

Shareholder Wealth Maximization, Business Ethics and Social Responsibility

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ABSTRACT. The primary objective of this article is to develop a framework for analyzing the ethical foundations and implications of shareholder wealth maximization (SWM). Distinctions between SWM and the more widely examined construct of profit maximization are identified, the most significant being the central role played in SWM by the market mechanism for pricing the corporation's securities. It is argued that empirical tests concerned with evaluating the ethical implications of SWM will almost surely involve a joint hypothesis. A number of recent empirical studies aimed at testing hypotheses with explicit ethical content are reviewed.

The absence of issues associated with business ethics and social responsibility in corporate finance textbooks is well documented (Hawley, 1991). Given the importance of these issues, this is disturbing because textbook content typically reflects the coverage given to material in courses.¹ This lack of attention to ethical considerations also appears to extend outside the classroom into the realm of corporate finance practitioners (e.g., Rappaport, 1986). Does this imply that substantive ethical considerations are not involved in corporate financial theory? As it turns out, fundamental ethical issues are submerged in specifying the primary objective of financial management: shareholder wealth maximization (SWM). This objective provides the basis for decision

rules which determine corporate behaviour, e.g., if there is no capital rationing, select all positive net present value projects.² By failing to consider ethical implications directly, corporate financial theory implicitly assumes that SWM satisfies the requisite ethical requirements.³ To date there has been limited direct analysis concerning the implicit ethical foundations and implications of SWM. The primary objective of this article is to take an initial step in this direction.

As developed here, the analysis starts by examining SWM and developing its connection to the more widely examined construct of profit maximization. Substantive differences between the two concepts are identified; the most significant being the central role played by the market mechanism in SWM for pricing the corporation's securities. Given this, in Section II ethical considerations associated with SWM are related to theoretical and empirical views about how the securities market incorporates ethical and social responsibility concerns in forming prices. It is argued that empirical testing of a given view is difficult and will almost surely involve a joint hypothesis. In Section III, a number of recent empirical studies are reviewed to illustrate the difficulties associated with establishing the empirical validity of a given view. An already complex problem is shown to be further complicated when the notion of "agency costs" is introduced.⁴ In conclusion, the potential for SWM to compel corporations to produce ethical or socially responsible outcomes is assessed.

I. SWM and profit maximization

Over time, considerable ethical analysis has been given to the concept of profit maximization as

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reflected in the classic article by Milton Friedman in the *New York Times Magazine*, "The Social Responsibility of Business is to Increase its Profits", e.g., Grant (1991), Danley (1991). Given this, establishing a connection between the goals of SWM and profit maximization provides a useful initial starting point for developing an ethical analysis of SWM. While there are similarities, the inconsistencies between these two approaches is well illustrated in the classic text by Solomon (1963, chp. 2). In particular, while there is considerable overlap between the two objectives, the goal of profit maximization is designed for the traditional microeconomic world where there is no uncertainty, the decision-maker is the owner of the firm, the capital stock is fixed and there is only one period. This structure is well-suited to analyzing the variables which are of central interest: prices of inputs and outputs, the level of production and so on. Under appropriate assumptions (e.g., Winch, 1971) profit maximization is consistent with the restricted ethical goal of a Pareto-optimal (utilitarian) allocation of resources.⁵

In opposition to microeconomics, it is the intertemporal allocation of financial resources by corporate entities which is of central concern in corporate finance.⁶ The change of focus introduces a number of elements which are of limited concern within the profit maximizing paradigm.⁷ In particular, the corporate structure involves a separation of firm ownership, which is in the domain of common (voting) stock shareholders, and firm decision-making, which is controlled by management. In addition, the explicit intertemporal framework shifts attention to the valuation of *uncertain* future cash flows where the capital stock position is one of the variables to be determined. The SWM objective is developed by exploiting the utility maximization framework: as agents for the firm's owners, management should seek to maximize the expected utility of the wealth of shareholders. Under a specific set of conditions, e.g., wealth is the only argument in the shareholder's utility function, maximizing the expected utility of shareholder wealth reduces to the more direct objective of SWM.⁸

