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**Article — Published Version**

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Managerial and Decision Economics

**Provided in Cooperation with:**

John Wiley & Sons

*Suggested Citation:* Follert, Florian; Klingelhöfer, Heinz E.; Daumann, Frank (2023) : The dark side of shareholder orientation: A reflection of Rappaport's concept of shareholder value, Managerial and Decision Economics, ISSN 1099-1468, Wiley, Hoboken, NJ, Vol. 44, Iss. 6, pp. 3277-3288,  
<https://doi.org/10.1002/mde.3877>

This Version is available at:

<https://hdl.handle.net/10419/288074>

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## RESEARCH ARTICLE

# The dark side of shareholder orientation: A reflection of Rappaport's concept of shareholder value

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## Abstract

The concept of shareholder value has been the subject of heated debate for 40 years. Surprisingly, the literature seems to overlook the fact that shareholder orientation by management is something completely different from the implementation of this idea in the well-known shareholder value concept, which aims to measure the contribution of management to shareholder welfare. Using a market-oriented framework, this study shows that the fundamental orientation of shareholders' subjective preferences is supported by a property rights perspective inspired by the ideas of the Austrian School of Economics. In contrast, Alfred Rappaport's shareholder value concept is based on neoclassical equilibrium thinking and, therefore, counteracts the real, imperfect environment of the corporation's decision-makers, especially their subjective values. This results from individual preferences and decision parameters, as well as incomplete and asymmetric information. Thus, it ignores the reality of managerial decision-making. Based on these considerations, we argue that the advocacy of a general managerial orientation toward shareholders' objectives does not logically imply full support for the implementation of the idea under Rappaport's concept. In doing so, this essay contributes to a more differentiated discussion on valuation, corporate governance, and managerial decisions.

## JEL CLASSIFICATION

B53, D25, G31, G32, G34, M21, P12, P14, P17

## 1 | INTRODUCTION

Corporations are characterized by the collisions of (often heterogeneous) interests of different stakeholders. From a business economics perspective, this problem culminates in the question of which group(s) a corporation's management should align its decisions with. The literature discusses a strict orientation toward shareholders versus a pluralistic view that also integrates the goals of other stakeholders (e.g., Clifton & Amran, 2011; Freeman, 1984; Lazonick & O'Sullivan, 2000). Following the shareholder approach, one often finds a bridge to Rappaport's (1981,

1986) shareholder value concept, triggering “the most significant change in American capitalism in the past 40 years” (Fligstein & Goldstein, 2022, 72). In this respect, creating value is understood as “considering the interest of shareholders while making financial decisions [...] and taking steps to maximize the shareholder wealth [...] by capital appreciation with the increase in market value of shares or in the form of dividends or both” (Venugopal et al., 2019). This argument conforms to the view that shareholders are the ultimate owners of the business and the risk takers.

However, the literature ignores the fact that implementation by Rappaport (1979, 1981, 1986) and his successors (e.g., Byrne &

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Stewart, 1992) is completely different from the basic idea of shareholder orientation in theoretical terms. This connection between a corporate governance perspective and managerial (financial) decision-making is noteworthy because it mixes two sets of problems which, taken together, lead to a potentially inaccurate picture of the shareholder approach. This dangerous conflation is reflected in the expression “shareholder value capitalism” (Fligstein & Goldstein, 2022). Therefore, in the following sections, we will show that a general orientation of management toward the shareholders' subjective goals and Rappaport's approach to precisely *measure* the shareholder value do not have a unified theoretical foundation, and even contradict each other. While the owner orientation is a direct consequence of a market orientation that explicitly considers the shareholder's individual objectives and their individual situations and opportunities (their decision field), the practical implementation of Rappaport's concept refers to a quite simplistic static market view.

To contrast these different views, the argument of this study is built on a market-oriented analytical basis inspired by the Austrian school of economics that sees the market as a dynamic process (e.g., Huerta de Soto, 2009; Kirzer, 1973) but without the concept of general equilibria used in mainstream management and entrepreneurship research (e.g., Bylund et al., 2022; Klein & Bylund, 2014). This mainstream research generally starts from the features of a perfect and static efficient market—in contrast to the concept of dynamic efficiency established by Austrian scholars like Schumpeter (1942, 1968 [1911]), Kirzer (1973), or Huerta de Soto (2009)—but does not refer to (in reality normally given) market imperfections that restrict a usual shareholder, such as incomplete information, individual (time and perhaps even investment) preferences, other opportunities different from the capital markets, limited borrowing and lending conditions (often even at diverging interest rates), and the nonexistence of a market value that equally applies to all market participants. Therefore, like Bylund and Packard (2022) but in a different context, we note a break between theory and real markets.

