Financialized accounts: Restructuring and return on capital employed in the S&P 500

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Abstract

A central feature of financialization is the argument that the relative autonomy of management has been realigned with the interests of shareholders and their demand for higher returns on capital employed (ROCE). This paper reveals that average ROCE in the S&P 500 has not been transformed in the 1990s, relative to an earlier period, even after extensive corporate restructuring. Deconstructing S&P 500 ROCE reveals how additional cash and profit generated out of income are offset by inflated balance sheet capitalization putting a brake on the ROCE. In the US business combinations are now accounted for at their market value and this, we argue, is forcing a financialized ratchet because management will need to step-up cost reduction to finance balance sheet restructuring. Corporate cash is being used to finance share buy-backs which: facilitate balance sheet restructuring, improve reported ROCE and provide a pool of treasury stock that can be used to reward managers who deliver shareholder value. This paper concludes that the nature and relative scale of these financial transactions can be employed to construct financialized accounts.

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1. Introduction

In “The Modern Corporation and Private Property” (1932) Bearle and Means observed how, over the period 1880–1930, US owner-managed corporate capital had become increasingly concentrated. Corporate growth had generated a need for substantial additional external financing making it increasingly difficult for owners to retain their majority stockholdings and the ownership of share capital becomes increasingly dispersed. In these circumstances stockholders retain beneficial ownership which includes the right to dividends and capital gains from selling shares...
in a second hand market but delegate control to a cadré of professional managers thus separat-
ing ownership from control. This divorce raised concerns about the principal–agent relationship
between investors and managers when the motivations of managers may not coincide with those
of stockholders, for example, managers may prefer to retain cash and profit for expansion at the
expense of dividend distribution. In effect managers become less accountable to stockholders and
Bearle and Means cite that by 1929, out of the top 200 US non-financial corporations, 44% of
managers had stockholding interests of less than 20% a level which Bearle and Means deemed to
be a controlling interest.

When share ownership is dispersed management is able to assume strategic corporate control
employing appropriate organization structures to manage strategy (Chandler, 1962). The deci-
sion, for example, whether to outsource or internalise production acknowledges a positive role
for management (Chandler, 1977). As such management strategy texts are concerned with how
management moves can transform corporate fortunes and sustain competitive advantage (see, for
example, Drucker, 1954; Porter, 1985; Prahalad & Hamel, 1990). Stockhammer observes that a
central feature of managerial capitalism of the post war period has been the relative autonomy of
management but that:

“... through the shareholder revolution, its interests were realigned with those of share-
holders, who have a stronger preference for profits, as opposed to growth”

Stockhammer (2004)

A key feature of the post-war period has been that individual stockholders progressively ceded
responsibility for managing their share capital and this, coupled with the growth in occupational
pension schemes, has led to a pooling of assets under management. Investment banks such as
JP Morgan Chase, Merrill Lynch and Goldman Sachs manage large blocks of corporate share
capital, for example, JP Morgan Chase manages over $1 trillion dollars of equity funds (see
Annual Report, 2005). Asset management is concentrated in a few large companies and their
fund managers are paid generous bonuses if their portfolios perform well. This is an industry
which is dependent on raising fee income which is calculated as a percentage of the aggregate
MV of funds under management (FUM). In a highly competitive market where fee structures
have eroded (McKinsey, 2003) there is additional pressure on the corporate sector to increase
return on capital which, it is generally argued, will strengthen share prices and aggregate MV
of FUM.

Financial incentives and the threat of corporate takeover focus managerial attention on the
objective of increasing return on capital employed (ROCE) for shareholder value (SV). Rather
than rely solely on managerial competence(s) what is required are mechanisms, monitoring sys-
tems and incentives around the metrics of SV that serve to align management behaviour with
investor interests. Managers are encouraged to deliver SV and are paid bonuses or are allocated
share options when they increase return on investor capital (see Fama & Jensen, 1983; Jensen &
Meckling, 1976). If managers do not secure increased return on capital for investors there is an
active market for corporate control that will discipline poorly performing management (Jensen,
1986; Manne, 1965).

During the 1990s consulting companies played an important function advising companies
on how to wrap SV performance metrics into corporate governance and executive remuneration
packages (Boston Consulting Group, 1994; Stern Stuart EVA™, Holt Associates and CFROI).
According to Froud, Johal and Williams (2002) strategy is financialized because management
behaviour is consistent with the interests of shareholders and this is made possible because:
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