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Accounting Forum 30 (2006) 21–41

ACCOUNTING FORUM

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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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Keywords: Financialization; Corporate restructuring; Business combinations; Return on capital

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

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0155-9982/$ – see front matter © 2006 Published by Elsevier Ltd.
doi:10.1016/j.accfor.2006.01.001

in a second hand market but delegate control to a cadré of professional managers thus separating 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 decision, 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 shareholders, 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 systems 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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