Thus, this study elaborates that literature often mixes things that have no common theoretical grounds, while a shareholder orientation can be theoretically derived from a capitalistic framework. Rappaport's prevailing implementation, which is associated, among others, with an—often criticized as “just”—short-term increase in share prices, contradicts the usually individual objectives and decision fields found in businesses. In particular, a company's decision-makers usually act under conditions of imperfect and incomplete markets, and their objective might not necessarily be to maximize the value resulting from the possible sale of shares and/or dividends today.<sup>1</sup> This may be a reason why the discussion about “shareholder (value) capitalism” has led to controversy and a differentiated view has been missed. While the establishment of a measurement concept for the creation of shareholder value can be understood as an attempt to legitimize shareholder orientation (Aglietta, 2000) since the 1980s, this justification is not necessary.

To not run the risk of confusing the two different perspectives in this paper, we will refer to “shareholder orientation” or “shareholder approach” when referring to the fundamental orientation of a

corporation's management to its owners. If we mean Rappaport's concept, we will speak of “Rappaport's shareholder value.” We list Alfred Rappaport as the founder of this concept (1981, 1986), although there have been numerous further developments (e.g., Byrne & Stewart, 1992; Stewart, 1999) with similar theoretical bases. At this point, we would like to point out that we deliberately refrain from giving a concise definition of the term “shareholder value.” This is because Rappaport's concept covers a wide range of approaches and instruments. To avoid narrowing down our study to a single perspective, we deliberately keep the concept open and try to focus on the theoretical basis as a common feature of the many different instruments of Rappaport's approach.

The remainder of this paper is structured as follows. In Section 2, the literature on shareholder value is reviewed. In Section 3, we argue, based on the perspective of a mainly Austrian economics framework, that a strict orientation toward shareholders is both appropriate and necessary. In Section 4, we contrast this view with Rappaport's neoclassical concept, which is obviously not in line with most markets in reality since they are neither perfect, nor complete, nor static efficient. Finally, Section 5 draws essential conclusions for future research at the interface between corporate governance, managerial economics, decision-making, and management control in business practice.

## 2 | LITERATURE REVIEW

The basic idea of the management's shareholder orientation has prominently been pointed out by Milton Friedman (1970), according to whom “an entity's greatest responsibility lies in the satisfaction of the shareholders” (*Friedman Doctrine*). In accordance with this, it must be the target of a company to maximize shareholder wealth. To operationalize the basic idea into a managerial concept, Rappaport (1986) made an important contribution to the development of the concept of shareholder value. In particular, he shows that accounting-based instruments are generally unsuitable for evaluating shareholder-oriented management decisions. With the emergence of Rappaport's shareholder value concept propagated, the definitional boundaries between general shareholder orientation and the concept of measurement have blurred. Various research has been conducted to address the following questions:

1. How can it be justified that management make decisions according to maximizing shareholder value and where are the limits of this justification?
2. What determinants influence shareholder value? What instruments can be used to increase shareholder value?
3. What instruments can be used to measure shareholder value? How can these instruments serve as a guide for management?
4. How does the strict orientation of shareholder value maximization affect other aspects like market structure and employees?

**Ad 1:** Various studies justify a management orientation toward shareholder value (e.g., O'Connell & Ward, 2020), while others criticize it

(e.g., Fontrodona & Sison, 2006). To this end, the following lines of argument are regularly used: A contractual obligation for management to maximize shareholder value is derived from agency theory (Davis & Thompson, 1994; Dobbin & Jung, 2010; Fligstein, 2001), but this neglects the complexity of the situation (Letza et al., 2008; Pargendler, 2016). From the perspective of controlling management, shareholders play a paramount role, as they can sanction management decisions. However, management is also bound by other obligations that may be derived, for example, from the legal system or moral values (Letza et al., 2008). Hence, it should be taken into account that in case of deviations the management can also be sanctioned.

Further, it is argued that shareholders are entitled to residual income due to the fact that they provide funds to the company. Since all other stakeholders are compensated by contract income, shareholders bear a significantly higher risk and, therefore, have an interest in the long-term existence of the company (O'Connell & Ward, 2020). However, the argument is that other stakeholders do not receive contract income from the company either (O'Connell & Ward, 2020). Finally, some authors claim that shareholder value positively correlates with general welfare (Morck, 2014). Thus, employees, customers, taxing authorities, and other stakeholders benefit from a prosperous company. This fact is also regularly put into question; Jones et al. (2016), for example, emphasize that the orientation toward shareholder value would have led to "massive layoffs," which would have resulted in significant reductions in the welfare of the workforce.

