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CORPORATE MALFEASANCE AND THE MYTH OF SHAREHOLDER VALUE

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ABSTRACT

The bankruptcy of Enron in December 2001 marked the beginning of broad awareness that American corporations had left behind the strategy of expanding through diversification that was the hallmark of the 1950s through the early 1980s. CEOs now made it job one to meet the earnings projections of securities analysts, such that by the year 2000 they were, in record numbers, "restating earnings" – admitting that they had cooked the books. Accounting shenanigans were the tip of the iceberg, and what lay under the water was a new approach to running the corporation to produce numbers that analysts and institutional investors would like. Three groups that stood to benefit from the new strategy spun it to investors as in the interest of all. Managers of hostile takeover firms defined their business as setting firms on the path to performing for shareholders. Institutional investors defined earnings management, rather than acquisitions management, as increasing shareholder value and focused management attention on earnings by popularizing stock options. Securities analysts hawked their own profit projections as the reigning metric of corporate performance, and favored easy-to-analyze single-industry firms through "buy" recommendations. These three groups changed the incentives executives faced,

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making accounting shenanigans in the pursuit of earnings management widely popular and enriching institutional investors, analysts, and executives in the process. Regulatory changes to end malfeasance have made it marginally more difficult to perform illegal accounting practices, but they have not changed the core corporate strategy that has emerged since the early 1980s. The changes illuminate the rise of groups of business professionals in the power structure, for it was not investors but different groups of business professionals who won the day. The changes illuminate, as well, the role of the social construction of interest in power relations among groups – it was by convincing executives and shareholders that a new corporate strategy was in their own interest, which these business professionals succeeded.

THE MYTH OF SHAREHOLDER VALUE

Avid readers of the business press noted a new fad among hot companies late in the 1990s – the restatement of earnings. Formal earnings restatements to the SEC had, by a conservative count, averaged 49 a year between 1990 and 1997, but they rose sharply to 91 in 1998, 150 in 1999, and 156 in 2000 (FEI, 2001).[1] In discussing the fad, the business press cited increased regulatory oversight – in July 2001, half a year before Enron declared bankruptcy, the Wall Street Journal reported "the number of corporate earnings restatements has skyrocketed during the past three years, driven in large part by stepped-up enforcement at the SEC" (Weil, 2001, p. 15). We now know that earnings restatements were becoming widespread for another reason – executives were increasingly cooking their books to satisfy securities analysts and institutional investors. They massaged profit reports to keep their companies on analysts "buy" lists (although we now also know that analysts seldom recommended anything but "buy" at the turn of the millennium), and to keep institutional investors pumping new pension contributions in their direction.

Corporate malfeasance took a new form in the 1990s. Executives no longer looted company coffers and fled to sunny isles without extradition treaties. They lied about how much money their firms made. This practice was not new, but the peculiar form it took was new. They lied to make corporate earnings appear to rise at a constant rate toward an infinite horizon, and to conform to the projections of securities analysts. They cooked the books in both directions, withholding news of exceptional earnings as

insurance against a rainy day. Five executives at Freddie Mac, the semi-public mortgage company, were deposed after famously under-reporting earnings by 5 billion dollars between 2000 and 2002.

What produced this change in the nature of executive misbehavior? CEOs revolutionized the core business strategy of big firms in the last quarter of the 20th century, shifting from a focus on diversification and expansion to a focus on "shareholder value." Whereas previous shifts in corporate strategy had come about, depending on whom you listen to, because existing strategies of increasing returns had run their course or because new management factions within the firm sold executives and shareholders on new strategies, this change came about because three groups with new clout in financial markets succeeded in imposing their will on corporations. They redefined corporate efficiency, and realigned the material interests of others.

Those three groups – hostile takeover firms, institutional investors, and securities analysts – each had their own reasons for selling a new corporate strategy, in which "shareholder value" (defined eventually as the capacity to meet securities analysts' profit projections) was the holy grail. Those groups succeeded by articulating the myth of "shareholder value," to replace the myth of corporate "portfolio management" that had supported expansion-through-diversification as the guiding strategy of the large American firm.

What redirected executive attention were the new rhetoric of shareholder value and a new compensation strategy. Institutional investors encouraged firms to compensate executives with stock options, designed to align executive interest with shareholder interest – with the predictable consequence that executives would fib about profits. The big accounting firms enabled this fibbing by hawking instruments that made profits appear and disappear, and by lobbying against the accounting of stock option grants as expenses. Securities analysts were complicit, for the financial institutions they worked for had vested interests in seeing firms perform well (Swedberg, 2004).

