Corporate strategy financialized:
Conjuncture, arbitrage and earnings capacity in the S&P500

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Abstract

The conjuncture that ushered in the era of shareholder value served to embed capital market expectations into corporate governance aligning management and shareholder interests. Market arbitrage focussed on modifying contractual relations with stakeholders to extract a (higher) return on invested capital. In this article we focus on cash earnings on capital employed generated by the S&P 500 survivor group of firms covering the period 1990-2008. We use this financial data to construct three complementary perspectives on corporate financial performance: firm, firm-relative and macro. Within this framework the financial numbers and perspectives are analogous to a dhall of mirrorsô where ambiguity and contradiction are in play frustrating the construction of straightforward narratives about strategic purpose and financial outcome. Rather than abandon the approach we argue it has technical merit because it provides the basis to construct alternative critical narrative(s) that explore the limits to strategic purpose and corporate financial transformation in an era of shareholder value.

Key words: Financialization, market arbitrage, shareholder value, earnings capacity

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1. Introduction

> From being a sporadic trait, of doubtful legitimacy, in the old days of the "natural" and "money" economy, the rate of profits or earnings on investment has in the nineteenth century come to take the central and dominant place in the economic system. Capitalization, credit extensions, and even the productiveness and legitimacy of any given employment of labor, are referred to the rate of earnings as their final test and substantial ground. (Thorstein Veblen, 1904:47)
>
> The primary goal of the corporate managers of such companies was to maximize the value of their common stock. Veblen put corporation finance as the centerpiece of his analysis of large, acquisition-minded companies. In Veblen's analysis, the corporate finance structure was capitalized on the earnings capacity of the corporation as a going concern (cited in Ganly, 2004).

In *Business Enterprise* 1904 Veblen is concerned with owner-managers quest to increase the rate of ópro fits or earnings on investmentô or as Ganley (2004) observes corporate earnings capacity which provides the platform for stock market valuation, and thus wealth accumulation for stockholders. Veblen observes that in the modern corporation a complex network of business relations are managed where contractual negotiation and shrewd manipulation are at the centre of things. This position on the firm as a network of contracts up for continual re-negotiation contrasts with Coase (1937), whose objective was to understand why there are firms. That is, under what circumstances do firms establish contracts and consolidate financial transactions that, might otherwise, have been executed by a market mechanism. Veblenôs observation about how owner-managers manipulate contracts with stakeholders for the purpose of boosting earnings capacity and wealth accumulation for owner-managers is insightful and informs the structuring of this paper.

Jensen et al (1976), in a later period, was concerned with the gap that operated between what managers were doing with corporate excess cash resources and the demands of investors for maximum return on capital employed. Jensenôs argument was that debt finance, with its contractual obligation to pay interest, would force

managers either to invest in positive Net Present Value (NPV) investment projects or distribute the free cash back to shareholders. The conjuncture that ushered in the era of shareholder value during the past two decades progressively aligned managerial and shareholder interest closing the principal-agent gap identified by Jensen (Rappaport, 1986, Stern Stuart, 2002). A critical literature identifies contradictory outcomes, for example, suggesting that the era of shareholder value encouraged a policy of ñdownsize and distributeò by US firms that undermined competitiveness (Lazonick and OôSullivan, 2000, Lazonick, 2008). Froud et al (2006) emphasise the discrepancy between managerial narratives and financial numbers where transformation, in a world where strategy is financialized, is often disappointing.

This paper builds on the approach taken by Froud et al where financial numbers are deployed to construct alternative critically engaged narratives. Our ófinancial numbersô framework of analysis is grounded in accounting to make óvisibleô earnings capacity (cash return on capital employed) and our approach takes the form of series of *perspectives* on financial performance: firm, firm-relative and macro using the S&P 500 survivor group[1] of firms. Froud et al observe that ócompany narratives exist in a context that often includes industry narratives and grand narratives of macro-economic trajectoryô recommending that analysis óneeds to distinguish different micro-, meso-and macro narratives whose interrelation can involve contest and challenge as much as support and confirmationô (Froud et al, 2006:126). Our financial framework of analysis in this paper reveals contradiction and ambiguity within and across firm, firm-relative and macro boundaries of analysis which, we argue, like Froud et al, can support the construction of critical narratives that engage with a tendency to exaggerate corporate purpose and financial outcome(s) in an era of shareholder value.

Our micro-level financial accounts reveal how a firmôs earnings capacity is the product of complex and often contradictory market arbitrage interventions within a network of stakeholders. Where, one firmôs relative performance is as affected by the strategic actions taken by other firms as much as those taken (or not) by the individual firm. Whilst a macro perspective reveals the extent to which S&P 500 survivors have

[1] S&P 500 firms listed continuously in the S&P 500 composite index 1990 to 2008

transformed both the level and trajectory of earnings capacity. All three perspectives are, we argue, necessary because they collectively reveal the extent to which earnings capacity has been transformed and form the basis upon which alternative critical narratives can be constructed.

2. Corporate strategy financialized.

In this section we conceptualise corporate strategy financialized using three organizing elements: first the notion of conjunctural break where managerial and shareholder interests align in an era of shareholder value, second market arbitrage to describe how managers (as agents) exploit disturbances between and within markets to modify stakeholder contracts, and third a financial framework to reveal firm, firm-relative and macro perspectives on earnings capacity. Our purpose is to employ the financial numbers and perspectives on financial performance to construct alternative critical narratives about financial transformation in the S&P 500.

2.1 Conjunctural break: aligning managerial and investor interests

In Veblenôs text on Business Enterprise owner-managers are at the centre of things in terms of understanding how corporate finance and physical resources can be deployed to increase earnings capacity and market capitalization for investors. In a later period, Chandler observes that family owner-managers became increasingly decoupled from the strategic and day to day management of the American corporation.

