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The End of (Shareholder Value) Ideology?

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Frank Dobbin and Dirk Zorn have admirably summed up what we know about how large U.S. corporations have been governed in the past 20 years. As such, I do not have many quibbles with their story. Instead, I would like to argue that the era of shareholder value has now come to a close. This is for two reasons. First, and most importantly, the methods and practices of financial engineering Dobbin and Zorn describe have reached an endpoint in their ability to make corporations more profitable. The recent stock market crash is at least in part a result of investors becoming convinced that firms could not sustain the upward profit path.

Second, the financial scandals of the past few years show the limits of these tactics. Firms like Enron and Worldcom were aggressively pursuing exotic forms of financial engineering with the help of their accountants and the forbearance of financial analysts. They, of course, veered from legality into illegality as they tried to convince investors that their futures were bright. This shows that these tactics could no longer produce bountiful profits and only by pushing them in a questionable fashion could the upward trajectory of profits continue.

The Oxley-Sarbanes Act has made it more difficult for CEOs to cook their books and it has pushed accounting firms out of the business of selling such advice. Financialization in the pursuit of increasing shareholder value has been given a bad name from which it is unlikely to recover. In my essay, I would like to briefly describe why I think this. Then, I briefly illustrate some of this through the Enron case. I conclude with some speculation about the future of the American economy.

The case for my argument is based on the theoretical view that in any given era, there are a set of shared strategies or tactics that produce profits for the largest

corporations. These strategies are based in a common understanding amongst managers and owners about "what works" to make money. I have called these understandings "conceptions of control" (Fligstein 2001). These strategies come into existence, spread across the population of large corporations, and are eventually displaced as they inevitably fail to continue to work as economic conditions change. A conception of control is not just a cognitive framework that suggests how to make money. It helps define and is defined by the social relationships between competitors, suppliers, customers, employees, financial markets, and governments.

These strategies and the social relationships they are embedded in have moved in cycles of approximately 20-25 years for the past 130 years. Political and economic crises such as war, depression, or slow economic growth erode the position of the largest firms. Under those conditions, the old tactics fail and this opens up the possibility exists for a new group of owners and managers to step forward and produce a new path. These new groups are often outsiders who come along and reorganize the way things work. They begin by growing new or existing firms in some spectacular fashion. Once their tactics are understood, there is often a merger movement that pushes the spread of these tactics across firms. At the end, there is often a recession or depression often accompanied by a long bearish stock market. Then the cycle begins anew. There have been 6 distinctive conceptions of control in the past 130 years in the U.S. which I have identified as direct control, monopoly control, manufacturing/oligopoly control, sales and marketing control, finance control, and the shareholder conception of control (Fligstein, 1990, 2001). From my point of view, Dobbin and Zorn have described the current cycle, what can be called the shareholder value conception of control.

In the past, corporations were more likely to be focused narrowly on their principal competitors. But since the 1950s, they have increasingly been involved more closely with the financial markets. During the 1950s-70s, the dominant view was that the large corporation should operate like a capital market. It should have many kinds of products and investments were made to smooth out business cycles. Firms bought and sold other firms in order to exit slow growing and enter fast growing businesses. The extreme form of this approach was the emergence of large conglomerates which used mergers to grow during the merger movement of the 1960s. That merger movement ended in 1969 and the 1970s witnessed an economic crisis caused mostly by the oil shocks. This crisis produced a decade characterized by slow economic growth and high inflation. These were conditions that eventually inspired some managers and owners to begin to look for a new way to make profits.

In the 1970s, the dominant view of corporate managers was that they needed to adjust to the poor economic environment by trying to make themselves less vulnerable to high interest rates, high inflation, and slow economic growth. They did so by not borrowing money and they kept cash on hand to finance their growth. As physical assets (like plants and equipment) were inflating in value, managers tended not to revalue them on their books. Since many of the measures of firm financial performance were based on returns on assets, revaluing assets made their financial performance look worse. The stock market drifted through the 1970s as investors stayed away from stocks and instead invested in bonds which had high yields.