We have two points to make. One is that this new corporate strategy was an idea hatched not by corporate executives, as was the case with previous strategies, and not by shareholders, as mythology suggests, but by professional groups in financial markets. These groups managed to change the incentives that executives faced and thereby to change the behavior of firms. These were not robber barons in cigar-filled rooms, but MBAs and CPAs working within large financial institutions. The idea that the power elite is comprised of capitalists and captains of industry now seems antiquated – knowledge workers who redefined corporate efficiency were the initiators and biggest beneficiaries of these changes. The changes produced huge

windfalls for hostile takeover specialists, institutional investors, and securities analysts, as well as for executives. The second point is that while regulatory reforms now make it harder for firms to cook the books, the fundamentals of the new system have not changed. Institutional investors still control large blocks of shares: securities analysts still project profits; and CEOs are still compensated with stock options. The scandals surrounding Enron and WorldCom led to regulatory changes, but not changes that would alter how the whole system works. The so-called shareholder-value model of the firm unambiguously displaced the growth-by-diversification model, but nothing has yet appeared to replace the shareholder-value model.

Parts of the story were the result of happenstance, to be sure. It was happenstance (the baby boom) that pension investments grew by leaps and bounds and were increasingly put into the stock market, leading institutional investors to control the majority of stock in major corporations. It was happenstance that the high technology boom would replace the conventional metric of corporate success, profits, with the arms-length metric of meeting analysts' profit/loss projections. But the new shareholder value model of the firm was also the result of professional strategizing by groups that were empowered by these historical shifts, institutional investors in the first place and securities analysts in the second.

FROM GROWTH-BY-ACQUISITION TO BEAT-THE-ANALYSTS

The shareholder value strategy is not the first new strategy to sweep across American firms. For Alfred Chandler (1977), the production–expansion strategy was supplanted by the sales and marketing strategy, which in turn was supplanted by the diversification strategy. Each change represented a stage in the evolution toward more efficient corporate forms. Each change was initiated by inside managers and was spread through competition among firms. For Neil Fligstein (1990), these changes came about because marketing specialists, and later financial diversification experts, struggled to win control over firm strategy - not because they necessarily had superior strategies but because they gained executive positions by convincing management and boards to adopt their strategies. Each change represented a new social construction of corporate efficiency. Each change was initiated by insiders and was spread through rhetoric.

The rise of the so-called shareholder value firm was different. Its proponents were located outside of firms, and they succeeded by changing how executives and shareholders perceived their own interests.

From the perspective of the average CEO circa 1975, the best way to get ahead was to "grow the company" through diversifying acquisitions. Most of the money CEOs made came in the form of salary, and the bigger your company, the bigger your salary. There was good evidence that diversifying acquisitions depressed stock price – paradoxically, they typically increased the stock price of the seller but decreased the stock price of the buyer. If executives were looking to serve shareholders, it stands to reason, they should have tried to sell. Instead, they tried to buy other companies because they understood buying as the path to career advancement. After all, CEOs who sold out were put out to pasture, and CEOs who bought other firms stood atop enlarged empires.

Three groups came along to argue that diversifying acquisitions were inefficient, and that firms should instead focus on maximizing "shareholder value," or stock price. Each of the groups had something to gain if firms abandoned growth-by-acquisition and embraced beat-the-analysts. The groups succeeded in institutionalizing a new metric of executive performance – beating analysts' profit projections rather than negotiating fancy acquisitions – by convincing executives that the metric was in their interest. They did this by replacing the system of executive compensation, in which salary was a function of firm size, with a system in which CEOs who could beat securities analysts' forecasts saw stock option windfalls.

The old system of executive compensation was harshly criticized by institutional investors and by agency theorists in economics for serving CEOs but not investors. CEOs expanded their corporations for their own benefit, they argued, ignoring the real interest of shareholders, which was to see the price of stock increase. But the system that replaced it was dysfunctional in another way; it created an incentive for CEOs to put all of their energy into meeting the profit projections of securities analysts – into earnings management. Institutional investors had lobbied to change CEO compensation, and this meant that CEOs were now granted stock options at a given price, which they could exercise after a certain future date. If the stock options were granted at today's share price, and if they could be exercised a year from today, the race was on to produce strong profit numbers and thereby inflate stock price over the coming year.

Another important change contributed to the earnings-management strategy. The high technology boom convinced many that simple stock price was a poor measure of the firm value. The companies of the future were

operating in the red, but by being first-movers they were establishing themselves in their respective markets, or so the story went. Thus, institutional and individual investors increasingly looked to analysts' projections of profits and losses, and to whether firms could meet those projections. Amazon was a good value so long as it lost no more than the experts expected, and hence stock price increased and fell on a firm's ability to meet analysts' estimates. This is what encouraged not simply earnings exaggerations, but earnings management or the smoothing of corporate profits to match analyst projections. Executives hoping to reap regular rewards by exercising stock options, and then selling the stock, had to meet analyst projections regularly to buoy stock price so that profits from newly exercised options could be realized regularly.