**Ad 2:** Research recognizes that various factors influence the shareholder value:

- Corporate governance channels the actions of the board of directors; in this way, it reduces typical agency problems in a company (e.g., Prahalad, 1994) and
- Capital structure, in particular,
  - the use of a leverage effect on shareholder value (Atiyet, 2012; Eljelly, 2004; Niresh & Alfred, 2014)
  - control of working capital (e.g., Boisjoly et al., 2020; Kent et al., 2017),
  - company size, sales growth, and liquidity (e.g., Jahfer, 2015; Serghiescu et al., 2014).

**Ad 3:** The shareholder value is regularly equated with shareholder wealth, that is, with the value of shares and/or dividends (Venugopal et al., 2019). Thus, traditional accounting measures, such as earnings per share (EPS), return on investment (ROI), return on capital employed (ROCE), and return on equity (ROE), are unsuitable for measuring shareholder value (Chen & Dodd, 1997; Venugopal et al., 2019). Against this background, many studies have identified indicators such as economic value added (EVA), market value added (MVA), and created shareholder value (CSV) (e.g., Byrne & Stewart, 1992; Fernández, 2002; Petwson et al., 1996). However, other studies deal critically with these instruments (e.g., Biddle et al., 1997). In addition, several empirical studies have been conducted on these indicators, in which the quality of these indicators to predict shareholder value is

analyzed (e.g., Chen & Dodd, 1997; Elali, 2006; Hall, 2016; Subedi & Farazmand, 2020; Turvey et al., 2000). For example, Chen and Dodd (1997) found that EVA is a useful metric for measuring shareholder value, but there are other metrics that deliver the same information. However, Hall (2016) finds that accounting-based variables (EPS, ROA, and NOPAT) are better suited to explain shareholder value creation than economic-based variables, such as EVA and ROCE.

**Ad 4:** A branch of the research on shareholder value deals with the effects of management following this paradigm. The analysis of these effects is regularly combined with normative demand for a new management orientation (Fligstein & Goldstein, 2022). This means that on the one hand, there are studies that aim at a positive analysis. On the other hand, there are studies that normatively call for a move away from shareholder orientation from the effects. Essentially, the following aspects of shareholder value are subject to more detailed analysis:

- Effects on profits (e.g., Fligstein & Shin, 2007; Jensen & Ruback, 1983; Ravenscraft & Scherer, 1987) and competitiveness of companies (Davis, 2018a; Hansen et al., 2013). For example, Jensen and Ruback (1983) show that corporate takeovers have positive effects on the target firm's stock price, and that "bidding firm shareholders do not lose." According to Hansen et al. (2013), orienting management toward shareholder value leads to an improvement in the competitiveness of the company.
- Management preferred actions. Empirical studies conclude that share buyback programs are a frequently used instruments to increase shareholder value (Lazonick, 2009, 2013).
- Effects on competition (concentration overall and on individual markets; Boushey, 2019; Grullon et al., 2019; Philippon, 2019). Orientation toward shareholder value seems to lead to greater concentration in the market. This is shown, for example, by the studies conducted by Boushey (2019) and Philippon (2019) in selected American markets.
- Effects on management behavior—management strategies (Davis, 1991; Westphal & Zajac, 1998, 2001) and remuneration (Bebchuk & Grinstein, 2005; Dencker & Fang, 2016; Shin, 2014). Davis (1991) found that management influences the use of poison pill mechanisms to prevent unwanted hostile takeover bids. Further, studies show that management remuneration has risen considerably because of its orientation toward shareholder value (Dencker & Fang, 2016; Shin, 2014).
- Effects on the work force. In summary, related empirical studies show that the orientation of management toward shareholder value has led to employee layoff, union membership decrease, pressure on wages, a reduction in other benefits for employees, such as health care programs, and increased outsourcing (Averett & Hotchkiss, 1995; Blank, 1990; Cobb, 2015; Currie & Yelowitz, 1999; Fligstein & Shin, 2007; Gustman & Steinmeier, 1999; Kochan & Dyer, 2020; Weil, 2014). Effects on income distribution cause changes in income structure (Dencker & Fang, 2016; Falato et al., 2021; Shin, 2014), wealth distribution (Saez & Zucman, 2016), and the role of trade unions (Fligstein & Shin, 2004; Shin, 2013).

- Increasing financialization: The increasing dominance of the financial sector is triggered by management's orientation toward shareholder value (Davis, 2018b; Jung & Lee, 2022; Pernell, 2020).

Since this study aims to work out that shareholder orientation by management is based on a completely different paradigm than the implementation of this idea in the well-known shareholder value concept by Alfred Rappaport, only research strands 1 to 3 are relevant for further consideration, as research branch 4 does not deal with the fundamentals of the paradigm. The first aspect will be analyzed based on the market-oriented view, particularly supported by the Austrian school of economics. We then use the central assumptions of this theoretical foundation to critically assess the third aspect: the measurement of shareholder value. It becomes apparent that operationalization based on Rappaport's concepts, which are now considered established, is truly problematic and partially contradicts the realities of entrepreneurial and managerial environments.