The poor performance of firms brought about a critique of sitting management teams around 1980. Those doing the blaming, not surprisingly, were the representatives

of the financial community: institutional investors, stock analysts, and investment banks. These groups argued that managers were not paying enough attention to shareholder's interest. They felt that managers were not using their assets effectively to earn profits and that this explained firms' poor performance on the stock market. They wanted managers to concentrate on raising profits and thereby raising the stock price. By 1980, many managers found that given the inflated value of their assets and their lack of debt and large hoards of cash, their firms' stock prices were so low that their firms were worth more broken up than as a single entity.

The 1980s and 1990s produced several waves of financial reorganization of American corporations. In the first merger wave from 1979-1987, firms were either broken up or unprofitable capacity was shut down. This produced the deindustrialization of America. Managers realized that if we wanted to stay in control of their firms, they needed to work with the newly mobilized financial community, learn to talk their talk, and make their firms look attractive to investors. Managers who avoided being targets did so by engaging in mergers themselves, spinning off unprofitable businesses, and gathering debt. The "shareholder value conception of control" that Dobbin and Zorn describe focused managerial attention on making balance sheets look good to financial analysts in order to encourage them to recommend the stock and thus, enhance, shareholder value.

Managers realized that their balance sheets were going to be the most important factor in their success or failure. This created huge incentives to engage in financial engineering and to discover how to manipulate balance sheets to get rid of assets and hide any liabilities that might make ratios such as return on capital look bad. As Dobbin and

Zorn note, the natural heirs to power in the firm were the chief financial officers (CFO). Before 1980, CFOs were often little more than accountants or treasurers who played little role in corporate strategy. But as the era of financialization took off, they were the people who could claim to speak to the financial community. By the late 1980s, the relationships between boards of directors, CEOs, CFOs, institutional investors, stock analysts, and the large accounting firms had altered. Accounting firms were offering firms advice on how to make their balance sheets look better while financial analysts were telling CFOs how they wanted their books to look. CFOs followed their proscriptions and engineered the books to produce higher profits for the firms. Boards of directors wanted to be responsive to shareholder interests and if the stock price perked up as a result of using financial tactics, they could claim they were performing their fiduciary responsibility. Managers who focused on stock prices and balance sheets were seen as heroes.

I would like to make the case that the great expansion of shareholder value has reached its endpoint. As I noted earlier, new conceptions of control emerge about every 20-25 years. The shareholder value conception of control has existed for just about that long. New conceptions of control often appear during a merger movement. This is because a merger movement reflects a re-shuffling of corporate assets in line with some new conception of how firms ought to look. The shareholder value conception of control began with the merger movement from 1979-1987. The end of a cycle is often indicated by a stock market downturn which often proceeds or even causes a recession. Markets crash when profit expectations for a particular way of doing business end. Markets often are prescient in their prediction of economic downturn, because the end of a bull market means people expect there to be slower economic growth in the future. The stock market

crash in 2000 was an event at least partially caused by the end of shareholder value. There were, quite simply, unsustainable expectations over the future of corporate profits. One of the reasons that this occurred was because firms ran out of creative ways to do financial engineering and this failure signaled the onset of a market downturn. Not surprisingly, this downturn has been accompanied by an economic recession.

To make matters worse, the crash of the stock market was accompanied by the revelation that financial analysts, CFOs, boards of directors, and auditors had frequently engaged in distorting firms' financial performances in order to boost stock prices. The people who pushed the financial envelope here did so precisely because they had exhausted the easiest ways to make their balance sheets look better. In pursuit of higher gains, they turned to ploys that were illegal. This resulted in some spectacular firm failures and a new piece of legislation, the Oxley-Sarbanes Act. Before turning to the Oxley Sarbanes Act, it is useful to consider the type of thing that firms who were pushing the financial envelope were doing that was illegal. It is instructive to consider the case of Enron who engaged in complex financial arrangements in their attempt to maximize shareholder value.