> Owners continued to participate as full-time executives in decisions establishing top-level policy and resource allocation. But in making even these decisions the family members worked closely with full-time salaried top-and middle-level managers who had little or no equity in the enterpriseò (Chandler, 1990:48)

Consider the specific case of General Motors whose stockholders increased from 1,900 (1917) to 343,000 (1936) where over eighty percent of these stockholders held less than 50 shares each (GM Archive, US). Hannah (2007) reveals the extent of the separation of ownership and control in the US but is more cautious about using capital market modernity as an explanation for US superior economic performance.

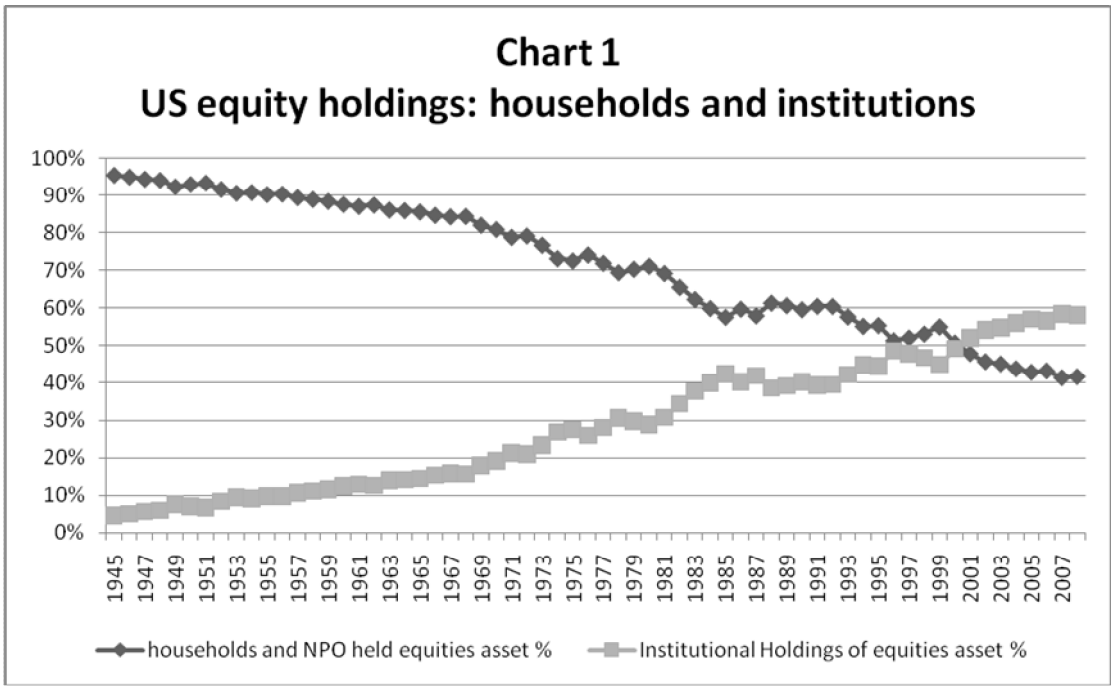
> Slowly, but surely, Americaôs leading industrial firms *did* list on New York: Carnegie Steel (reborn as the core of US Steel) in 1901, Standard Oil in 1920, Procter & Gamble in 1929, Gulf Oil in 1943, Alcoa in 1951. Shareholdings in listed firms also became more dispersed, as directing families trickled out their stocks to the public. Berle and Means really *could,* by the 1930s, celebrate Americaôs having caught up with Britain and overtaken continental Europe in the divorce of ownership from control: by then, in the typical American quoted company, the managers owned only 13 per cent of the equity, a figure identical to my crude London estimate for 1900. (Hannah, 2007: 36)

Arising out of the separation of ownership from control is the argument that managers, as agents might deliver less than the maximum earnings on investorôs capital when interests of managers and investors diverge. Jensen and Meckling (1976) are concerned that corporate resources would find their way into investment projects that delivered less than an optimal return for the shareholder-investor. Jensen (1986) introduces the concept of free cash flow to reveal agency cost as resulting from managers investing in negative Net Present Value (NPV) projects. To limit this behaviour Jensen agues that debt finance, with its contractual requirement to return interest and principal sum to the investor, would act as a disciplinary instrument forcing managers to ensure that returns on investment exceeded the cost of capital.

> Free cash flow is cash flow in excess of that required to fund all projects that have positive net present values when discounted at the relevant cost of capital. Conflicts of interest between shareholders and managers over payout policies are especially severe when the organization generates substantial free cash flow. The problem is how to motivate managers to disgorge the cash rather than investing it at below the cost of capital or wasting it on organizational inefficiencies (Jensen 1986: 230)

A more recent literature on the financialization of strategy (Lazonick and OôSullivan 2000, Froud et al 2006, Millberg, 2008, Millberg and Winkler, 2009) emphasises how the interests of managers and shareholders align. Lazonick and OôSullivanôs contribution to the debate on financialization and corporate governance is their account of how households have delegated management and trading of corporate equity to investment banks on their behalf. According to Froud et al (2002), this form of coupon pool capitalism (share capital concentrated and managed by investment banks and insurance companies) also becomes an institutional regulator of firm behaviour through corporate governance where managerial remuneration is tied to financial performance. In the US throughout the post-war period, households directly

manage a smaller proportion of corporate equities with financial institutions steadily increasing their share of domestic corporate equities (see chart 1)



Source: Federal Reserve Board, Flow of funds tables (Z1) table L213, various years

