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# Apple's changing business model: What should the world's richest company do with all those profits?



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## ABSTRACT

Apple Inc. stands out as the world's most famous, and currently richest, company. To the general public, Apple is known for three things: its intriguing CEO Steve Jobs, who has achieved iconic status in death as in life; its amazing iOS products, especially the iPhone and the iPad, and their predecessor the iPod, which have literally placed sophisticated technology in the hands of the masses; and its stratospheric stock price, which even when in March 2013 it had dropped to 63 percent of its September 2012 peak, gave Apple the highest market capitalization of any company in the world. As a result of its phenomenal success, at the end of fiscal 2012 Apple had \$121 billion in liquid assets. In April 2013 the company committed to distributing as much as \$100 billion to shareholders in stock buybacks and cash dividends by the end of calendar 2015. By employing the theory of innovative enterprise to analyze how over the course of its 37-year history Apple became so profitable, we argue that there is no economic justification from a risk-reward perspective for this distribution to Apple's shareholders. Taxpayers and workers have superior claims on these profits. In analyzing by whom value is created as a basis for considering for whom value should be extracted, we raise the implications of Apple's changing business model for the future of innovation at this heretofore exceptional American company and even in the U.S. economy as a whole.

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## 1. Apple's phenomenal growth and profits

In the second decade of the 21st century, Apple Inc. stands out as the world's most famous, and currently richest, company. To the general public, Apple is known for its intriguing CEO Steve Jobs, who has achieved iconic status in death as in life<sup>1</sup>; its amazing iOS products, especially the iPhone and the iPad, and their predecessor the iPod, which have literally placed highly sophisticated technology in the hands of the masses; and its stratospheric stock price, which, even when in March 2013 it had dropped to 63 percent of its September 2012 peak, gave Apple the highest market capitalization of any company in the world.<sup>2</sup> As a result of its phenomenal success, at the end of fiscal 2012 (year end September 29) Apple had \$121.3 billion in liquid assets: \$10.7 billion in cash and cash equivalents, \$18.4 billion in short-term marketable securities, and \$92.1 billion in long-term marketable securities (Apple 10-K 2012, 44).

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<sup>1</sup> Steve Jobs died of pancreatic cancer on October 5, 2011, at the age of 56.

<sup>2</sup> Apple's stock price reached a peak of \$705 on September 21, 2012. On March 29, 2013, its stock price closed at \$443. The company's market capitalization on that date was \$415.7 billion, ahead of Exxon Mobil with a market cap of \$403.7 billion. In third place was Google at a mere \$261.8 billion.

How did Apple achieve this exalted position? And what are the implications for the future of the company, and the U.S. economy in which it is based, of its announcement on April 23, 2013 of a program to distribute \$100 billion in cash to shareholders – \$40 billion in cash dividends and \$60 billion in stock repurchases – by the end of calendar 2015? What does Apple's changing business model mean for the future of industrial R&D; the role of the state in supporting, and even initiating, investment in new technologies; and the relation between corporate resource allocation decisions and the performance of economy in which the company grew and in which it as a corporate entity still resides?

In this paper, we lay a foundation for addressing these issues in the case of Apple Inc. by employing “the theory of innovative enterprise” to analyze the relation between Apple's changing business model and its economic performance (for other applications of this perspective, see Lazonick, 2009a; Lazonick & Mazzucato, 2013; Lazonick & Tulum, 2011). A business model entails the interaction of a company's strategy, organization, and finance. Through strategy, a company chooses the products with which it will compete and processes through which it will produce those products. Through organization, a company mobilizes the capabilities of people in a hierarchical and functional division of labor, often extending beyond the boundaries of the firm, to transform purchased inputs into sold outputs. Through finance, a company sustains this transformation process until it can generate financial returns.

In the theory of innovative enterprise, the combination of strategy, organization, and finance seeks to generate higher quality products at lower unit costs than were previously available (Lazonick, 2010; Lazonick, 2013c). The innovation process is uncertain, collective, and cumulative, and as a result requires strategy, organization, and finance. Given the uncertain character of the innovation process, investment in innovation depends on the abilities and incentives of executives who exercise *strategic control* over the allocation of company resources. Given the collective character of the innovation process, the learning that yields higher quality, lower cost products depends on the *organizational integration* of people with an array of functional capabilities and hierarchical responsibilities. Given the cumulative character of the innovation process, the ability of the firm to sustain the innovation process from the time at which investments in productive capabilities are made until the innovative products are sold depends on *financial commitment*. Taken together, strategic control, organizational integration, and financial commitment constitute *social conditions of innovative enterprise* (Lazonick, 2010). In this paper, we analyze Apple's performance as a company from the time it was founded in 1976 to the present in terms of these three social conditions of innovative enterprise.

Innovation demands the strategic allocation of resources to the development and utilization of productive resources. Strategic control gives decision-makers the power to allocate the firm's resources to confront the technological, market, and competitive uncertainties that are inherent in the innovation process. For innovation to occur, those who occupy strategic decision-making positions must have both the abilities and incentives to allocate resources to innovative investment strategies. Their abilities to do so will depend on their knowledge of how the current innovative capabilities of the organization over which they exercise allocative control can be enhanced by strategic investments in new, typically complementary, capabilities. Their incentives to do so will depend on the alignment of their personal interests with the interests of the business organization over which they preside in attaining and sustaining its competitive advantage.

The implementation of an innovative strategy requires organizational integration: a set of relations that creates incentives for people with different hierarchical responsibilities and functional capabilities to apply their skills and efforts to strategic objectives. The need for organizational integration derives from the developmental complexity of the innovation process – that is, the need for organizational learning – combined with the imperative to secure high levels of utilization of innovative investments if the high fixed costs of these developmental investments are to be transformed into low unit costs. Modes of compensation in the forms of work satisfaction, promotion, remuneration, and benefits are important instruments for integrating individuals into the organization.

This collective learning, moreover, accumulates over time, thus necessitating financial commitment to keep the learning organization intact until it can generate financial returns. What is often called “patient” capital enables the capabilities that derive from collective learning to accumulate over time, notwithstanding the inherent uncertainty that the innovation process entails.

The impact of the social conditions of innovative enterprise on Apple's economic performance cannot be understood as a linear trajectory from startup to success. It happens to be the case that over three decades ago, when Apple Computer had barely emerged from its startup phase, the company was already famous for much the same types of things as it was until recently: its visionary leader (even if not then CEO) Steve Jobs; its (for the time) sophisticated digital products aimed at the masses; and the four-year-old company that, on December 12, 1980, had raised the most money in an initial public offering since the Ford Motor Company, then 53 years old, had gone public in 1956 (Polsson, 2013). In the interim, however, there were important changes in Apple's business model – the interaction of strategy, organization, and finance – that set the stage for understanding the company's phenomenal growth over the past decade. And, as we shall argue, since the death of Jobs, under his successor as CEO Timothy D. Cook, important changes in Apple's business model have occurred that suggest that Apple's innovative capability will be much diminished in the future.

This paper asks questions regarding the sources of innovative enterprise that can only be answered by analyzing the interaction of strategic control, organizational integration, and financial commitment in determining a firm's economic performance. These questions include the following:

- As a strategic decision-maker, how important was Steve Jobs to the success of Apple, both before September 1985 when he was ousted from the company he had founded and after December 1996 when he returned? How was strategic

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