### 3 | SHAREHOLDER ORIENTATION: EQUITY AS STARTING POINT FOR ENTREPRENEURIAL ACTIVITY

Private property can be viewed as an absolute right. Given the ownership of one's own body, one may dedicate all related abilities to a productive activity and appropriate the resulting fruits (Hoppe, 1993; Locke, 1690; Rothbard, 2009 [1970]). Since people have different abilities, knowledge, and expectations (von Hayek, 1937, 1945, 1952), it is understandable that inequality exists with regards to property rights. However, von Mises (1998) [1949]: 272) noted that in a pure market economy, richness is a result of "filling best the demands of the consumers" and can be preserved "only by continuing to serve the consumers in the most efficient way."

As the entrepreneur combines production factors (Gutenberg, 1965), property usually represents the beginning of productive activity; hence, equity capital sets entrepreneurial activity into motion.<sup>2</sup> It also assumes a liability function vis-à-vis creditors if the entrepreneur fails to meet his contractual obligations; for example, the entrepreneur contracts with employees and suppliers, from which both of these derive claims, even before he has received a single dollar from his product sale. Instead, the entrepreneur or owner is only entitled to residual income after all stakeholders have been satisfied, thus bearing risk (Knight, 1921, 1942: 127). Therefore, according to von Mises (1920, 1932), private ownership, which allows trade, enables pricing and economic calculation (e.g., Boettke, 1998; Boettke & Candela, 2023), prevents waste of resources, and ultimately creates wealth.

In the case of an individual entrepreneur, the capital and power of disposal coincide (e.g., Braun, 2022). However, this is no longer the case in a corporation, and a new problem arises (Berle & Means, 1932; Fama & Jensen, 1983; Jensen & Meckling, 1976). Since shareholders transfer the power of disposal of capital to management for an unlimited period, a conflict between agents (managers) and

principals (shareholders) may appear (Jensen & Meckling, 1976). This discretionary potential is important in the context of financial accounting since the annual financial statements prepared by management determine the additional economic welfare (e.g., via the possible dividends) of shareholders.

We cannot say with certainty why an individual invests capital in an enterprise in a specific case. We can only observe and analyze the action starting from the proposition that human action is purposeful, which we accept as a priori true (von Mises, 1998 [1949]).

Assuming that an investment (in the corporation) helps an individual achieve a subjective end, the individual values this investment as better suited to achieve his objective than the alternate action. This is crucial because it implies that the corporation cannot have a "purpose" in itself, but only for a certain individual who assigns it a purpose, uses it as a means to achieve their goals, "the relief from a felt uneasiness" (von Mises, 1998 [1949]: 92).

If we therefore accept that the corporation is a means for the owner to achieve an objective (e.g., welfare maximization), that is, it exists because the owners want it to achieve their goals, then we have taken a first step toward justifying why managers should align with the owners' objectives. The shareholders provide the equity that gets the business going in the first place and bear the risk of other market participants (already Knight, 1921), since only this equity is initially available to satisfy employees, suppliers, and other contractual partners. Investment in this capital allows for the creation of goods that can provide additional value to consumers. Hence, shareholders make an advance payment to receive, via the actions of managers, higher returns later. In this respect, it is only logical from an economic viewpoint that a company's actions are oriented to the relevant decision determinants of shareholders.

This can be explained by the fact that other stakeholder groups are protected by contracts with the company. If we assume that the relationships between

- a supplier and the company,
- an employee and the company, or
- a customer and the company

are based on a voluntary exchange between responsible economic subjects, then, from a utilitarian perspective, there is no reason to base the company's decisions on these groups. If the transactions are voluntary, both parties increase their utility. Contractual partners have the opportunity to incorporate their subjective preferences into the decision and value the equivalent money more than what they offer. In Mises' words:

What gratifies less is abandoned in order to attain something that pleases more. That which is abandoned is called the price paid for the attainment of the end sought. (von Mises, 1998 [1949]: 97)

All groups that voluntarily exchange with the corporation can incorporate their subjective preferences into the decision of whether

to enter into a contract with the corporation. From this viewpoint, one can derive the question: Why should managers, who have been entrusted by the owners to run the company, now also be guided by these groups instead of representing those who entrusted them to do so?