The conjuncture ushering in an era of shareholder value increases the pressure on managers to extract a higher return on capital invested, for example, modifying the alchemy of business models to boost shareholder value and increase the probability of a higher stock market valuation and wealth accumulation for shareholders (Feng et al, 2001). Millberg (2008) argues that US firms recalibrated their global organisation of production through out-sourcing and off-shoring to extract additional cash from operations. This additional cash resource distributed as dividends, share buy-backs and cash acquisitions to shareholders (Andersson et al, 2007 and Lazonick, 2008) where the demands of financial institutions that manage share capital becomes incorporated into corporate governance structures and incentives driving managerial remuneration and bonus contracts (Andersson, 2009). Many senior executives have remuneration packages that stress meeting certain financial targets such as: earnings per share (EPS), cash and profit return on assets / capital employed, and Economic Value Added (EVAÊ) *relative* to a selected peer group or industry sector. All of these performance metrics combine earnings (as profit or cash) and a measure of capital employed where the general objective is to boost earnings capacity (profit or

cash generated per financial unit of capital employed) relative to other firms in a competition of all against all.

2.2 Arbitraging markets for financial gain.

Coaseôs (1937) seminal paper on transactions costs is concerned with why there are firms and observes that firms exist and survive where the cost of organizing transactions within the firm are lower than the costs of organising in another firm or leaving transactions to be organised by the market (Coase, 1937:14). The transaction cost itself, according to Coase (1960), is connected with the need to:

> é discover who it is that one wishes to deal with, to inform people that one wishes to deal and on what terms, to conduct negotiations leading up to a bargain, to draw up the contract, to undertake the inspection needed to make sure that the terms of the contract are being observed (Coase, 1960:15).

Williamson (1975, 1981), Williamson and Winter (1993) explain how alternative forms of organisation structure arise where the objective is to reduce the cost of negotiation and enforcement embodied in the organisation and expense of transacting. Difficulties arise, however, when trying to identify transaction costs in financial statements and reconciling the variety of theoretical approaches employed to explain why transactions congeal into organisations rather than left to the market.

Rather than try to identify transaction costs and justify why there are firms and how transaction costs can lead to the development of particular forms of organisation we are interested in the issues of negotiation, bargain and resultant contract. Veblen (1904), observed how the development of modern corporation finance resulted in a more complex network of business relations where contractual negotiation and shrewd manipulation are important. And that this mediation is through pecuniary transactions carried out for business ends rather than from simply a narrow efficiency of industry perspective. Veblenôs observations on pecuniary negotiation separates the businessman from the rest of society because they are able to exert discretion and position to exploit change and disturbances in and across markets to (possibly) boost earnings capacity and increase the probability of wealth accumulation for owner-managers.

> In proportion as the machine industry gained ground, and as the modern concatenation of industrial processes and of markets developed, the conjunctures of business grew more varied and of larger scope at the same time that they became more amenable to shrewd manipulation.....
>
> The adjustments of industry take place through the mediation of pecuniary transactions, and these transactions take place at the hands of the business men and are carried on by them for business ends, not for industrial ends in the narrower meaning of the phrase. (Veblen 1904:17-18)

In this article we take the position that managers (as agents) deploy corporate resources to modify the firmôs networks to ôarbitrageô stakeholder contracts that are located in various markets. The Oxford Pocket Dictionary describes arbitrage as the ôsimultaneous buying and selling of securities, currency, or commodities in different markets or in derivative forms in order to take advantage of differing pricesô. This definition drifts towards a narrow financial markets perspective where the traffic of transactions is predominantly located in specific markets where relatively standardised contracts are traded, for example, currencies or securities. In a narrow financial markets use the term arbitrage describes the exploitation of price differentials to earn a profit margin after commission fees. In this article we employ the term market arbitrage to describe how negotiations modify contracts with corporate stakeholders across and within markets to establish permanent or temporary control over resources. Managers, arbitrage markets to exploit physical, financial and temporal asymmetries where these differences offer the possibility of financial leverage and a boost to earnings capacity for corporate shareholders.

2.3 Revealing financial performance and earnings capacity.

In this section, we construct a financial model of the firm that reveals earnings capacity as a variable outcome of arbitrage within and across markets. Constructing this financial model is not itself straightforward because transactions recorded in the financial statements of publicly quoted firms generally use the ôfunctionô rather than ônatureô of the expense format to present income statements. Expenses classified by function include marketing, selling and distribution, research and development, which are subject to managerial judgement concerning the allocation of expenses and do not align with ômarketsô. Whereas, expenses classified by their nature more closely align

with market-derived costs such as materials and procurement purchases, labour costs and charges associated with capital employed. This alternative format of presenting financial statements using the nature of expenses approach is generally not employed by North American firms although more common in Europe (Baker et al 2005). The intention, in recent drafts of International Accounting Standards 1 (IASB, 2003: 1), is to encourage firms to also disclose expenses by nature if they have already presented disclosed expenses by function in their presentation of financial statements.

The nature of expenses approach also aligns with national and sector traditions of national accounting where estimates as to the value of net output of an industry sector or national economy are required. Cox (1979) reveals how the national accounts employ a nature of expenses format to calculate value added which measures the net output of a firm after deducting external expenses thereby avoiding double counting income and expenses relating to the activities of other firms. The nature of expense value added calculative formula facilitates the aggregation of firm financials into sector and national aggregates and, significantly, reference group(s) against which the individual firmôs financial performance can be calibrated. In the early 1970´s value added accounting gained popularity within accounting in most European countries as the focus shifted from how to measure income to whose income to measure as a result of the shift in the political landscape. Interest in the concept of value added has faded since the publication of the Corporate Report in UK 1975 (ASSC 1975) which suggested the presentation structure of a value added statement (value retention). To construct a computation of value retention eight financial elements are required:

- Net revenue (R),
- Bought-in-materials and services (IC),
- Salaries and wages including benefits (W),
- Dividends paid (Div),
- Net interest paid (I),
- Taxation (T),
- Depreciation of fixed assets (Depr)
- Retained earnings (R).