The game executives played was not the game institutional investors and agency theorists had envisioned when they promoted stock options, which was of maximizing the profitability of a company executives both managed and held large stakes in. Instead, it was a game of maximizing profits from company stock sold as soon as it could legally be sold. CEOs did not hold onto stock, which would have aligned their interests with those of shareholders. They sold stock as soon as they could manipulate its price upward, with the argument that diversification was more prudent than putting all of your eggs in one basket (Khurana, 2002). Instead of aligning CEO and shareholder interests, the stock option craze produced irrational short-term exuberance.

Growth-by-acquisition had encouraged executive behavior that was sometimes irrational, but rarely illegal. CEOs might acquire firms that would not increase overall profitability, but this was not against any laws. Beat-the-analysts encouraged behavior that was irrational and sometimes illegal. It encouraged legal means of altering profit statements, but illegal means as well.

This was the dynamic that led firms to a new corporate strategy. Now to the three groups that advocated for it. How did three groups of professional managers, sitting outside of major corporations, so dramatically change the course of America's largest firms? The answer says a lot about the changing nature of power in the business elite. If the classical view of capitalism was that factory owners were enriched by the sweat of workers, extracting surplus value from the production process, what we see happening here is something quite different. The business-knowledge elite manipulates the behavior of large corporations, enriching themselves (money managers and institutional investors, securities analysts and bankers, and corporate executives) by skimming profits from the pension reserves of workers and from the investments of the lumpen bourgeoisie.

Hostile Takeover Firms

Hostile takeover firms dramatically reshaped large corporations in the late 1970s and early 1980s by dismantling diversified conglomerates and selling off the parts, demonstrating that diversified firms had low stock prices that did a disservice to their shareholders. Executives at first despised them, but takeover specialists succeeded in making a business case for what they were doing – they increased the value of the firms they took over by spinning off tangential business units. In a short period of time, they gave a bad name to diversification and focused corporate attention on stock price, because they only took over firms that were undervalued and that could be sold off, piece by piece, at a profit.

Before the increase of the shareholder value firm, there was of course a theory of why the diversified conglomerate was a good idea. Portfolio theory, in economics, reinforced the idea that the modern firm should be run as an internal capital market, investing in promising sectors and spreading risk across different sorts of industries (Fligstein, 1990). The institutional economist Oliver Williamson (1975) seconded this idea, arguing that conglomerates could acquire poorly performing firms and improve their profitability by managing them under financial accounting methods. Meanwhile, the major consulting firms – McKinsey, Arthur D. Little, The Boston Consulting Group – had developed technologies that simplified the management of diversified conglomerates. They proselytized, and provided the tools for the strategy of diversification. By the end of the 1970s, 45% of the Fortune 500 had adopted these portfolio planning techniques (Davis, Diekmann & Tinsley, 1994, p. 554).

The inflation of the 1970s, the invention of the "junk bond" and the leveraged buyout (LBO), and Reagan's regulatory changes all fueled the hostile takeover trend. First, the inflation of the 1970s left many firms with low book values, but managers were reluctant to increase the book value of assets because this would put pressure on their profit margins. Returns on assets looked better when assets were artificially low due to inflation, but the result of not adjusting book values was that many firms had low market valuations that made them takeover targets (Fligstein, 2001; Fligstein & Markowitz, 1993; Zorn, 2004). Second, new finance tools such as high yield "junk" bonds and new acquisition strategies such as the LBO made hostile takeovers possible. Third, Reagan's regulatory stance helped takeover firms in two ways. On the one hand, Reagan relaxed restrictions against mergers among competitors, and this allowed buyers of firms to sell off tangential business units to the most interested parties – the direct competitors of those

units. On the other, the courts relaxed controls of hostile takeovers themselves (Davis et al., 1994, p. 554).

The firm of Kohlberg, Kravis, and Roberts (KKR) showed how successful the strategy of buying up large conglomerates and selling off tangential and unprofitable businesses to increase the stock price could be. Beginning in 1976, they bought up over 40 companies and restructured them, including such behemoths as Beatrice Companies and RJR Nabisco. R.J. Reynolds and Nabisco had merged only in 1985, but in 1989 KKR bought the company out for close to $25 billion, and then its head office of a mere dozen professionals ran the company using financial controls (Useem, 1993, p. 35). They often sided with management in these buyouts, in the role of "white knight" against external hostile takeover firms. But the results of the "white knight" takeover and the hostile takeover were much the same; the diversified conglomerate was broken up and a streamlined firm (with improved stock market valuation) emerged.