Another misunderstanding of shareholder orientation is that managers who follow the shareholders' objectives do this on the expenses of other groups such as consumers, employees, or other contractual partners. If we assume that managers must base their actions as agents shareholders' objectives, this does not necessarily mean that managers do not act in accordance with the guiding principle of the *ehrbarer Kaufmann* (honorable merchant) (e.g., Albach, 2003; Gerbaulet, 2018). Rather, building a reputation (e.g., Gerbaulet, 2016) with other market participants is a basic prerequisite and, to that extent, a necessary condition for making profits (von Mises, 1998 [1949]). Owing to consumer sovereignty and high competition in many markets, corporations must naturally orient their actions to the needs of their customers (e.g., Bagus et al., 2022). Despite all the powers the entrepreneur wields, von Mises (1998 [1949]:270) brings it to the point:

The captain is the consumer. Neither the entrepreneurs nor the farmers nor the capitalists determine what has to be produced. The consumers do that. If a businessman does not strictly obey the orders of the public as they are conveyed to him by the structure of market prices, he suffers losses, he goes bankrupt, and is thus removed from his eminent position at the helm. (von Mises, 1998 [1949]: 270)

To survive in the market, it is essential for an entrepreneur as well as for a corporation to satisfy the preferences of the contracting parties. Of course, a shareholder-oriented approach will also take this into account. In this respect, it is a truncated and misleading representation that the shareholder approach is only interested in “short-term profitability” and “short-term results” (Fligstein & Goldstein, 2022: 72, furthermore Fligstein & Shin, 2007; Jung & Dobbin, 2016).

## 4 | A CRITIQUE ON RAPPAPORT'S SHAREHOLDER VALUE CONCEPT

### 4.1 | Analytical framework

We would like to investigate whether the two objects of analysis, which we consider separately as “shareholder orientation” and “Rappaport's shareholder value,” are consistent with a market order. Our analytical framework is based on a few concepts that can be considered fundamental to the capitalist view:

- People exchange goods voluntarily to improve their present situation; they do so when the gift is valued individually higher than the counter-gift (Bentham, 2000 [1823]; Block, 1973; Menger, 2007 [1871]; von Mises, 1944, 1998 [1949]).

- They have objectives but can only realize them by using scarce resources (Block, 1973; Menger, 2007 [1871]; von Mises, 1998 [1949]).
- The subjective value of an individual in general, as well as the values expected by entrepreneurs (e.g., Bylund & Packard, 2022), is determined by the marginal utility (Gossen, 1854; Jevons, 1871; Menger, 1871; von Böhm-Bawerk, 1921; von Wieser, 1900; Walras, 1874).
- From a subjective perspective, it does not make sense to try to *measure* the value from an external perspective (e.g., Menger, 2007 [1871]; Mises, 1953 [1920]: 38, 1998 [1949]: 205; Rothbard, 2009 [1970]: 19) as there “is no universal unit to gauge personal satisfaction” objectively (Bylund & Packard, 2022: 1246).
- Nevertheless, the decision-maker in a company needs an economic calculation tool to compute critical prices (Herbener & Rapp, 2016: 8), but von Mises (1998 [1949:329] distinguishes such an appraisal/appraisal from valuation, as it does not value the subjective use, but anticipates the market prices: “Valuation is a value judgment expressive of a difference in value. Appraisal is the anticipation of an expected fact. It aims at establishing what prices will be paid in the market for a particular commodity or what amount of money will be required for the purchase of a definite commodity.”

### 4.2 | Rappaport's neoclassical world—A brief sketch

Rappaport (1981), in selecting the strategies that should create shareholder value, explains that the “economic value of any investment is simply the anticipated cash flow discounted by the cost of capital”—he refers to the discounted cash flow (DCF) analysis as a method of choice to determine this value, criticizing that many companies “use it more often at the project level than at the corporate strategy level”—and advocates its use on a much broader scale, “from piecemeal applications to the entire strategic plan.” To discount the cash flow, he refers to the (risk-adjusted) weighted cost of capital; hence, in total, he follows a neoclassical approach (e.g., Matschke & Brösel, 2021: 16; Olbrich et al., 2015: 9).

Fisher (1906) can be interpreted as the founding father of neoclassical thinking. The Fisher separation theorem (Fisher, 1930) applies in perfect capital markets, allowing investment and financing decisions to be evaluated in isolation. This means that the management of a company (as the owners' agents) can make investment decisions without knowing the shareholders' (i.e., the principals') investment and consumption preferences, motivated by the target to maximize profits. This results from the given identical market interest rate for borrowing and investing unlimited amounts of money in perfect markets, delivering the decision criterion; irrespective of individual preferences, all investments with better returns will be realized, and those with lower returns will not. Hence, by following the objective of profit maximization, management will always make the best decisions in shareholders' interests so that management and owners can be separated.