These elements are arranged to calculate value retention;

Subtractively as:

$$VR = R - IC \quad (1)$$

Additively as:

$$VR = W + Depr + T + I + Div + R \quad (2)$$

In practice, value retention is calculated using equation 2 and bought-in-material and services (IC) calculated as residual when sales revenues (R) and value retention (VR) are known in equation 1, as bought-in-material is not normally published by public quoted firms. The value retention computation in equation (2) is computed additively as the summation of its distributed elements. The residual after deducting wages and salaries (W) describes cash from operations or the more popular Earnings before Interest Tax and Depreciation (EBITDA). EBITDA revealing how much cash is generated from operating activities conducted by the firm and is a key element in shareholder value metrics.

Cash from operations (EBITDA) is calculated;

Subtractively as:

$$VR - W = (EBITDA) \quad (3)$$

Additively as:

$$EBITDA = Depr + T + I + Div + R \quad (4)$$

To complete a financial model that describes a firmôs earnings capacity it is necessary to introduce a measure of the stock of capital employed which is a summation of interest demanding capital, normally debt and shareholder equity taken from the balance sheet. This earnings capacity (the cash return on capital employed) shown in equation (5) as cash return on capital employed (Cash ROCE):

$$\frac{\text{Sales ï (Intermediate inputs + internal labour costs)}}{\text{Long-term debt + Shareholder equity}} \qquad (5)$$

This approach of formatting a financial model the firmôs earnings capacity for value creation has the advantage of revealing stakeholder expenses arising from intervention is various ómarketsô and their deduction from sales revenue. Identifying the share of external procurements in sales revenue, value retention and its distribution to employees (labour market), and dividends and net interest paid (capital market). Deducting labour costs from value retained reveals the cash generated from operations (EBITDA) and this can be set against the stock of capital employed (as debt and equity funds) for both value creation and value absorption for shareholders (Andersson et al, 2008a). We can aggregate financial information for a group of firms (the reference group) to calibrate one firmôs relative financial performance against the others or present aggregate averages. In the following section we construct three analytical perspectives to account for the transformation in earnings capacity of S&P 500 survivor firms during the period 1990 to 2008.

3. Accounting for transformation in the S&P 500 1990-2008.

In this section we construct a series of perspectives to account for the transformation in earnings capacity in the S&P 500 survivor group. We start at the firm level and deconstruct earnings capacity before turning to construct a firm-relative and macro aggregate account of changes in cash return on capital employed in the S&P500. All three perspectives are necessary to construct a critical account that explores the extent of financial transformation (earnings capacity) in the S&P 500 survivor group.

1. Firm level financial performance

We start by constructing a hypothetical example to reveal a spectrum of possible earnings capacity outcome(s) and these are shown in table 1. In this table a movement left to right involves our hypothetical firm generating additional cash from operations out of income after deducing the external costs of materials and supplies and internal labour expense. Incorporating capital employed into this table enables us to calculate

earnings capacity, that is, cash generated per financial unit of capital employed (Cash ROCE). Movements left to right in table 1 reveal that, after adjusting for capital intensity, earnings capacity (return on capital employed) increases from 5 to 45 per cent. Out-sourcing and off-shoring, for example, offer the potential to boost earnings capacity (OECD,2007) where organisational unbundling (Jacobides, 2003) reconfigures the mix of activities undertaken by the firm and where internal cost reduction is not offset by increased external input costs and balance sheet capitalization. Gereffi (1994) shows how leading brand companies sought to re-structure their global value chains and the implications this has for governance, technical transfer, division of competences and (Sturgeon 1997, Lee and Chen 2000) how power within global markets utilised to extract higher returns (Kaplan and Kaplinsky 1998).

Table 1

Firm financial operating ratios and earnings capacity

FIRM	A_{t0}	A_{t1}	A_{t2}	A_{t3}	A_{t4}
Sales revenue	100	100	100	100	100
Purchases	-90	-70	-50	-30	-10
Value added retained	10	30	50	70	90
Employee expenses	-9	-21	-25	-21	-9
Cash retained	1	9	25	49	81
Capital employed % sales revenue ï capital intensity	20	60	100	140	180
Cash ROCE %	5	15	25	35	45

Source: Authors

Table 2:

Changes in earnings capacity: some illustrative cases

	Hershey		Johnson and Johnson		Eastman Kodak		Bank of America	
	1990	2008	1990	2008	1990	2008	1990	2008
Sales	100	100	100	100	100	100	100	100
Purchases	(71)	(69)	(50)	(47)	(47)	(71)	72	64
Value retained	**29**	**31**	**50**	**53**	**53**	**29**	28	36
Labour costs	(14)	(12)	(29)	(23)	(31)	(23)	12.6	16.2
Cash (EBITDA)	15	19	21	30	22	6	15.4	19.8
Capital intensity	0.55	0.35	0.55	0.8	0.72	0.23	0.5	1.5
Cash ROCE	**27.3**	**54.3**	**38.2**	**37.5**	**30.6**	**26.1**	**31.0**	**13.3**

Sources: SEC Edgar database
http://www.sec.gov/edgar.shtml

Notes: Financial information converted into a percentage of total sales revenue. Capital intensity is capital employed (long-term debt plus equity) as percent of total sales. Value retained is sales revenue minus purchases. Cash is value added retained minus labour costs. The Capital to intensity index is sales revenue divided into capital employed (long-term debt plus shareholder equity). The cash ROCE found by dividing cash share of sales by the capital intensity index. For Bank of America revenues are interest income plus non-interest income. Purchases are interest expenses and all other external charges for services provided. Capital intensity index is net revenues divided into shareholder equity.