Davis, Diekmann, and Tinsley (1994) provide several sorts of evidence of the effect of the hostile takeover movement on Fortune-500 companies. First, they show that in the 1980s, firms that were diversified were significantly more likely to be acquired (and presumably broken up) than firms that were not diversified but were otherwise similar. The new management model led people to try to acquire and restructure conglomerates. Second, they show that about 30% of these corporations received some sort of takeover bid in the 1980s. In a comparable sample, we find that about 11% of firms received hostile takeover bids in the 1980s – so about one-third of all takeover bids were hostile (Zorn, Dobbin, Dierkes & Kwok, 2004). Every large American firm recognized the growing threat of hostile takeover. The phenomenon declined significantly toward the 1990s, partly because two-thirds of large firms instituted takeover defenses such as the poison pill (Davis, 1991). Many CEOs inoculated against takeover by dediversifying their firms themselves.

There is also good evidence that the takeover trend helped to put an end to further diversification. Davis and colleagues show that the lion's share of the acquisitions in the late 1980s was horizontal and vertical acquisitions. Diversifying acquisitions were now rare. In our sample of large publicly held firms, the median firm operated in three different industries in 1968, in five by 1983, and again in three by 1995. This despite the fact that the average firm was much larger, in terms of revenues and employment, by 1995. Firms also became increasingly likely to acquire within their own industries – acquisitions of firms in related fields made up four-fifth of all acquisitions in 1988, and less than nine-tenths in 2000 (Zorn et al., 2004). A firm did not

have to receive a hostile takeover bid to read the writing on the wall, and many CEOs restructured to inoculate themselves.

Hostile takeover firms broke conglomerates up, demonstrating that the component parts could sometimes be sold for more than the previous market valuation – that the parts were greater than the sum of the whole. These firms and their proxies argued forcefully that such break-ups were in the interest of investors, who reaped higher share prices, and ultimately benefited the economy as a whole. As Michael Jensen wrote in the Harvard Business Review in 1984, critics ignore "the fundamental economic function that takeover activities serve." Congress was alarmed at the wave of takeovers in the early 1980s, but that alarm was misplaced:

> In the corporate takeover market, managers compete for the right to control – that is, to manage – corporate resources. Viewed in this way, the market for corporate control is an important part of the managerial labor market... After all, potential chief executive officers do not simply leave their applications with personnel officers. Their on-the-job performance is subject not only to the normal internal control mechanisms of their organizations but also to the scrutiny of the external market for control (Jensen, 1984, p. 110).

Jensen thus legitimized takeover activity as a mechanism for ousting poorly performing chief executives and giving control of their firms to those better suited to run them. In the end, takeover specialists convinced the world that what they did for a living, far from threatening the corporation, was efficient. That it was in the interest of shareholders.

As takeover firms broke up conglomerates whose market valuations they judged to be too low, arguing that shareholders were the beneficiaries, executives became increasingly sensitive to the valuation of their firms by financial market constituents because their compensation was based increasingly on stock options and because neglecting stock price sometimes invited hostile takeover bids that left the CEO jobless. Takeover firms and the LBO faded away because corporate executives took their lessons to heart, dediversifying and focusing on stock price themselves.

Takeover specialists made huge sums of money from takeovers. They succeeded in popularizing the value orientation, and legitimating their own activities, by arguing that they were not just stock speculators. They argued that they were promoting a new vision of how the firm should behave and ousting executives with an antiquated vision. The power of takeover specialists to reshape the American corporation thus came from their ability to frame their activity as in the interest of shareholders – as forcing executives to manage firms to benefit their true owners. This rhetorical ploy worked, and it would be institutional investors and securities analysts who shaped

the particular meaning that a value orientation would have, that of beating analysts' profit projections.

Institutional Investors

As a professional group, institutional investors saw themselves as advocates for the thousands of pension fund participants and mutual fund buyers they represented. As they themselves were paid for the performance of the funds they managed, it was in their interest to encourage firms to maximize stock price – this is what fattened their own paychecks. So they saw their interests and those of the individuals they represented as synonymous. Similar to hostile takeover firms, institutional investors encouraged executives to do what they could to maximize stock price. As it became widely believed that diversified firms had artificially low stock prices, one of the strategies they promoted was dediversification. By focusing on stock price, encouraging firms to pay executives for stock price performance, and encouraging firms to spin off business unrelated to their main activity, institutional investors reshaped corporate strategy.

Driven partly by the explosion of defined-contribution pension plans and the increasing popularity of mutual funds as a form of investment, and partly by the aging of the baby boom generation and the expansion of its pension holdings, institutional investors grew from minor players to the dominant group controlling the flow of money into the stock market (Swedberg, 2004). Peter Drucker's 1976 book, *Unseen Revolution: How Pension Fund Socialism Came to America* and *John Stephens' 1980 The Transition from Capitalism to Socialism* anticipated the change. In our sample of over 400 large American corporations, institutional investors controlled slightly over 20% of stock in 1980 and roughly 60% by 2000. As they controlled more stock, institutional investors made greater demands on corporations. Between the mid-1980s and the mid-1990s, the number of shareholder resolutions supported by pension funds and other investment companies tripled (Proffitt, 2001).