However, in business reality, these perfect conditions are usually not fulfilled. This may have resulted from restricted and differing borrowing and lending conditions, as shown by Hirshleifer (1958) and Weingartner (1963). Consequently, management would no longer be able to make the best decision, regardless of shareholders' individual preferences. While in a perfect capital market, the unique market interest rate for unrestricted borrowing and lending allows for the realization of the best possible solution in whatever desired point of time (without changing the investment program), this becomes difficult in imperfect markets, as the following simple consideration shows (for an example with different consumption preferences compare Klingelhöfer, 1999): a shareholder interested in maximizing their future money would have a low lending rate as an opportunity; thus, they will still make all investments with higher returns. However, another shareholder interested in maximizing their present money would need to employ credits at usually higher borrowing rates. This will most likely make many of the projects disadvantageous that were still profitable when the lower lending rate was the opportunity. Hence, in imperfect markets, the present or future value of an investment becomes highly subjective, because it depends on individual preferences.

Moreover, manufacturing companies may have opportunities other than the financial market (Klingelhöfer, 2009, 2010), such as investing in other technologies, increasing/reducing production, investing in/closing facilities, employing/laying off workers, or purchases/sales of emissions allowances. Then, both—Rappaport's way of calculating “ordinary” (net) present values, for example, by discounting expected cash flows with exogenous interest rates (even if adjusted to uncertainty), as well as the often considered alternative of (real) option values—become inadequate for the financial valuation of investments. Instead, in imperfect markets, discount rates are endogenous to the investment program (Hax, 1964; Hering, 2004, 2022; Hirshleifer, 1958; Klingelhöfer, 1999, 2006, 2009, 2010, 2017; Weingartner, 1963), and the (net) present values, in most cases, have to be corrected for restricted capacities (Klingelhöfer, 2009, 2017).

This fundamental result implies that there is no theoretical foundation for employing the (risk-adjusted) weighted cost of capital to discount cash flows, as proposed by Rappaport, when referring to employing DCFs. Instead, the theoretically correct discount rates result in investment programs endogenously as (in case of risks: state-related and corrected by the discounted values of the employed restricted capacities) initial interest rates at the particular points in time/states of the then starting boundary investment objects of the company (Klingelhöfer, 2010, for the mathematical derivation Klingelhöfer, 2006). In other words, only under exceptional circumstances, Rappaport's (risk-adjusted) weighted average cost of capital may coincidentally equal the theoretically correct discount rate that delivers the optimal investments.

Furthermore, due to the interdependences between investments, finance, production, environmental protection, and marketing on imperfect markets, it is *usually still not possible* to calculate the additional value of a company resulting from additional projects, by “just” adding up the individual DCFs of these projects; a mere calculation of the net present value of an additional object does not say much

regarding its profitability, because such a net present value does not account for capacity shortages resulting from the realization of this additional object, which, subsequently, may also alter the decision relevance of other objects or capacities (Klingelhöfer, 2010, 2017). In imperfect markets, even theoretically correctly calculated (partially corrected) net present values, employing endogenous interest rates, are usually *not* value-additive.

Consequently, assessing the degree of profitability of an additional single investment or activity within imperfect markets means a comparison of the situation after investing (i.e., the “valuation program” [VP]) to the one before investing [i.e., the “basic program” [BP]] (Hering, 2006 [2021]: 57–59; Jaensch, 1966: 664–665; Klingelhöfer, 2006: 59–91; 2017; Matschke, 1975: 253–257, 387–390). By doing so, a sensible approach implicitly considers (unlike neoclassical approaches) that such a technology investment is usually indivisible—it is either undertaken entirely or not at all. In the case of a greater maximum value in VP than in BP, investing becomes reasonable. Ensuring this by means of a minimum withdrawal constraint, VP computes the price ceiling, that is, the highest possible price  $p$  the company can afford.

Uncertainty may be considered by using trees of future states (Klingelhöfer, 2017: 3 with reference to Magee, 1964a, 1964b; Mao, 1969; Klingelhöfer, 2006: 59–83; Laux, 1971: 19–22, 39–44), which makes valuation under uncertainty similar to that under certainty but without the restrictive assumptions of the Bernoulli principle and its axioms.

However, instead of dealing with a theoretically correct concept that, due to the required data, might indeed be difficult to implement in practice, many scholars take the convenient path of a concept that might be easier to derive mathematically but that requires the unrealistic case of a perfect capital market. Hence, using such simplified approaches is most likely to lead to suboptimal or even incorrect solutions.

Nevertheless, it cannot be concealed that, owing to the high data requirements, the practical implementation of such a calculus, as the one explained, may still face challenges. Therefore, a theoretically justifiable and more pragmatic approach could employ the well-known concept of hierarchical planning, as described by Hering (2022).

Furthermore, instead of condensing the results into a single decision point that gives little idea about the involved risk/uncertainty (even if it is risk-adjusted), a disclosure in the form of a range can be considered (e.g., Hering, 2022). The decision-maker can then select the relevant investment program based on their subjective risk appetite.

