Financialisation, strategy and governance: or what management has become

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Stream #7: Critical Accounting

Abstract

The argument in this paper has three points of origin: (i) dissatisfaction with mainstream strategy literature which is too preoccupied with the product market, confirming examples and endlessly surprised by unexpected turns of events; (ii) curiosity about how and why corporate governance has acquired such a high profile over the past decade so that what began as a low key response to corporate malpractice is now presented as a key control technology; and (iii) contribution to the growing literature on financialisation and how new relations through the capital market have in the UK and US reshaped macro, meso and micro processes for firms and households.

Our theme is how the intrusion of the capital market since the early 1990s has re-shaped the work of management in the US and UK in a way that requires us to rethink strategy and helps us to explain governance. The result is a more complex view of what management has become as the relation with the capital market compels management of financial results and media representations, against a background of activity constraints arising from the product market which ensures management has many moves but few transforming levers. This context in the 1990s provides the motive and the opportunity for self-serving rapacity which better governance now hopes to control.

The new challenge for the US and UK corporate sector was rhetorically represented in the media by the slogan “shareholder value”. That slogan needs to be distinguished from the social science object of financialisation. As we have argued (Froud et al., 2002), financialisation is a multi level (macro, meso and micro) process which has in the US and UK created a new form of “coupon pool capitalism” with large flows between firms and households and the capital market acting as regulator of behaviour (not an intermediary). Within this macro frame, the argument in this paper is an attempt to figure out how such regulation operates and influences management action and calculation in large quoted US
and UK corporations (ie the FTSE 100 and the S&P 500). In considering the intrusion of the capital market in the 1990s and the 2000s, it is important to distinguish between secular changes (that have persisted over at least one business cycle) and ephemeral changing requirements. The secular change from the early 1990s is that financial results and values became the privileged measures of enterprise success.

The consequences of this change have been: (i) a focus on an earnings hurdle in the form of a target rate of profit in the form of a return on capital employed (ROCE) greater than the cost of capital. In the 1990s, this was 12% plus for all firms (regardless of sector and subject to quarterly reporting); plus ideally growth of corporate earnings either through organic growth or acquisitions; (ii) the importance of maintaining share price at least relative to the market: share price is relevant to all because, in the bull market of the 1990s, (as in the post 2000 bear market) share price is the major source of gain or loss; this is particularly important for those firms with high price earnings (p/e) ratios or those using shares as an acquisition currency; (iii) an emphasis on maintaining credit ratings to allow debt to be raised and serviced relatively cheaply. The (risk of) downgrades not only increases the costs of borrowing but usually also damages share price.

In understanding the impact of the capital market on management calculation, it is sensible to begin by asking how does the large US or UK corporation manage its (newly important) relationship with the capital market? The immediate answer is by (a) delivering financial results and (b) managing media representations. The nature of this work is defined by a world where financial performance is constrained and representations are mutable. Our understanding of the work of managing results and representations has been intellectually prepared by behavioural finance, the shift away from the efficient market hypothesis and the realisation that, in Shiller’s (2000) phrase, an overvalued market rests on the “indifferent judgement” of millions of investors, and politically dramatised by recent US scandals where corporate reputations were built on dodgy accounts and good press.

The management of results and representations is described from a market point of view by Golding (2001): firms must: i) manage expectations; ii) deliver no surprises; iii) create an impression of transparency; and ideally iv) get onto a growth trajectory, whereby what is delivered must be relatively effortless and moving upwards. The product is firm reputation or an account of how and why the firm delivers what it does, generating enough understanding to encourage the belief that the firm will/or will not deliver next year. In the 1990s this was increasingly tied up with the star CEO (positively with GE under Welch, variably with BP under Browne, negatively with AOL/Time Warner under Case). Reputation influences share price, market funding and support for offensive and defensive strategic moves. The method is to incorporate journalists and analysts, as members of a small community, into narratives of trajectory and/or identity which both proliferate and breakdown.

