actions, it can be argued that is increasing the stock price the real value what investors want? The shift in investors' way of thinking can be seen in the stock markets, there are funds created to focus on socially responsible companies, or those that focus on sustainability.

Companies are in a difficult situation regarding social responsibility. Shareholder value maximization promotes that the only way companies are socially responsible is to create as much profit as possible. The argument made by Friedman is outdated. It creates a false understanding of companies' responsibilities. If companies are not socially responsible for what they do, then who is? Companies should take responsibility for their actions. Global warming is caused by companies not taking responsibility for their actions, which shows how significant impact companies can have when neglecting the responsibility for their actions.

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Appendices

Title of the Appendix