To this point, the ethical approach of corporate finance is similar to that of microeconomics, e.g., the use of utility maximization inherits features of the utilitarian ethic. However, the introduction of time, uncertainty, and separation of firm decision-making

from ownership also introduces substantial complications in establishing the ethical objective of Pareto optimality (e.g., Diamond, 1967; Mossin, 1977). Available conditions under which SWM can achieve this result are idealized. Given the considerable and substantive ethical criticisms which have been levelled at the notion of Pareto optimality (e.g., Little, 1950; Sen, 1987), failure to achieve even this limited objective would appear to support the view that SWM cannot provide a viable ethical foundation for corporate finance. However, there are essential features of SWM which are not encompassed by the Pareto optimal framework. Most importantly, shareholder wealth depends directly on the price of common stock and, as a result, on the process by which the market for ownership claims incorporates information about ethical concerns.⁹

Assuming that managers pursue SWM ("zero agency costs"), a number of key issues can be identified. In particular, because SWM depends fundamentally on market processes to establish a value for financial claims to firm ownership, issues arise about whether market forces produce security prices which place value on socially responsible or ethical firm behaviour. With correct specification, certain aspects of these issues can be addressed empirically. This requires resolving subsidiary theoretical and empirical questions associated with how market prices incorporate information on firm behaviour. Inevitably, evaluation of these questions introduces the unresolvable complexities of what constitutes appropriate behaviour, i.e., what types of behaviour *should* the market reward? Even further complications can be introduced if the assumption of "zero agency costs" is dropped, i.e., it is assumed that management actions can deviate from SWM. This raises further questions such as: what constitutes ethical behaviour by management, especially regarding the interests of shareholders?

II. Determining share prices

While not directly focussed on evaluating ethical issues, a central concern in financial economics is the process of security price determination. In this vein, considerable attention has been devoted to the "Efficient Markets Hypothesis" (EMH) which postulates

that the prices of securities rapidly reflect available information relevant to the pricing decision. Distinctions can be drawn between different forms of the EMH based on: the type of information considered to affect prices; and, the specification of the model for determining prices. By construction, empirical tests of the EMH involve a joint null hypothesis of the EMH and the pricing model selected. Hence, the EMH is not one hypothesis, but rather a large number of conjectures and results gathered under one heading.

Given this background, the EMH can be used to provide a framework for empirically evaluating the ethical implications of SWM. Specifically, in order for SWM to satisfy a given ethical standard, the stock price must rapidly and appropriately reflect information about events with relevant ethical content. Formulation of the applicable joint hypothesis requires both the EMH and a model of how ethical events are reflected in pricing behaviour. This process will necessarily require statement of an ethical standard. Empirical tests can be conducted on security price behaviour to evaluate whether information about relevant ethical events is rapidly reflected in market prices. In the process of evaluating the ethical implications of SWM, the conventional joint hypothesis will typically be extended to include the assumption that management pursues SWM. However, this issue could be a separate testable hypothesis, e.g., by comparing the impact of ethical events on firms which are known, *a priori*, to exhibit differing degrees of adherence to SWM.

The issue of management adherence to SWM represents a potential limitation in using the EMH framework. Consider the proposition that SWM encourages unethical and socially irresponsible behaviour in a given firm by, say, permitting management to pursue illegal activities which (somehow) have a positive expected value. This could occur because the expected gains from the illegal actions were substantial relative to fines, penalties, and other possible sources of economic losses such as reduction in goodwill. Further mitigating factors could arise where the probability of getting caught was small or there was enhanced ability to limit losses with timely damage control. It is possible to use the EMH to argue that under SWM such activities either: could not occur (e.g., Cooley and Roden, 1988, p. 14); could occur only if the stock market was not strong-

form efficient (Hawley, 1991, p. 717); or, could occur in general depending on the specific circumstances of the firm (e.g., Weston and Brigham, 1990, p. 17). Based on EMH arguments, it is difficult to evaluate whether alternative courses-of-action would have produced differing price behaviour, e.g., if unethical behaviour is observed whether this is due to the ethical failings of SWM or to management practices which were inconsistent with SWM.

The upshot of this discussion is that the EMH, by its nature, involves a *joint hypothesis*, i.e., some model of price determination is always implied when the EMH is invoked (Fama, 1970). Ignoring the issue of empirical verification for the moment, if the assumed model of price determination requires addressing relevant ethical issues in order to maximize shareholder value then the EMH null hypothesis would require that 'unethical' behaviour violate SWM. Such a pricing model is proposed, for example, by Treynor (1981) who postulates that management must address the financial claims of various constituencies in order to continue as a viable organization.¹⁰ These constituencies include employees, customers, suppliers, debtholders and stockholders. In this framework, SWM would require management to pursue practices which are consistent with the legal and ethical standards associated with the business at hand, for all the relevant constituencies, *not just shareholders*. This approach can be extended to use SWM to justify recommending various socially responsible corporate actions, e.g., Cornell and Shapiro (1987).