The conventional wisdom ca. 1980 was that if an investor did not like the way a firm was managed, she could vote with her feet, moving her money elsewhere. Institutional investors came to believe that it made more sense to reform management than to sell off stock. Family owners had been the main proponents of management reform before this, but the family that held a significant stake was becoming a rarity (Useem, 1996). Some Hewlett-Packard (HP) family heirs fought to prevent the HP merger with Compaq,

for instance, but this role had become the exception. Now institutional investors with large chunks of stock in General Motors, for instance, preferred to lobby for management changes when stock price languished. Selling off at a low price cost shareholders dearly, and translated into smaller paychecks for institutional investors. They encouraged executives to pay more attention to stock price.

Institutional investors were vocal advocates for replacing the old executive compensation system, which amounted to pay-for-size because the highest salaries typically went to managers of the largest corporations, with pay-for-performance via stock options. They sometimes cited agency theory in economics. Michael Jensen, a finance professor at the University of Rochester who would later move to Harvard Business School and become a principal of the Monitor Group consultancy, was coauthor of the article often credited with popularizing agency theory in financial economics (Jensen & Meckling, 1976). Writing in Harvard Business Review, Jensen (Jensen & Murphy, 1990) argued forcefully that major firms made the mistake of paying their executives bureaucrats, tying compensation to showing up for the job rather than to performing. Jensen and Murphy called for boards of directors to require CEOs to be substantial shareholders, to link compensation to performance through stock options and bonuses, and to fire CEOs when they performed poorly. Boards had some trouble demanding that CEOs be major stockholders, for even if executives exercised stock options to buy stock, they could turn right around and sell the stock. Boards also found it difficult to fire CEOs, partly because CEOs typically staffed boards with their cronies. Boards found it easy to offer stock options on top of regular salary and bonuses, and so this is the advice they most often took. As Rakesh Khurana (2002, p. 191) concludes: "Enormous grants of stock options to CEOs have been justified on the grounds that they link CEO pay to performance. Yet recent research has shown that one of the first actions that new CEOs typically take is to break this link by exercising their options (and selling their shares) as soon as possible."

The single most important change institutional investors brought about was the rise of stock options in executive compensation. As these investors came to be paid for the performance of their portfolios, they saw it as in their interest to make sure that executives of the companies they invested in were also paid for their stock performance. This helped to redirect CEO attention to stock price, and it encouraged CEOs to follow the current advice of dediversifying to improve transparency and value.

The other change institutional investors favored was the abandonment of the diversification model. One reason was that it was their job to build

diversified portfolios for the institutions they worked for, and they could do this better when firms themselves had clear industry identities. Building a diversified portfolio out of firms that were themselves diversified portfolios was a messy business. The other reason is that takeover firms had made clear to the world that diversified firms tended to be undervalued. This may have been partly because institutional investors did not favor them, of course, making the prophesy that diversified firms were undervalued self-fulfilling.

It was not until 1990 that the theory of why single-industry firms were better managed than multi-industry firms was well articulated. Core-competence theory was given its name in 1990 by C. K. Pralahad and Gary Hamel in the Harvard Business Review, in an article titled "The Core Competencies of the Firm." But managers such as Jack Welch at General Electric had since the early 1980s argued for a style of hands-on management and corporate focus that presaged the idea, even if Welch oversaw a diversified behemoth. As Michael Useem (1996, p. 153) argues, "While diversification had been a hallmark of good management during the 1960s, shedding unrelated business had become the measure during the 1980s and 1990s." Institutional investor preference for single-industry firms translated into changes in business strategy. Fortune-500 companies whose stock was held by institutional investors at the beginning of the 1980s were more likely than others to spin off unrelated businesses (1996, p. 153).

Securities Analysts

Hostile takeover firms deconstructed diversified conglomerates and gave CEOs a reason to spin off unrelated businesses themselves; to preclude takeovers that would depose the executive team. They also focused executive attention on stock price, for takeover targets were undervalued firms. Institutional investors discouraged further diversification, for they saw it as their job to create diversified portfolios. They also focused executive attention on stock price, promoting stock options for executives to align executive interest with the interest of shareholders and of institutional investors themselves.

Like hostile takeover firms and institutional investors, securities analysts took actions that both discouraged diversification and focused CEO attention on financial numbers. They also helped to establish the yardstick by which corporations were measured, meeting analysts' projections or "making the quarter."