This focus on the management of results and representations changes the work of management, which becomes (at least partly and in appearance) about giving the capital market what it wants. The basic policy for managers seeking a high share price has to be
“find out what the stock market wants us to be and then deliver to that template”. This introduces new complications because it pushes management towards what Orleans (1999) calls “mimetic rationality” when the market’s judgement is usually superficial and the market periodically changes its shallow mind. Against this background, we can understand why the stock market has both a preference for more information and greater transparency that would reduce nasty surprises, as well as a great capacity for inconsistency as it sometimes idolises the opaque. Thus the UK and US stock markets have, from the early 1990s, indicated a generalised hostility to conglomerates and a preference for unbundling. But, as with almost everything else in the market’s repertoire of preferences, the general principle is suspended for acquisitive conglomerates which deliver apparent success.

As for company management, it has to live with the contradictions inherent in the various demands placed upon it and these establish the distinctive character of management in our time. In the 1990s, the representations had a self fulfilling life of their own through the myth of the new economy which became the meso fantasy of the NASDAQ about how the glittering prospects of digital technologies justified sky high valuations, as allocation of venture capital and new issues fuelled a boom in company promotion. The average firm had practical difficulty in delivering the required return on capital employed because, even in the good years of the 1990s, many UK and US firms could not create EVA and extract 12-15% ROCE from the product markets (in which they competed against competitors from Japan or Germany who not only have different cost structures but can happily survive on much narrower margins). Now, in the bear market of the 2000s, the average firm is vulnerable to the new risks, especially the risk of downgrade, which usually makes the task of management more difficult. In early 2003, 45% of US investment grade corporate bonds were rated BBB, just one notch above junk; and only 7 non financial companies in the United States have AAA credit ratings from S&P and Moody’s.

These observations raise a series of questions about management action. What can management do to shift the constraints on financial performance? Or maybe more realistically, why can’t management shift the constraints? The answer brings us back to problems of strategy: management means many operating moves just to keep up with the competition but also few operating levers that deliver sustainable improved financial results in a world where competition is a corporate constraint not an opportunity. Many old and new industries are unattractive to the stock market because in competitive product markets adverse power relations and group behaviour by the firms ensures that benefits are given away to customers.

Even more interesting is the way that, at the level of the individual firm, financialisation has extended the range of generic strategies with only limited leverage. If the mission of management is cost recovery, there are now three kinds of generic corporate strategies which correspond to different kinds of intervention (market, productive and financial): (a) revenue recovery oriented to the product market; (b) cost reduction oriented to process improvement and (c) financial engineering ie working on the financials directly with the aim of impressing the capital market. The problems with all these generic strategies arise
from group behaviour and the distribution of competences. Similarly, (c) financial engineering as a strategic level for a firm is problematic because it mostly offers only short-term gains. Because generic strategies generally do not deliver sustainable advantage and because financial engineering promises more than it delivers, most firms have an operating dilemma about how they “keep it going” for the capital market by delivering the financial results and media representations which justify the share price.

If we try to understand how management acts to keep it going (after generic strategies have delivered all they can), we must understand how management must think divergently about the offensive possibilities of sector matrix moves and the defensive role of continuous restructuring. The end result is management as mystery because it becomes progressively more difficult to judge the relation between cause and effect. Effort and performance is increasingly complicated where short and long term trends, negative and positive, easy and difficult achievements are all mixed up where information and self serving representations add further confusions. This is deeply paradoxical because most markets seek accountability and disparage the clubby arrangements of earlier forms of capitalism where, at least in public, nobody has to apologise or explain.

From this point of view, we can understand how and why the work of corporate management (and even more so consultancy product) often rests on what Zilbovicius calls “sincere lies” ie change initiatives and restructuring are promoted through problem/solution couples which privilege variables, select evidence and assert or assume cause/ effect relations which the reflective know are, at best, half truths. Governance in a broad social sense means the social compromise between stakeholders that sustains the firm. But US and UK public discussion in the 1990s increasingly focused on governance in a much narrower economic sense as the mechanisms that ensure that management acts in the shareholder interest. All this takes place against a background of high profile failures of governance and the reactive promotion of better governance as the solution. Governance in the shareholder interest is not so much an object as a field in which diverse positions on performance and accountability can be developed and the stock market variously figures as part of the problem or the solution. The paper concludes by arguing that the notion of better governance is a narrow, ineffective response to the problems created by the pressures of the market and those who legitimated a stock market based revolution in management pay.

References