The requisite pricing model connection between SWM and EMH can also be developed using traditional corporate financial theory. Consider the role of SWM in capital budgeting: based on the classical results initially provided by Fisher (1930), a fundamental proposition of corporate finance is that SWM requires the firm to undertake investments in positive net present value (NPV) projects. Calculation of NPV involves discounting a sequence of *expected* net cash flows, where the selected discount rate reflects the risk of the project under consideration. In practice, evaluation of the net cash flows requires forecasts of sales, operating expenses, tax payments and so on. Forecasts of these variables will be based on some model of firm performance assumed by management which may or may not incorporate ethical and social responsibility con-

cerns.¹¹ In this context, share price performance will reflect the market's assessment of the management's decision. Incorporating ethical concerns into the process of forming cash flow estimates will be consistent with SWM if such considerations are reflected in superior share price performance.

Given the SWM-based NPV rule, invoking EMH provides a framework for relating the actions of management with empirical studies of share price performance. Under the EMH, price-sensitive information about management's selection of present and future projects is incorporated rapidly into share prices. While it is possible for management to select any number of ethical or unethical strategies in developing expected cash flow estimates, it is the securities market process of translating information on firm activities into share prices which determines whether SWM is actually achieved. This raises important questions. For example, does the securities market discriminate among different sources of net cash flows based on ethical concerns? Addressing this point leads to an empirical question: how to assess whether observed share prices reflect valid ethical considerations on the part of management? The EMH approach suggests specifying a model of share price determination and testing a joint hypothesis. For present purposes, the relevant null hypotheses will have an explicit ethical component.

This discussion again raises a key question which was identified in Section I: what constitutes ethical or socially responsible behaviour by management? In other words, what types of behaviour *should* be reflected in share prices? In certain respects, this question cuts to the core of the ethical foundation of SWM. Much as in the ethical debate over profit maximization, there is a conflict between different approaches. There is often an implied tendency for those favorably disposed to SWM (or profit maximization) to take a narrow view of ethical behaviour where ethical is loosely defined as legal. In this 'ethical is legal' approach it is argued that appropriate ethical behaviour is dictated by society which imposes numerous civil and criminal legal restrictions on business behaviour: bond covenants, labour laws, product liability statutes, and so on. The potential for gains arising from illegal or "unethical" practices is obviated by the securities market which assesses punitive costs to illegal actions.

In opposition to the 'ethical is legal' view are a

range of positions representing various ethical frameworks. Numerous persuasive arguments against the 'ethical is legal' view have been advanced, e.g., that the legal system is not immune to manipulations of economic interests, resulting in a legal structure which permits management to engage in unethical activity (Grant, 1991). In effect, it is possible to argue both that some legal activities are not necessarily ethical and that some ethical activities are not necessarily legal. If this is the case, some *a priori* set of ethical criteria must be established in order to evaluate the ethical implications of SWM. It is possible to further expand the criteria beyond purely ethical requirements to include considerations about corporate social responsibility. However, this significantly increases the potential for disagreements over what constitutes appropriate behaviour. In addition, empirical testing of whether adhering to SWM produces socially responsible outcomes would require specifying an appropriate model of pricing behaviour.

In any event, it is difficult to get around the normative requirement of identifying what types of ethical or socially responsible behaviour *should* be incorporated into security prices. If the ethical requirement is legality, then the security price impact of illegal activities can be examined to assess whether SWM induced ethical behaviour. If some broader definition is imposed, then different types of activities could be examined. In practice, the process of testing a given view will be difficult. In addition to the need to specify an appropriate joint hypothesis, specific ethical issues of interest may not have a price impact. In these cases, it must be concluded that SWM does not provide much guidance. There may also be substantial variation across firms, industries and countries, significantly reducing the potential for reaching useful generalities.