Enron was on the leading edge of financially oriented corporations that viewed themselves as primarily in the business of creating shareholder value by raising the stock price of the firm. Enron is a case of the shareholder value corporation run amuck. It is useful to describe some of what Enron was doing in some detail because it gives us a flavor of the kinds of things that financially oriented managers were doing in many companies. One of the main measures that firms use to evaluate performance is return on assets (calculated as earnings/assets). Now there are two ways to make this number

bigger: make earnings higher or make assets lower. Financially oriented managers figured out that taking assets off the books could make firms look better. They could do this in several ways. First, they could lease assets like machines, office space, or factories. These costs would then be expenses which would not figure into assets and thus could help their returns on assets.

But, financially oriented managers discovered another way to take assets off the books without having to sell them off entirely. They could spin assets off into subsidiaries and then sell off part of the subsidiary to another firm. This would allow them to book part of the sale of assets as sales and hence have it directly help earnings. Another effect of doing this, was also to allow firms to take all of those assets off their books because they no longer owned them entirely. Instead, they owned part of the subsidiary. This would affect the ratio described above by reducing assets. This ploy allowed the firms to play one other lucrative game. They would pay money to the subsidiary for use of those assets (thereby providing money to their partner for their investment). They could then use that payment in two ways that helped the balance sheet. Part of the money they paid to use the assets would come back to the main firm in the form of profits from the subsidiary (the subsidiary sold the use of the assets to the firm and it was able to report a profit from that activity). The money could also be booked as a cost from the point of view of the main firm. Thus, a firm could affect its earnings by simply paying itself money it already had and simultaneously making a profit from the subsidiary and subtracting an expense. This ploy would affect both assets and earnings and thus make the ratio rise. Financial analysts observing such ratios would then recommend the stock and the share price would rise. Now, if the reader has followed this

discussion, they will be astonished that all of this is legal. But it is. What Enron did was to push the envelope on deals like this (as well as a number of other financially oriented activities) by creating a number of these vehicles that were embedded in one another to create a kind of pyramid scheme. While the executives at Enron used these vehicles in illegal ways, those practices that were legal were widespread amongst American corporations.

The Oxley-Sarbanes Act is an attempt to push firms towards honest reporting of their financial results. It tries to do so in two main ways. First, it forces accounting firms to resume an arms length relationship with their customers. This pushes firms to have to be honest about their financialization tactics and if firms are going overboard puts outside auditors in the position whereby they might discover fraud. Second, it forces CEOs to sign off on the honesty of the accounting. This means that CEOs cannot look the other way. Oxley-Sarbanes is oriented towards preventing the types of excesses that the shareholder value conception of control encourages. It draws a line at legal and illegal activities and forces firms to change their relationships to their accountants.

The end of the bull market driven by firms attempting to maximize shareholder value through financialization and the sealing of that end by Oxley-Sarbanes, suggests we are entering a new era for firms. Not surprisingly, the past four years have produced a shallow recovery in spite of the government running huge budget deficits and the Federal Reserve keeping interest rates extremely low. The basic problem is that firms lack a clear set of tactics to renew the economy.

If we are trying to decipher what those new tactics might be, it is useful to consider the past. It often took 5-10 years for new tactics to emerge. These tactics

frequently came from outside the established core of business. And finally, one looks to find fast growing firms with a new way of doing business to see how money will be made in the "new" economy. Circa, 1998, one might have bet on software and information technologies or biotechnology for showing the new way. But, the spectacular failure of the technology sector and the slow progress of biotechnology to produce useful products, suggests these are not the obvious paths to the new future. A more promising set of tactics is the hollowing out of firms through supply chain management, outsourcing, partnering, just in time inventories, and the extensive use of computer technology to manage flatter firms faster. Companies like Wal Mart exemplify these tactics. These are gains that create new businesses (ie. businesses to teach and help firms attain these gains) and are generalizable across a wide sector of industry. But these tactics do not so far seem to have produced spectacular growth rates (with the exception of a few firms).

The American economy is huge and awesomely diversified across products and geographic space. That some sets of firms will eventually figure out a new way to do business seems likely. The dynamism is there. What seems evident is that the shareholder value focus on stock prices and financial engineering seem to have run out of steam. What will follow is anyone's guess.

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