### 4.3 | Neoclassical basis and the corporation's reality

The concept of Rappaport's shareholder value and its further developments through various management consultancies (e.g., Copeland et al., 1990; Koller et al., 2020; Stern et al., 1995; Stewart, 1990, 1999) is based on a neoclassical understanding of markets. All models for measuring Rappaport's shareholder value are based on a perfect

capital market. Such a market is among other things characterized by two crucial features (e.g., Hering, 2000, 2022; Matschke & Brösel, 2021):

1. There is an exogenous market interest rate  $i$  at which market participants can invest and borrow capital in unlimited amounts.
2. There is information symmetry between market participants; that is, all individuals have an identical level of knowledge.

**Ad 1.** In a world of perfect markets, things are simple. However, as explained in the previous section, the real world is complex. In imperfect markets, values are subjective as they are highly dependent on the individual decision-maker's objectives and decision field. Different (time) preferences can lead to other values, and the given (restricted) investment and finance opportunities at different borrowing/lending rates, as well as the decision-maker's relevant opportunities (which can be nonmonetary) are highly decision-relevant for the resulting optimal investment program and its value, as explained in the previous section.

**Ad 2.** A crucial problem for the corporation can be seen in the agency between owner and manager (see e.g., Berle & Means, 1932; Fama & Jensen, 1983; Picot & Michaelis, 1984; Rathenau, 1918; Schreyögg & Steinmann, 1981). Jensen and Meckling (1976) laid the foundation for Rappaport's concept by linking incentive-based governance with the issue of value. Indeed, conflict between managers and shareholders cannot be negated. However, the question arises that to what extent a combination of two concepts based on different assumptions can be purposeful?

The basic model of an agency and the resulting problems only exist because there is an information problem (e.g., Arrow, 1985; Holmström, 1979; Ross, 1973; Spence, 1973). The information of all players is incomplete, and there is an information gap between the principal and agent: The agent is better informed about a contract's characteristics and intentions before its conclusion, while control after its conclusion is only possible at very high costs (Jensen & Meckling, 1976).

However, this information problem is negated in the neoclassical-value world. It is assumed that information symmetry exists. It seems almost absurd that firms, in reality, have to deal with information problems on different levels, such as between shareholders and managers in the headquarters and between the headquarters and business units (see Albach, 2001). Nevertheless, Rappaport proposed a neoclassical concept as a solution that does not allow for information asymmetry.

Further, we see that the Rappaport approach regularly refers to the CAPM (Lintner, 1965; Mossin, 1966; Sharpe, 1964) to determine the cost of capital, then the nonmarket mindset of a static equilibrium world becomes even more obvious. In addition to the already discussed assumption of a perfect capital market, the CAPM assumes that

- market participants are risk averse and
- have homogeneous expectations (Lintner, 1965: 591; Mossin, 1966: 769–770; Sharpe, 1964: 424, 428, 433).

Obviously, the last two assumptions contradict the general image of a capitalist entrepreneur (Huerta de Soto, 2009; Kirzer, 1973; Knight, 1921). In particular, from the perspective of the theory of free exchange, it is inconceivable that people always have homogeneous expectations. Instead, it is precisely a precondition of exchange that people have different expectations regarding the future utility of a good, and they may also differ in their risk appetite. Why should all shareholders follow the same objective? For example, what may be waste for one (e.g., used paper) may be a highly sought-after resource for others (e.g., a recycling company). Some people now need money, for example, to finance their education, while others want to save for their retirement. While this would not be a problem under perfect market conditions because of the Fisher separation, under market imperfections, this simple assumption can lead to a completely different investment program.

Similarly, the assumption of static equilibrium becomes a problem. Only market imperfections cause a deviation from this state. However, the real dynamic market process is made possible by these imperfections. Investors and speculators constantly seek (often exclusive) investment opportunities. While this static view is reflected in the single-period representation of the CAPM (Lintner, 1965: 591), real market participants are regularly confronted with a multi-period planning horizon. Within several periods, the framework conditions, such as the information or alternative capital usage, change. This is ignored in the Rappaport approach.

All these arguments let it appear as serious that the CAPM bases its entire equilibrium theory on the assumption that market participants are equally invested in a market portfolio. The majority ownership of a corporation would not be conceivable at all, and it would be impossible for an investment to reach a positive net present value because everybody would need consider it equally in their investment decisions (and, as such, it would be part of the market portfolio) (Klingelhöfer, 2010; Olbrich et al., 2015). Although it would indeed be possible to relax this, since one might allow for an exclusive investment that is only available for one or a few investors, this relaxation itself would imply that, for the respective investors, the market portfolio becomes different; hence, the pre-assumptions for the derivation of the CAPM would be violated (Klingelhöfer, 2010). A further result of this assumption would be that, for the respective investors, different values enter into the calculation of the covariances. Hence, only discounting certainty equivalents but not cash flows with risk-adjusted weighted cost of capital (as explicitly demanded by Rappaport) would lead to results that are consistent with the CAPM.