III. Empirical issues

In Section II it was argued that evaluating whether adhering to SWM leads to ethical or socially responsible managerial behaviour cannot be fully resolved by examining the empirical evidence. Some statement of what constitutes acceptable behaviour is required and, given the complexities of ethical issues, there will be disagreements over what is appropriate.

Given this, under certain assumptions, it is possible to formulate specific joint hypotheses which could give insight into some facets of the issue. In this vein, while relatively limited in number, there are theoretical and empirical studies which relate to the share price impact of various forms of ethical or socially responsible behaviour by management. Potentially relevant topics which have been examined include price-fixing, South African divestment, investment in nuclear generating capacity by electric utilities, and hostile takeovers. A number of these studies were designed to directly address the SWM issue. Ignoring problems arising from potential methodological failings in given studies, it is possible to draw some limited inferences from the evidence that is available.¹²

Of specific relevance to the 'ethical is legal' view is the evidence on price-fixing, an illegal activity specifically aimed at being risk-reducing. In theory, price-fixing is also likely to result in increased entry of new firms to the industry, increased excess capacity, and lower profits (Waldman, 1988). If management is pursuing SWM, price-fixing actions could be theoretically rationalized by arguing that losses in profit are offset by a lower discount rate, due to lower business risk, resulting in a higher NPV. However, if SWM does lead to 'ethical is legal' outcomes, then price-fixing activity will ultimately result in reductions in shareholder wealth. Empirically, Bosch and Eckard (1991), Cloninger *et al.* (1987), and Skantz *et al.* (1990) report significant negative returns to shareholders associated with public disclosure of legal action aimed at correcting corporate pricefixing. While it is appealing to conclude otherwise, this evidence could be interpreted in a number of ways. For example, while the lower returns could be attributed to the market assessing punitive costs for unethical behaviour, it could also be due to perceived increases in business risk, unrelated to ethical concerns.

The evidence of price-fixing illustrates the difficulties of invoking the EMH joint hypothesis to test whether adherence to SWM leads to ethical outcomes. Because the negative return reported in the empirical studies is associated with the event of getting caught rather than the actual act of price-fixing, there is the question of what information was initially incorporated in prices. If the initial share prices were based on information indicating that the

firms were engaged in price-fixing activity, the negative returns could reflect the need to change to a riskier, more competitive, lower NPV business policy. In this case, the expected litigation costs and fines resulting from the court cases would already be, at least partially, discounted into the price. On the other hand, if the price-fixing had been conducted in a covert fashion, then announcement of legal action would require the price to be readjusted to account for the costs associated with the unethical activities, i.e., litigation costs, fines, and loss of goodwill. In this case, the costs associated with changing to a more competitive business policy would already be reflected in the price.

This potential for drawing conflicting conclusions from a given body of evidence carries over into other areas of concern. Consider the evidence on a corporate responsibility issue: South African divestment. Patten (1990) examined the stock price behaviour of publicly disclosed US corporate signatories to the Sullivan Principles and found evidence that investors do use social responsibility information in making investment decisions. Similar results were reported by Blinder *et al.* (1991), though this study found much of the abnormal shareholder gains to holding divested Canadian companies had dissipated by the early 1980's. Feigenbaum and Lowenberg (1988) found that divestment was a major consideration in the holdings of the most important US stock holding institutional group, pension funds. Various other sources also confirm the superior investment performance of divested portfolios, though in certain cases these results may be due to a combination of factors and not exclusively related to social concerns of investors being reflected in share prices, e.g., a disproportionate investment in Far East vs European stocks in international stock portfolios.¹³ It is also possible to interpret this evidence in a number of ways.

Specifically, based on the NPV approach, corporate financial theory postulates that changes in either the perceived discount rate or the expected net cash flows can produce changes in security returns.¹⁴ Hence, the superior performance of divested funds could be due to either ongoing increased risk or a deterioration of expected business performance of South African corporations, i.e., the abnormal returns were not related to concerns about social responsibility but rather to changes in expected

investment profitability.¹⁵ The risk and expected return issue is also related to assessing the affect of social responsibility on investment in nuclear electric generating capacity. While Fuller *et al.* (1990) found that financial markets valued nuclear utilities at approximately 20% less than comparable non-nuclear utilities, careful consideration of these results reveals that changes in perceived "risk" due to events such as Three Mile Island and the Washington State Public Power Supply System bond default may be responsible for the observed valuations. In effect, while it is tempting to conclude otherwise, it may be coincidental that social responsibility considerations were involved in a positive fashion.