In table 2 we have extracted financials for: Hershey, Johnson and Johnson, Eastman Kodak and Bank of America where the purpose is to illustrate how key financial operating ratios can change over a period of time to increase or reduce earnings capacity (cash return on capital employed). Hershey a consumer discretionary manufacturer of chocolate products had reduced external purchase costs (predominantly cocoa) from 71 to 61 percent by 2005 but a significant increase in the price of cocoa per pound weight (from 69 cents to $1.19 and a high of $1.50 in 2008) increased purchase costs out of revenue back to 69 percent. Overall, a reduction in the share of purchase costs and labour costs in sales revenue served to boost cash earnings in sales from 15 to 19 percent. This favourable performance, in combination with a significant reduction in capital intensity (long-term debt plus shareholder equity in sales) helped to double cash earnings capacity from 27 to 54 percent. Hershey had deployed roughly half of its cash from operations (1990 to 2008) to repurchase $4bn of issued share capital at an average market price of $35 per share. This accumulated treasury stock amounted is accounted for (in the balance sheet) as a deduction from shareholder equity. This had the effect of lowering reported shareholder equity to

$300 million, reducing capital employed and boosting earnings capacity (Cash ROCE).

Johnson and Johnson (J&J) has expanded overseas manufacturing capacity during the last few decades. During the period, 1988 to 1999 non-US manufacturing capacity increased by 20% and in the following period (1999 to 2007) the cumulative increase was significantly higher at 40%. This shift to overseas production is coincident with a reduction in external costs as a share of sales from 50 to 47 percent. In addition, the switch into overseas markets for production may also have contributed to a reduction in the share of internal labour costs from 29 to 23 percent of sales revenue. The combination of lower external and internal labour costs increases the share of cash extracted out of sales revenues from 21 to 30 percent. Yet the earnings capacity (cash ROCE) for the company remained steady during this period at 38 per cent because capital intensity (capital employed per dollar of sales revenue) increased by sixty percent offsetting the gains in cash share in sales.

J&J in similar fashion to Hershey has deployed considerable sums of cash to buy-back shares for treasury stock. Over the period, 1990 to 2007 J&J spent $33.2bn of cash resources on capital expenditure and, an equivalent sum $38.5bn, on share buy-backs. As at December 31st 2008 the balance on treasury stock was $19bn with further $20bn previously allocated to support a stream of acquisitions the most recent of which was the purchase of Pfizerôs Consumer Healthcare operations (for $16bn) that included products such as Listerine. The majority of these corporate acquisitions accounted for using the purchase method following regulations outlined in Statement of Financial Accounting Standard SFAS 141 óBusiness Combinationsô where the full market value (rather than book value of the acquisition) has to be accounted for in the acquiring company balance sheet. This had the effect of inflating the J&Jôs balance sheet ahead of cash earnings and reducing reported cash ROCE (Andersson, 2007). The change to ómark to marketô accounting resulting from pressure by institutional investors. Writing in the CPA magazine in 2006, Shortridge at al observe:

> Perhaps the strongest argument for a move to fair-value accounting is that historical-cost financial statements do not provide information that is relevant to investors. http://www.nysscpa.org/cpajournal/2006/406/essentials/p37.htm

Eastman Kodak once dominated the provision of consumer and professional films, traditional photofinishing and certain industrial and aerial film market segments but these markets have been in steady decline with the advent of digital imaging technology. Company sales peaked in 1996 at $16bn but thereafter the company having restructured migrated into new business segments, for example digital technology and healthcare imaging systems. By 2008, value added retained in the company had fallen from 53 percent to 29 percent and employment levels reduced by 60 per cent to stabilise operating ratios. At the end of this period in 2008 labour costs accounted for a very high 80 per cent of value added retained leaving only a small cash residual of 5 per cent of sales in 2008. Accumulated losses, asset write downs and previously accumulated treasury stock reduced the value of shareholder equity from $7bn in 1990 to $960 million and capital intensity from 70 percent of sales revenue to 23 percent helping to sustain reported earnings capacity even though the company was shrinking.

Bank of America generates net revenues from interest and non-interest income and after deducting interest expense and all other external charges for services provided net revenue retained in the bank was 28 percent of sales out of which 45% is then used to cover employee expenses leaving cash from operations at 15 percent of net revenues. By 2008 the share of cash generated out of net revenues had increased to 20 percent due to a reduction in external costs. However, capital intensity (shareholder equity in this case) increased by a factor of three so as to maintain capital adequacy ratios in line with the growth in assets (including securitized loans). Bank of Americas shareholder equity had increased at a faster rate than cash extracted out of net income reducing cash share of equity from 31 to 13 percent and incidentally also reducing the margin of safety from loan defaults and charge-offs (Heilpern et al, 2008).

These illustrative firm level cases reveal how arbitrage interventions and contractual re-negotiation with stakeholders across markets often do not align to increase earnings capacity. The financial framework of analysis permits a deconstruction of earnings capacity into its constituent market driven elements (product, procurement, labour and capital) to reveal how contradiction and ambiguity play out.