The role of stock analysts in encouraging firms to put all of their eggs into one industry has been well documented in the studies of Ezra Zuckerman (1999, 2000). The conventional wisdom that shareholders demand that diversified firms dismantle misses a key process. Analysts discouraged diversification because they specialized by industry. Multi-industry firm had fuzzy identities that made them difficult to analyze, and so analysts were less likely to cover conglomerates than single-industry firms of similar size. Firms liked analyst coverage, because analysts could only make "buy" recommendations for the firms they actually followed. In the late 1980s and early 1990s, executives in diversified firms responded by re focusing: selling off unrelated product lines, they hoped to benefit from increased share prices (Zuckerman, 2000). Zuckerman (1999) also shows that firms that were not covered by these industry specialists suffer, in terms of share price, relative to their peers. Firms with fewer analysts following them had lower market valuations than otherwise similar firms. Their CEOs, now dependent on stock options for income, suffered as well.

Meanwhile, the analyst profession was booming. Our data show that the typical industry leader was followed by eight analysts in the late 1970s and 18 by the early 1990s (Zorn et al., 2004). With so many analysts to satisfy, more and more executives appointed chief financial officers to communicate with them and to make sure corporate reports would satisfy them. In 1975, 5% of the industry leaders in our sample had CFOs. By 1995, 80% had them (Zorn, 2004).

In addition to promoting dediversification, analysts also transformed the obsession with stock price, which institutional investors had driven home, into an obsession with meeting analysts' profit projections. They did this by publishing profit projections for the firms they covered. The analyst project of inducing firms to pay more attention was fueled by the rise of high technology firms. Just when the number of stock analysts was rising, high technology stock that defied conventional analysis flooded the market. Amazon, AOL, and the likes lost money every quarter, but they were clearly the firms of the future. How to judge which to invest in? As during the heady days of 19th-century railway expansion, prospects for future profitability seemed more important than current accounts. Institutional and individual investors could not always judge a firm by its profits, but did profits meet with expectations? As Harris Collingwood wrote in the Harvard Business Review's June 2001 issue (p. 5); "There's a tyrant terrorizing nearly every public company in the United States – it is called the quarterly earnings report. It dominates and distorts the decisions of executives, analysts, investors, and auditors. Yet it says almost nothing about a business's health. How did a single number come to loom so large?"

Journalist Joseph Nocera (1998) notes that at Fidelity, the private institutional investment powerhouse, the focus shifted from actual performance in the late 1980s to beating analysts' forecasts in the late 1990s.

> From time to time, young Fidelity hands would rush into (CEO) Lynch's office to tell him some news about a company. They would say things like, "Company X just reported a solid quarter-up 20%." Eleven years later, as I review my old notes, I am struck by the fact that no one said that Company X had "exceeded expectations." There was no mention of conference calls, pre-announcements or whisper numbers. Nor did I ever hear Lynch ask anyone – be it a company executive or a "sell side" analyst on Wall Street – whether Company X was going to "make the quarter" (Nocera, 1998).

Fortune magazine suggests that the emergence of firms making available consensus forecast data, based on the averages of these profit projections, focused executive attention on analyst forecasts and corporate strategy on meeting those forecasts:

> Executives of public companies have always strived to live up to investors' expectations, and keeping earnings rising smoothly and predictably has long been seen as the surest way to do that. But it's only in the past decade, with the rise to prominence of the consensus earnings estimates compiled first in the early 1970s by I/B/E/S (Institutional Brokers Estimate System) and now also by competitors Zacks, First Call, and Nelson's, that those expectations have become so explicit. Possibly as a result, companies are doing a better job of hitting their targets: For an unprecedented 16 consecutive quarters, more S&P 500 companies beat the consensus earnings estimates than missed them (Fox, 1997).

Firms were, by their own accounts, relatively insulated from investor preferences in the 1960s and 1970s. Individual investors rarely had the time to scrutinize the firms they invested in, but with the proliferation of stock analysts and publications covering their projections, investors had more information, albeit often meaningless information, to look at. With stock analysts and institutional investors working full time to evaluate companies, executives became more and more sensitive to investor preferences – or more precisely, to the preferences of their proxies, institutional investors.

With this increase in attention came more volatility in stock price. Stock price began to move more frequently in tandem with quarterly earnings reports and with analysts' buy and sell recommendations. Since stock options now tied executive compensation to stock price, which hinged on meeting analyst expectations, meeting targets became a pre-occupation among corporate executives. As Justin Fox wrote in Fortune in 1997:

> This is what chief executives and chief financial officers dream of: quarter after quarter after blessed quarter of not disappointing Wall Street. Sure, they dream about other things too – megamergers, blockbuster new products, global domination. But the

> simplest, most visible, most merciless measure of corporate success in the 1990s has become this one: Did you make your earnings last quarter? (Fox, 1997).