In general, the problem of untangling the impact of a given type of activity on stock prices is complex. In addition to the difficulties already identified, allowance must also be made for the possibility that management is not oriented to pursuing SWM. Specifically, there is considerable theoretical and empirical evidence indicating that, in many cases, management may unethically pursue their own self-interest when these interests come into conflict with SWM, e.g., Findlay and Whitmore (1974), Jensen and Meckling (1976), Jensen and Smith (1985).¹⁶ This gives rise to various potential "agency costs" associated with monitoring management activity which ultimately results in lower shareholders returns. When agency costs are present, various facets of the specification and interpretation of empirical tests are further complicated. In addition to evaluating the potential relationship between ethical or social responsibility concerns and SWM, it is necessary to account for the impact of changes in market valuation associated with agency costs. This imposes considerable requirements on the empirical researcher to adequately specify tests of hypotheses that market prices reflect ethical considerations.

The evidence on price-fixing provides a useful illustration of how agency costs can alter the interpretation of empirical results. To see this assume that: in the absence of information to the contrary, the securities market sets share prices under the presumption that management is pursuing SWM. Given this, the announcement of legal action may produce negative shareholder returns not because the unethical illegal activity resulted in a significant reduction in the shareholder's perceived claim to the discounted expected future cash flow, but because of

the increased costs associated with monitoring management to ensure that SWM is being pursued. On balance, without some method of evaluating what type of information was contained in the initial share price, it is difficult to assess whether a specific pricing event reflected ethical considerations. Again, this raises the necessity for careful consideration of both the design and interpretation of a given empirical study.

Agency costs may also play a role in evaluating results of studies for other types of potentially unethical activity, particularly in the mergers and acquisitions area where management may have access to information which is not available to shareholders. In this vein, relevant empirical evidence is available on hostile takeovers. Recognizing that there is currently an ongoing debate about what constitutes ethical behaviour in this area, e.g., Almeder and Carey (1991), Jones and Hunt (1991), it is possible to assume (perhaps incorrectly) that hostile takeover activities are "unethical". Given this, the empirical evidence would appear to indicate that the market rewards ethical behaviour: typically, the returns to targets rise substantially while the hostile bidder's returns are negative to zero in the period following the announcement of hostile takeovers, e.g., Baradwaj *et al.* (1990), Franks and Harris (1989), Huang and Walking (1987), Jarrell (1985). In addition, due almost surely to the presence of agency costs, the use of 'shark repellants' or 'poison pills' by target management is likely to produce significantly negative returns for target shareholders, e.g., Meulbroek *et al.* (1990).

Can these results be used to support the proposition that ethical concerns about hostile takeovers are reflected in security prices? As it turns out, this evidence tends to raise more questions than are answered. For example, given the *ex ante* potentially small or negative returns to bidders from hostile takeover activity, it is difficult to argue that bidding management is pursuing SWM, i.e., there are potential agency costs, undercutting the connection between the observed evidence on ethical behaviour and SWM. However, it also is possible that bidder management does not knowingly pay too much for targets (Seyhun, 1990); part of the target bid premium is recouped through labour wage concessions (Rosett, 1990); and, 'unethical' overbidders will be more likely to become future targets than bidders

that were able to increase firm value (Mitchell, 1990). Given this array of apparently conflicting evidence, only the hypothesis concerning potentially unethical use of anti-takeover measures is supported by observed price behaviour. This is almost surely due to explicit firm value reduction inherent in the anti-takeover strategies, i.e., agency costs are present.

IV. Conclusion

It was argued in this paper that SWM accepts the ethical requirements inherent in a market-based system of evaluation: the price behaviour of the corporation's common stock is taken to be the most appropriate indicator of managerial performance. Even though managerial decisions may be formulated with specific ethical concerns in mind, in the process of determining the stock price the securities market decides whether these decisions are consistent with SWM. This raises a fundamental empirical question: to what extent are considerations of ethics and social responsibility reflected in securities prices? In this vein, while a number of relevant results are available, a need for carefully constructed empirical studies on pricing implications of unethical behaviour is indicated. However, even if agreement could be reached on the complex problem of what constitutes "ethical and socially responsible" corporate behaviour, various theoretical and methodological problems may prevent a completely adequate resolution of the issue on empirical grounds.