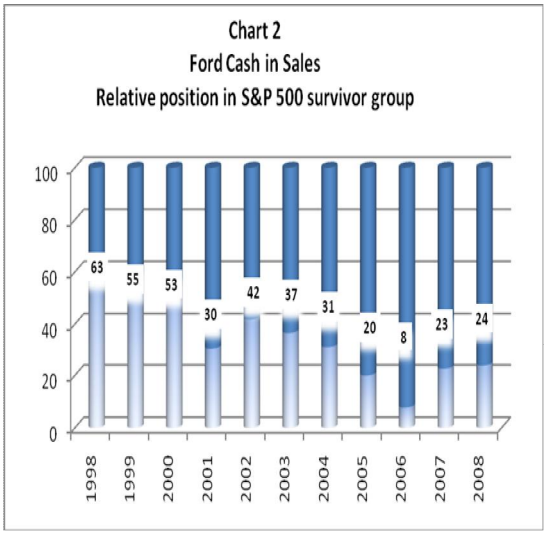
3.2 Relative financial performance

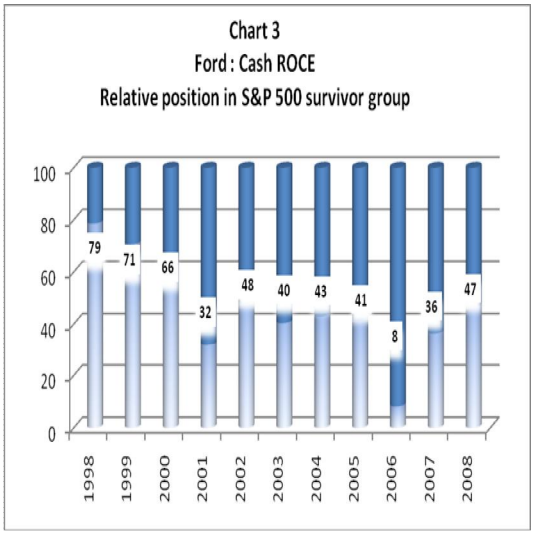
The remuneration packages of senior executives are often tied to relative performance metrics, for example, Pfizer and Ford Motor connect executive compensation to the relative to the performance of a ôPeer Groupô

> The (*remuneration*) Committee continues to believe that total shareholder return is the most appropriate measure of relative performance in relation to Pfizerôs business objectives and therefore selected relative total shareholder return as the sole performance measure for the 2009 PSA cycle. In the Committeeôs view our relative total shareholder return compared with the pharmaceutical peer group remained strategic priority during this period.
>
> http://www.sec.gov/Archives/edgar/vprr/10/9999999997-10-006958

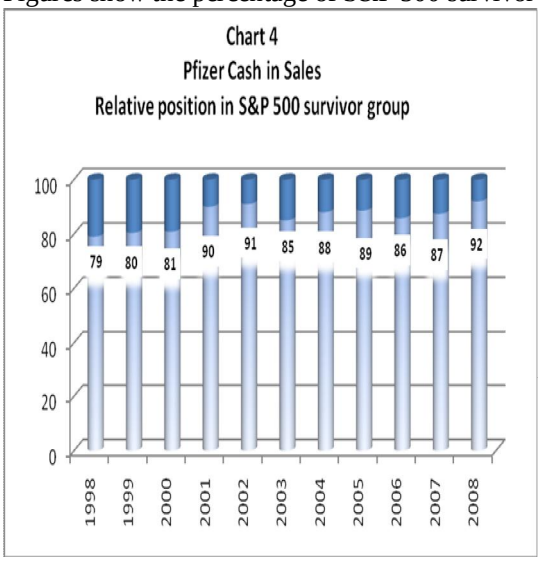
> Total Shareholder Returns of Ford Compared with Total Shareholder Returns of other S&P 500 Companies.
>
> http://www.ford.com/doc/2009_proxy.pdf

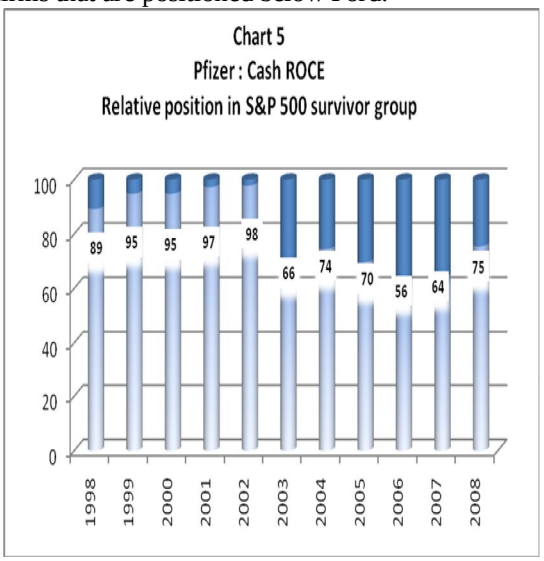
In this section, we compare the financial performance of Ford Motor Corporation and Pfizer relative to a reference group, that is, all S&P 500 survivors for the period 1998 to 2008. This reveals not only that there are winners and losers (migration) but also that relative performance is influenced not only by actions taken by the individual firm but those taken by all other firms in the reference group. For example, in Charts 2 and 3, we show how the Ford Motor Corporationôs relative position in terms of cash extracted from sales and cash return on capital deteriorates during the period 1998 to 2008. From a position where 79 per cent of S&P 500 survivor firms were below Ford to one where 47 per cent are below in 2008.





Source: Raw data from Edgar SEC dataset, 10-Kôs and ThomsonOneBanker
Note: Ford Motor Corporation positioned relative to all other firms in the S&P 500 survivor group. Figures show the percentage of S&P 500 survivor firms that are positioned below Ford.