Executives and CFOs responded by trying to game the numbers. CFOs held conference calls and reported updates about sales and costs much more frequently, trying to ensure accurate analyst forecasts. They also began to issue earnings pre-announcements to bring analysts' forecasts into line with their own forecasts. Among the firms we studied, the first did this in the early 1990s, and by 2000 some 50% were doing it. Firms also became more successful at "making their earnings," or meeting analyst forecasts. Whereas no more than half of firms met analyst expectations in the 1980s and early 1990s, by the late 1990s 70% of the firms we studied were meeting forecasts. Of course, the rapid increase in earnings restatements makes clear how some firms did this – where managing analysts failed, CFOs used legal and illegal means of deception.

Earnings management can be seen in other statistics as well. Using data on thousands of quarterly reports between 1974 and 1996, Degeorge, Patel, and Zeckhauser (1999) show that firms are significantly more likely to report earnings that exactly match analysts predictions than they are to report earnings that overshoot or undershoot by even a penny. And when earnings are off, firms are much more likely to slightly overshoot than to slightly undershoot. This pattern could only appear because managers manage earnings in myriad ways. Collingwood argues that CEOs and CFOs used every imaginable accounting trick to "make the quarter." Executives at Sunbeam reported as current earnings, expected future earnings on sales of barbecues at Wal-Mart and Sears. The stock crashed when word got out. Executives at SmithKlein Beecham's venture capital group lost millions in potential profits when their bosses refused to sell a biotechnology unit at the peak of the biotech market, for fear of reporting profits dramatically higher than analysts were projecting. Biotech stock indeed tanked, erasing the paper profit (Collingwood, 2001).

Hence, the job of CFO came to involve not only public relations, but also the development of accounting gimmicks that would allow firms to meet analysts' expectations. The accounting specialist gave way to the spin doctor. As Daniel Altman wrote in the New York Times in April of 2002, the job of CFO had changed. "Once upon a time, window-dressing was not in the job description. 'The CFO back 20, 30 years ago generally came out of the accounting profession,' said Karl M. von der Heyden, former chief financial officer of both PepsiCo and RJR Nabisco. They were glorified controllers… 'In the 90's, the CFO more and more became the partner of

the CEO in many good companies,' Mr. von der Heyden said" (Altman, 2002). The job became one of managing earnings.

> In the 1990s, men like Mr. Fastow (CFO at Enron) and Mr. Swartz (CFO at Tyco) were paragons of corporate ingenuity for meeting and beating ever-higher revenue forecasts, but those values have backfired. That model made it hard for investors to figure out how much companies are really worth. Now, even many scrupulous companies see earnings statements parsed for accounting gimmicks. In the last decade, as Wall Street demanded more frequent reports of results and more guidance about companies' prospects, chief financial officers became spokesmen and even salesmen, conducting conference calls with analysts and often delegating to others the mundane task of watching the numbers. Companies began recruiting lawyers, investment bankers and consultants as chief financial officers, more for their deal-making talents than for technical expertise or fiduciary integrity (Altman, 2002).

Thus the role of the corporate head of finance had changed dramatically. The vice president of finance had been upgraded from back office accountant to part of the top management troika, with the CEO and COO. The ideal CFO was the CEO's right hand man, with the accounting savvy to produce attractive numbers and the people skills to keep institutional investors and analysts content.

CONCLUSION: THE MYTH OF REFORM

Understanding power relations is not as straightforward under modern capitalism as it would seem to have been in the early days of industrialization in Manchester and Lowell. Karl Marx saw factory girls working long hours under onerous conditions, and factory owners reaping the lion's share of the profits. The control of capital was what separated one group from the other. Ownership of capital is no longer all that matters. Knowledge professionals in business specialties are ascendant, and the owners of capital are more likely to be workers themselves, investing through pension funds.

Increasingly, power depends on the capacity of one group of business experts to alter the incentives of another, and on the capacity of one group to define the interests of another (Roy, 1997). What takeover specialists, institutional investors, and securities analysts managed to do was to change the perceived interests of both corporate executives and shareholders. Executives were now convinced that it is in their interest to manage share price. Stock owners were now convinced that they were better off after hostile takeovers (despite the fact that takeover specialists became millionaires) and that they were better off with firms managing earnings.

They did this not exactly with malice aforethought, in part because these groups of business experts could not have guessed exactly where all of these changes would lead, and in part because they brainwashed not only CEOs and shareholders, but themselves. As in any good contact game, these groups had to make the case compellingly and genuinely that the course they proposed was really in everyone's interest. They conned themselves first and foremost. Takeover specialists convinced themselves that they were ousting inept CEOs. Institutional investors convinced themselves that CEOs should be paid for performance. Analysts convinced themselves that forecasts were a better metric for judging stock price than current profits. This is not to say that the new approach to management is not superior to the old approach. By some measures it is most certainly superior, but one should be skeptical of claims that making the company's focus the management of earnings is in the interest of shareholders. One should as well be skeptical of the claim that focused firms are inherently more valuable than diversified firms – valuations are endogenous to the system, which is to say that if securities analysts had come to specialize by company size, or region, or anything other than industry, they might have favored conglomerates and single-industry firms might have been undervalued.