At a more abstract level, even if it could be established that the securities markets "adequately" rewarded specific types of ethical corporate behaviour with enhanced stock prices, it still does not follow that pursuing SWM will necessarily result in ethical or socially responsible business behaviour in aggregate, i.e., that 'the social responsibility of business is to maximize shareholder wealth'. This hypothesis is considerably more complicated and would require introducing factors, e.g., government activity, which are outside the realm of securities pricing. In addition, given the limited empirical information on the impact of ethical concerns on security prices, management may choose to be ignorant, preferring to believe that less than ethical courses of action are consistent with SWM. The

implied reduction in the stock price from its maximum value may not be sufficient to induce the market sanctions, e.g., takeover bids or shareholder revolt, required to produce a change in managerial policy. In effect, even if SWM does require ethical managerial behaviour, market forces may not be sufficient to induce management adherence to SWM.

From this background, what can be concluded about the potential for SWM to induce ethical or socially responsible corporate behaviour? Regarding social responsibility, there appears to be little direct support for the proposition that pursuing SWM will cause corporations to be socially responsive. Indirect evidence on this position can be found in related empirical studies which have found no substantial relationship between corporate financial performance and social responsibility, e.g., Arlow and Gannon, 1982, Cochran and Wood, 1984.¹⁷ Where significant results have been reported, sensitivity to the choice of the measure used for social responsibility is observed. Low correlation (e.g., less than 0.50) between widely used measures is also found, McGuire *et al.*, 1988, reflecting the level of disagreement about what constitutes socially responsible behaviour. Consistent with the observations made in Section III, appropriate recognition of the role of risk appears to be necessary for adequate interpretation of empirical results (McGuire *et al.*, 1988, Ullmann, 1985).

Despite considerable effort being given to developing a theory of corporate social performance, e.g., Wood, 1991, if SWM is the primary corporate objective there appears to be limited incentives for management to pursue a general agenda of socially responsible goals, except where the stated goals directly coincide with achieving SWM. In this regard, there will likely be differences in the incentives for achieving specific goals across industries and between firms within the same industry, e.g., due to size or age of assets. As stated previously, gathering relevant empirical evidence will require careful specification of the hypotheses being tested. Even if this can be adequately done, the potential for significant differences in defining and measuring what constitutes socially responsible corporate behaviour effectively precludes a fully satisfactory resolution of the issue. Analyzing corporate social responsiveness where SWM is taken to be the primary objective

requires a substantial improvement in the current understanding of firm behaviour.

The case for SWM inducing ethical, as opposed to socially responsible, behaviour is less clear cut. Based on available empirical evidence, a reasonable *ceteris paribus* conjecture is that SWM is capable of deterring illegal behaviour, i.e., share prices react with a significantly negative revision in stock returns when intentional illegal corporate activity is revealed.¹⁸ In general, in the absence of ongoing corporate behaviour to the contrary, e.g., a history of illegal activity, it appears reasonable to assume that the securities market presumes corporations do attempt to adhere to legal restrictions involving substantial penalties.¹⁹ For similar reasons to those advanced in the discussion of social responsibility, it is difficult to argue for a wider concept of ethical content being reflected in security prices. Given the current state of empirical knowledge, the narrow view that 'ethical is legal' is the strongest maintained hypothesis that can be claimed for SWM. Given the considerable vagaries involved in identifying what constitutes legal behaviour, validating even this relatively weak maintained hypothesis presents significant difficulties.

Notes

¹ The issue of whether increased teaching of ethical content leads to corresponding increases in ethical awareness and reasoning by students is currently unresolved, e.g., Weber (1990).

² Those unfamiliar with basic notions of corporate financial theory have a number of excellent, accessible sources which can provide the relevant material, e.g., Brealey and Myers (1988) and Copeland and Weston (1979).

³ The basis for this statement is the presumption that unethical behaviour is *a priori* undesirable. Hence, the observed lack of attention to ethical concerns in corporate financial theory reflects an implicit assumption that appropriate ethical requirements (whatever those may be) are satisfied. The statement is not intended to negate the wide diversity of ethical views which could sustain or deny the ethical implications SWM.

⁴ Agency costs arise when managers pursue objectives which are contrary to shareholder desires. The terminology is associated with managers being "agents" for shareholders.