Source: Raw data from Edgar SEC dataset, 10-Kôs and ThomsonOneBanker

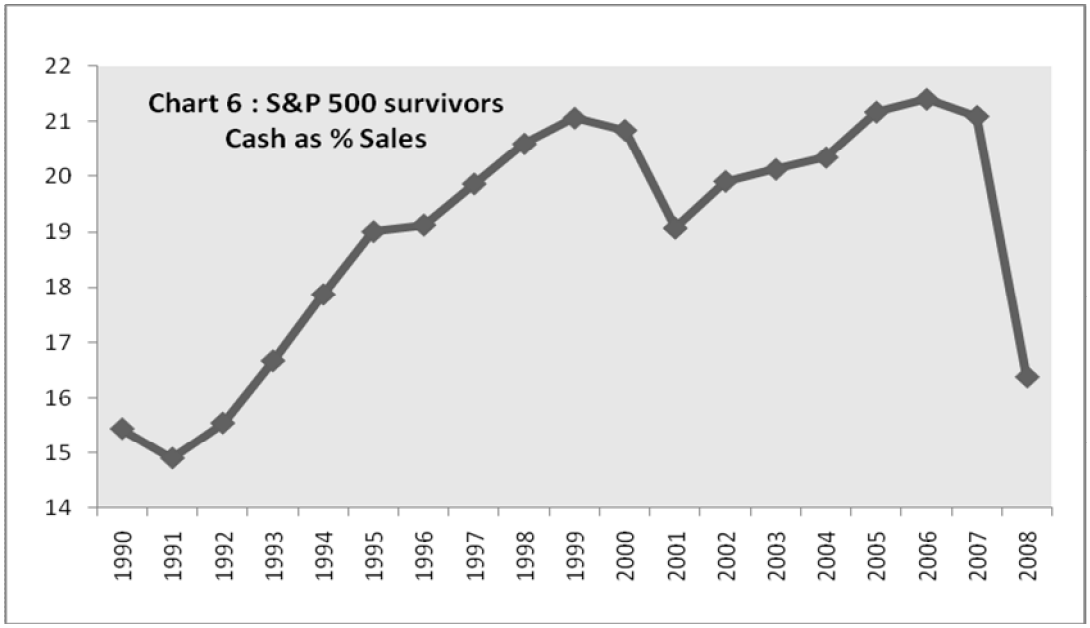
Note: Pfizer positioned relative to all other firms in the S&P 500 survivor group. Figures show the percentage of S&P 500 survivor firms that are positioned below Pfizer.

In contrast to Ford Motor, Pfizer improved its relative position in terms of cash extracted from sales revenue moving from a position where it is in the top 20 percent to the top 10 percent of S&P 500 survivors. However, Pfizerôs relative Cash ROCE position deteriorates after 2003 when the acquisition of Pharmacia Upjohn (accounted for at fair value) inflated balance sheet capital employed ahead of cash earnings taking it from the top 10 per cent to top 30 per cent of S&P 500 survivors.

We have argued that, at the level of the firm, market arbitrage interventions and re-negotiated stakeholder contracts do not straightforwardly translate into higher level of cash earnings on capital employed because stakeholder networks and contractual relations are complex and contradictory outcomes possible. In this section we introduced the additional dimension of órelativeô financial performance to reveal winners and losers. Moreover, once we introduce the notion of relative performance the actions of others firms in the reference group also matter and have influence because an individual firmôs relative position may change, for better or worse, due to the success (or failure) of other firms. Constructing a profile of both firm level and relative corporate financial performance provides insight into the extent to which arbitrage in specific markets adjusts firm level financial performance relative to all others. Although significant, firm and firm-relative narratives about performance need to be supplemented with a macro account because this reveals the extent to which all firms have delivered stronger earnings capacity and are on a sustained trajectory.

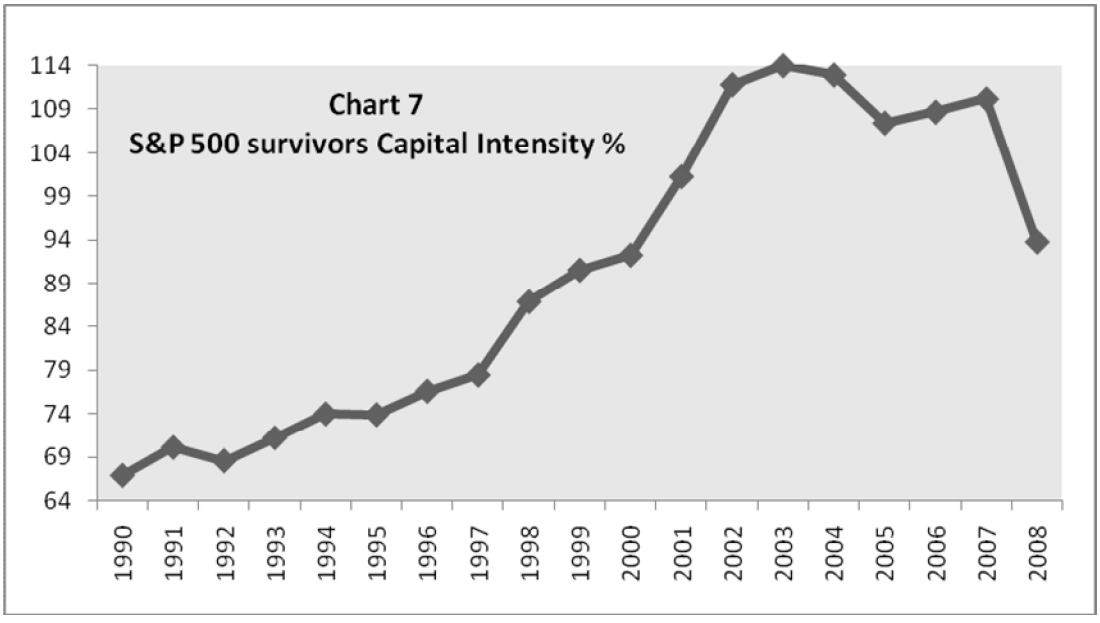
3.3 Aggregate financial performance in the S&P 500 survivor group

Our aggregate financial analysis reveals the performance of the survivor group of firms listed in the S&P 500 from 1990 to 2008. During the period 1980 to 1990 S&P 500 survivors increased cash extracted out of total revenue from 15 to 17 percent. During the 1990s the increase in the share of cash extracted out of sales revenue is more pronounced increasing to 21 percent by the end of the 1990s. Thereafter, the share of cash extracted out of total income remains just above 20 percent apart from cyclical downturns. For example, the severity of the recession in 2008 is revealed as a drop in the share of cash extracted from sales revenue back to levels last seen since the early 1990s