For the myth of shareholder value to take hold, three different professional groups had to construct their own interests, and the interests of executives and shareholders, in ways that favored a dramatic change in firm strategy. First, hostile takeover firms broke conglomerates up, arguing that the component parts could sometimes be sold for more than the price of the firm – that the parts were greater than the sum of the whole. They insisted that this activity was in the interest of investors, who reaped higher share prices, and that it ultimately benefited the economy as a whole by creating an efficient market for securities. They succeeded in convincing the world that what was originally seen as rank speculation in fact enhanced the economy's efficiency. Second, institutional investors, controlling ever-larger blocks of corporate stock, saw it as their job – not the firm's job – to build balanced portfolios. They saw executives focused on growth rather than stock price, and succeeded in changing the way executives were paid to focus their attention on stock price. Third, securities analysts specialized by industry, neglecting diversified firms. They argued that for themselves, and for the individual investor, it was impossible to evaluate a huge conglomerate operating in six different sectors. This encouraged diversified firms eager to attract coverage by industry specialists to divest unrelated business segments. They also collectively invented a new metric of corporate success, replacing simple profitability with meeting analyst forecasts of profitability.

This change set off a search for accounting gimmicks that would allow firms to report the kinds of numbers analysts liked to see. These three groups had important accomplices, of course. The big accounting firms vetted the profit reports of major corporations and peddled accounting gimmicks that would help them to "make the quarter." Securities analysts working for financial institutions that managed initial public offerings (IPOs) of upstarts recommended that investors buy stock in those very same upstarts (Swedberg, 2004). Many found ways to make out in the new world of shareholder value.

Of course, the shareholder value strategy coincided with a remarkable run-up in share prices, and it no doubt played a part. The bubble did burst, destroying much of the value that had been created. Moreover, the earnings management strategy that became the hallmark of shareholder value boomeranged on many firms. CFO magazine quotes none other than Michael Jensen, the early proponent of pay-for-performance, on the disasters associated with earnings management. As a result of compensation packages that encourage earnings management, "We've seen the ruination of many firms" (Fink, 2004).

If paying CEOs a fixed salary and a small bonus every year failed to resolve the agency problems inherent in hiring managers to run companies they do not own, the use of stock options and other "long term incentives" did not resolve the problems either. It has changed the specifics of the problem. Executives focus irrationally on managing earnings, rather than on new corporate conquests.

Much-touted regulatory changes such as the Sarbanes–Oxley A prevent some kinds of executive malfeasance, but do nothing to really alter the dynamic of the new system that these groups put into place. They may make it marginally harder for executives to game the profit reporting system, but only until someone comes up with more subtle accounting maneuvers that can pass through new regulatory roadblocks. It is not that nothing has changed. Variable elements, including stock options, as a percent of CEO compensation are down from a high in 2001 of 71% to 63% for 2003, according to Mercer Human Resource Consulting (Fink, 2004). But the practice of misreporting earnings has not come to an end, for the incentive is still there. The Canadian telecom manufacturer Nortel Networks reported 2003 earnings of $732 million in January 2004, only to admit 3 months later that earnings were barely half that (Fink, 2004). The CEO, CFO, and controller were fired on the news. According to the Huron Consulting Group (2005) corporate earnings restatements were up from 270 in 2001 to 414 in 2004, a new record.

What has not changed in the wake of regulatory changes is that CEOs, institutional investors, investment bankers and securities analysts now take

a much greater share of the economy's proceeds than they did in 1980. Whereas the business-knowledge elite used to live well at the expense of wealthy investors, now they live well at the expense of the average American with a pension plan and at the expense of non-profit universities.

What is striking is that we take this as business as usual. When three of Harvard's endowment managers were paid 30+ million dollars each for a year's work, the University's economist-president remained mute, but others defended the pay scheme arguing that Harvard was simply paying the going rate for money management. The idea that the system of remuneration had gotten absurdly out of hand did not seem to occur to them. The ultimate evidence of the ideological power of these finance professionals is that the idea that remuneration in the tens and hundreds of millions, whether for fund managers or executives, is necessary to attract able talent goes unchallenged. Just a generation ago, CEOs seemed perfectly happy to show up at work for $ 1 million a year and now they demand $20 million (Khurana, 2002, p. 190). The cost of living well has not gone up as fast as that.

NOTES

1. These numbers jump to 100, 207, and 157 for 1998, 1999, and 2001, respectively, if we include restatements required by the SEC's new ruling on In-Process Research and Development costs.

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