Furthermore, it should not be forgotten that the remaining pre-assumptions of the CAPM contradict the Modigliani–Miller theorem, although this is an important precondition for the calculation of the risk-adjusted weighted cost of capital (Modigliani & Miller, 1958, 1963); according to the Modigliani and Miller theorem, the world is preference-free; they assume eternal profits, the absence of asymmetric information, and, depending on the proposition, (do not) allow for taxes, while the CAPM, a one-period model, assumes risk aversion and is tax-free. To what degree the other assumptions of the



Modigliani and Miller theorem are fulfilled (perfect and efficient markets, no different treatment of equity and debts with respect to taxes, investors can get credits under the same conditions as companies, investors are indifferent between private debts and shares in levered companies, the borrowing rate does not change with the leverage of the company, and there is no danger of illiquidity and bankruptcy), the reader may decide on their own.

For all these reasons, it is confusing to regard the world of thought in which Rappaport's shareholder value approach operates as capitalist or market based. Rapp (2013) correctly pointed out that the world of thought bears the features of a socialist approach (see also Follert, 2020).

## 5 | SYNTHESIS AND CONCLUDING REMARKS

As we tried to show in Section 2, economic research on shareholder value is very differentiated and addresses various issues. On the one hand, the justification of management's orientation toward shareholder value or its rejection due to the associated consequences is an outstanding subject of relevant research. In addition, research on measuring and influencing shareholder value in the tradition of Rappaport is of immense importance, which is paradigmatically based on the fact that management's orientation toward increasing shareholder value is desirable.

Our approach, which is rooted in the findings of the Austrian School, concludes that it is indeed essential for management to focus on shareholder's objectives but that Rappaport's approach cannot achieve this. The reason for this is that this approach neglects the individual objectives and alternatives, that is, investors' decision parameters. In other words, Rappaport's approach ignores the subjectivity of value, market dynamics, and the existence of market imperfections and incomplete and asymmetric information.

This raises the question of how management's shareholder orientation can be operationalized without falling into the same trap as Rappaport and other neoclassicals.

One may retreat to the position that value, as an ordinally scaled concept manifesting itself only in the actions of individuals, is fundamentally unmeasurable (Mises, 1953 [1920], 1998 [1949]). There is often no common unit that helps compare different subjective values (Rothbard, 2009 [1970]). However, from a practical business perspective, the question is how can the relevant shareholders' objectives be considered in daily business practice.

Goals are often multidimensional and not necessarily financial; however, in several cases, monetary compensation is conceivable, so a calculus to provide a monetary exchange value seems indispensable for practical purposes. If one accepts this, then such a decision-oriented calculus must consider a corporation's real market conditions. Unfortunately, Rappaport's concept of shareholder value does not cater to them but transfers the conditions of the neoclassical market model (which primarily explains market processes) to a different world of managerial decision-making.

While many authors and practitioners refer to the ideal world of perfect markets, they often assume a homogeneous market interest rate for borrowing and lending as the decision-maker's opportunity. In a real world with market imperfections and incomplete and asymmetric information, another benchmark is needed to determine a project's economic attractiveness.

As a result, one may state that the shareholder value concept in the variant of Rappaport's ideas suffers from many theoretical flaws that may lead to incorrect decision-making in practical applications. However, investment theory-based literature offers other concepts that allow better decision-making results. Hence, it is essential that the literature in the field of corporate governance and management control turned to these approaches. This would be welcome for incentive effects in corporations and other organizations.

## ACKNOWLEDGMENTS

We would like to thank an anonymous reviewer for their valuable comments that helped us improve our manuscript. Open Access funding enabled and organized by Projekt DEAL.

## CONFLICT OF INTEREST STATEMENT

The authors declare that they have no conflict of interest.

## DATA AVAILABILITY STATEMENT

The article does not use any data.

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## ENDNOTES

<sup>1</sup> Under the conditions of imperfect markets, the objective to maximize the value at another point in time than at  $t = 0$  will often lead to other optimal investment programs; compare Hirshleifer (1958); Klingelhöfer (2010).

<sup>2</sup> To start the production of specific services, capital might not be necessary. However, arguing with Locke (1690), one could interpret even labor as the result of the productive use of one's own body as capital.

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**How to cite this article:** Follert, F., Klingelhöfer, H. E., & Daumann, F. (2023). The dark side of shareholder orientation: A reflection of Rappaport's concept of shareholder value. *Managerial and Decision Economics*, 44(6), 3277–3288. <https://doi.org/10.1002/mde.3877>