⁵ Among other things, the Pareto optimal requirement is restrictive because it does not lead to a specific equilibrium, rather only a set of potential equilibria. To pick out a

specific optimum optimum some form of a social welfare function is required. However, the specification of such a function is problematic, e.g., due to the difficulties raised by Arrow's impossibility theorem.

⁶ This position is an application to corporate finance of the more general view of Fama and Miller (1972) where: "The theory of finance is concerned with how individuals and firms allocate resources through time."

⁷ In addition, these differences can produce differing decisions. For example, it is possible to increase "profits" by issuing additional securities and purchasing net income producing assets, but with lower than acceptable risk-adjusted returns. Given this, it does not follow that profit increasing activities would be acceptable to the owners of the firm, i.e., profit maximization is not necessarily consistent with maximizing the utility of shareholders. At a more practical level, given the necessity of accounting statements for assessing corporate performance, it is not clear how profits are to be defined, e.g., earnings before interest and taxes or earnings available to shareholders. For this reason, earnings per (common) share (EPS) is often used instead of profit. However, maximizing EPS also can produce different solutions than SWM, e.g., by not adequately accounting for risk.

⁸ At this stage an important line of argument is being ignored. Specifically, it is possible that management perceives the shareholder's expected utility function to depend directly on the firm's achievement of ethical or socially responsible outcomes. For certain types of situations, e.g., in the management of ethical investment funds, this is the case. In effect, shareholders are willing to tolerate a lower share price in order to achieve specific objectives. The market for corporate control would be ineffective in this case because the shareholders would not be willing to sell their ownership interest to investor's seeking to acquire control and change firm policies, even though such a change in ownership would result in an increase in the share price. However, this type of argument would, likely, only apply to specific situations.

⁹ Subject to some minor qualifications, maximizing the firm's long run (common) share price is often substituted for the objective of SWM. This follows because the specification of shareholder's wealth involves the number of shares times the price per share. Hence, SWM is directly related to the pricing of the firm's common stock.

¹⁰ In the strategic management literature this approach is referred to as the "stakeholder" model of corporate performance, e.g., Freeman (1984).

¹¹ In turn, to evaluate the discount rate, some model of assessing "systematic risk", such as the capital asset pricing model (CAPM), is typically invoked. Unlike the determination of the expected net cash flows, arriving at an appropriate discount will be less likely to directly involve ethical considerations. While this point was raised by Hawley

(1991), the connection to setting the discount rate was not made. Hence, the conclusion that the CAPM is “modern financial theory’s coup de grace” is not correctly developed.

¹² Potential methodological failings which could arise are failing to risk-adjust returns properly, using total instead of systematic risk measures and not controlling for various problems which can arise in events studies.

¹³ Far Eastern stocks were over-represented due to the stricter prohibitions placed on corporate contacts with South Africa by countries in that region. In turn, Far Eastern stocks as a group earned higher returns during the periods of interest.

¹⁴ It is possible to derive the proposition, as it concerns “systematic risk”, from the CAPM; changes in beta require changes in expected returns. Similarly, the affect of changes in expected future cash flows can be derived either from the NPV rule or as an “alpha shift” in the excess return form of the CAPM. However, this argument is largely theoretical in nature because, for example, it is not clear in practice what the correct market portfolio to use for evaluating South African securities would be.

¹⁵ Various studies, e.g., McGuire *et al.* (1988), have also used total, as well as systematic, risk to measure financial performance. While useful, a well developed theory of how changes in total risk will affect expected security returns is unavailable.

¹⁶ While the notion of agency costs is usually related to topics such as bondholder-stockholder conflict and executive compensation, the usage here is in keeping with the definition given in Jensen and Smith: “. . . agency costs include all costs frequently referred to as contracting costs, transactions costs, moral-hazard costs and information costs” (p. 96).

¹⁷ In this literature there is often confusion as to the measurement of financial performance, with EPS, profitability and various accounting measures substituting for returns to shareholders.

¹⁸ An implication of this view is that illegal behaviour is not predictable. Available evidence on this point, e.g., Baucus and Near, 1991, indicates that there are some systematic elements, e.g., a history of prior violations and membership in certain industries. However, whether specific predictions about illegality are reflected in stock prices is still a topic for future research.

¹⁹ In effect, small infractions such as parking offenses by parcel delivery companies, ‘small’ pollution offenses by chemical companies and so on will not affect security prices.

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