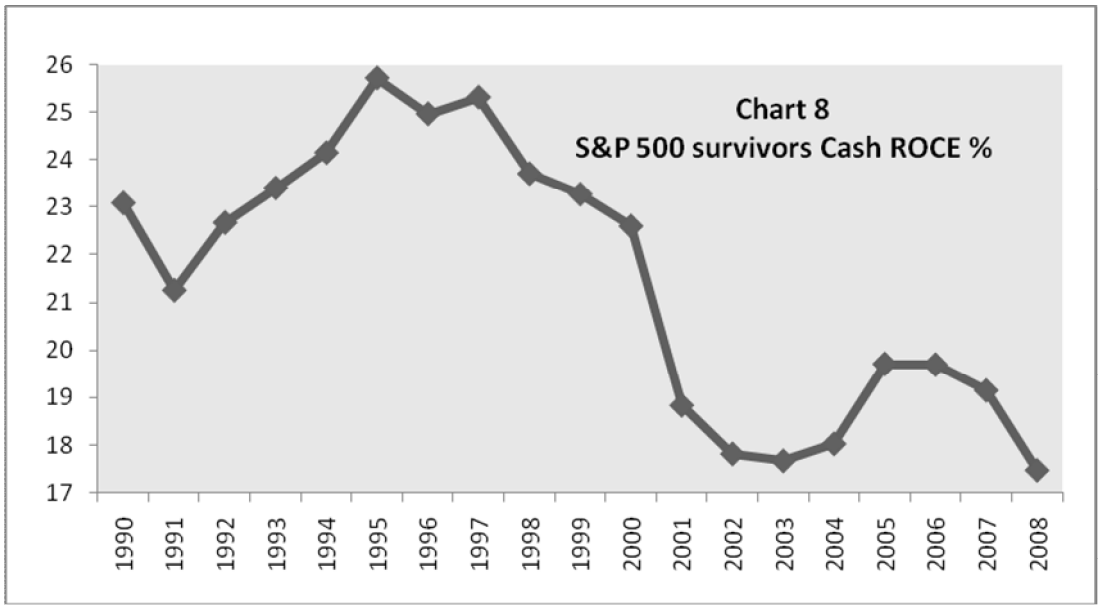
Source: Thomson One Banker and SEC Edgar datasets, various years

During 1990 to 1999, the S&P 500 survivor group increased cash extracted out of sales revenues but this coincided with an increase in balance sheet capitalization (long-term debt plus equity) which increased relative to sales revenue. From 65 cents of capital employed per dollar of sales in 1990 to $1.14 of capital employed per dollar of sales. Andersson et al (2008b) have argued that this is partially explained by the fact that corporate purchases (mergers/acquisitions) were progressively accounted for at market value (rather than pooled) during the last decade and a half.



Source: Thomson One Banker and SEC Edgar datasets, various years

After a brief period during 1990 to 1995 when the cash ROCE reported by the S&P 500 survivor group increased and then reached a peak of 26 percent it has since fallen steadily to a level of 17 percent in 2008.



Source: Thomson One Banker and SEC Edgar datasets, various years

Although the US corporate sector has been under pressure to generate additional cash out of capital employed for shareholders aggregate earnings capacity (cash earnings on capital employed) was not transformed in the S&P 500 survivor group.

4. Discussion / Summary

In this paper we have argued that corporate governance internalized the interests of institutional shareholders forcing managers to exploit market arbitrage, re-negotiate contractual relations with stakeholders, to boost earnings capacity (cash earnings on capital employed). As Veblen observed, managers were executing shrewd contractual negotiation and deal making to boost earnings capacity, and increasing the probability of wealth accumulation for shareholders.

Our objective in this paper has been to reveal financial performance in the S&P 500 survivor group employing a financial performance framework of analysis to make visible three complementary perspectives or levels of analysis: firm, firm-relative and

macro. These three perspectives on financial performance facilitate the construction of critical narratives about financial transformation in an era of shareholder value in the S&P 500.

At the level of the firm we employ this financial framework to deconstruct bottom line earnings capacity to show how interventions across and within specific markets/stakeholders are difficult to align because contradictory forces are in play. Out-sourcing, off-shoring, and mergers may not deliver increased earnings capacity if, for example: higher external costs in income are not offset by a reduction in internal labour costs or, the market value of corporate acquisitions inflates balance sheet capitalization ahead of cash earnings. Relative performance is also a key ingredient in the structuring of incentives aligning managerial and shareholder financial interests. In this paper we reveal firm performance against all S&P 500 survivors (the reference group) from which we can observe the extent to which migration is positive (Pfizer) or negative (Ford). This analysis not only reveals a pattern of winners and losers, but also how one firms relative performance changes as much from its own actions as those carried out (or not) by others in the reference group. To put relative corporate performance into perspective it is also necessary to construct an account of aggregate macro financial performance for the S&P survivor group to reveal level and trajectory. During the period 1990 to 2008, an era of shareholder value, we find that the S&P 500 survivor group did not, on average, transform earnings capacity.

Our focus has been with accounting for earnings capacity in the S&P 500 group of survivors at a firm, firm-relative and macro level. Within this realm of financial numbers and perspectives the analogy is with the hall of mirrors where ambiguity and contradiction are in play frustrating straightforward narratives that connect strategic purpose to financial outcome. Rather than abandon this framework of analysis we argue that this approach has technical merit because it facilitates the production of alternative critical narrative(s). These could, for example, be contrasted with those that present a stronger argument supporting a relation between strategic purpose and corporate financial transformation in an era of shareholder value.

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