Samuels and Wilkes

Management of Company Finance

Third edition

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Preface

Our aim in this book is twofold – to provide a framework of knowledge which will assist the financial manager in making decisions and to provide the student of finance and accounting with a text which will not only be of assistance in preparing for examinations but also be of help in the student's early years in management or professional practice.

On the whole, this is not an advanced work on the technical aspects of financial decision making, nor is it entirely a descriptive introductory text. It is designed to be of interest both to the student of management who may be prepared to follow the more esoteric points of the theory and to the practising manager who is interested in techniques and ideas to help him in the situations he meets every day.

There are four particular aspects which, we believe, make it of special interest. First, we have attempted to balance advanced analytical approaches to financial management with the more traditional approaches still often employed in practice. Many of the problems in finance can be subject to a rigorous type of analysis; other problems, however, are still solved by rules of thumb. Second, we have based it on the financial situation in Britain. Third, where relevant the empirical findings related to the theories and folk-lore of financial management are discussed. Fourth, the book emphasizes the importance of the links between company financial management and the financial community. The reactions of the stock market and the financial institutions to a company's decisions are especially important to the company and the future of the management of a company can depend upon the stock market. A text on financial management should therefore attach considerable importance to the workings of the financial community.

We appreciate that before these words appear in print it is likely that some of the situations described will have become out of date. It is now common to have more than one Budget in a year with a resulting increase in opportunities for changing the tax laws. Indeed over time there have been so many changes in tax legislation, that the authors know of one researcher who is attempting to show that it is the uncertainty, caused by the frequency of change in the tax laws, that is one of the factors contributing to the relatively low level of investment in the U.K.

The third edition of this book has involved a major rewriting of the earlier editions. Certain new chapters have been added, one deleted and major changes made to all the others.

There are now separate chapters dealing with internal financing, with the valuation of companies and with international finance. There is a chapter which is concerned with the flow of funds between the different sectors of the economy. The original capital budgeting material has been expanded and now occupies two long chapters. Greater emphasis has been given to sensitivity analysis and the treatment of risk. There is more material on portfolio theory and a critical evaluation of the capital asset pricing approach. The subject of inflation receives special attention at a number of points in the book.

It is surprising how rapidly the subject of company finance alters over time. What is written at the time of one economic situation becomes out of date by the time of the next set of circumstances. The theory of the subject does not, of course, change quickly, but it is slightly refined, and new ideas and techniques do emerge over time. But it is in the day-to-day problems of financial managers that most changes occur.

When the first edition appeared in 1971, the United Kingdom was in the midst of a merger and take-over boom which we were assured would revitalize industry. British Leyland had recently been created following the merger of two private companies. By the time of the second edition in 1975, financial managers were more concerned with survival than with growth through acquisition. Many companies had severe liquidity problems, and it was to the banks and the Government that companies were turning for help. The restructuring of British industry did not appear to have led to many improvements. British Leyland, short of funds, were to be taken over by the Government. Whereas the first edition of the book had leant in the direction of policies for growth, the second edition was more concerned with cash and working capital management.

So we come to the third edition, and again a different set of circumstances exists for the financial manager. Now the emphasis is on free enterprise, incentives, and less Government involvement in industry. There is now the possibility that, actually or potentially, profitable parts of British Leyland will be sold off to private investors. This change of attitude has needed to be reflected in certain chapters of the book.

The third edition is the first to be accompanied by a workbook; in the main text there are more worked examples than in the previous editions, but it is still felt that students need the opportunity to work out more problems for themselves. The workbook contains chapter summaries, worked examples, notes or suggested answers to problems in the text, further problems, and references to further relevant reading. It also takes some of the technical material of the text a little further and contains descriptions of other management science techniques that will be of particular value to professional managers.

We should like to express our thanks to Mr A. Piper, Professors J. Perrin, P. Halpern and R. E. V. Groves, for their comments on various parts of the book; to Mr Jeremy Lancaster for advice in connection with the third edition; to Professor G. Fisher, Mr D. Hallam and Mr A. Chesher for permission to use certain of their material; to the Institute of Chartered Accountants in England and Wales and the Association of Certified Accountants for permission to reproduce a number of their examination questions; and to Lorraine Morris, Kathleen Major, Marilyn Mansell and Jenifer Jones for their valuable assistance in the preparation of this edition.

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Contents

1 The financial environment

1.1 Objectives of the company

A company has a responsibility towards employees, customers, shareholders, creditors and society. Each group interested in a company sees the role of that company in a slightly different way. This book is concerned with the financial aspects of companies, and we need to consider not only the uses of finance, but also the sources, namely shareholders, debenture holders, creditors and others. We begin this chapter by considering the objectives of a company. Following our discussion on objectives we consider the relationship between the shareholders and the company. The shareholders are legally the owners of the business. We are not suggesting that this relationship is any more or less important than that of any of the other interested parties and the company; we are only glossing over these other relationships because they are subjects for other, primarily non-financial books. Having considered the shareholders, that is the investors, we introduce some of the problems that exist in the relationship between the investment community and companies, problems in the financial environment in which companies have to operate.

One of the long-term objectives of a company must be to make money for its owners, and its future is guaranteed or jeopardized according to the satisfaction or lack of it, that the shareholders exhibit regarding its performance on their behalf. There are of course other long-term objectives of a company. In particular those involving employee and customer satisfaction, but it is not possible to compromise on the financial objective.

During particular periods of time it may seem rather optimistic to think in terms of making money for the owners, and in the short term all efforts have to be devoted to keeping the company liquid and to maintaining the value of the owners' investment, these are, however, only short-term situations, and in the long run the owners of capital must be encouraged to invest in companies by the prospect of gains which are at least as great as those they can obtain from investing elsewhere.

The last century and a half have seen the rise and fall of more than one business philosophy dedicated to the problem of a company's rationale. When enlightened self-interest was a notion dear to the hearts of nineteenth-century capitalists, it was fashionable to justify the company almost exclusively as a quasi-benevolent institution satisfying a yawning social need by generously providing employment and other opportunities. Cynicism, today, permits us to recognize this as a half-truth inspired by some real benevolence and more real guilt. The fact was, and is, that a company must make sufficient money to be able to offer the providers of its capital an attractive return. This is not to deny that it must also provide all its employees, from directors down, with the means to enjoy an attractive life.

All who agree with some form of the capitalist system, should not find anything contentious in the preceding paragraphs. However, when we start to consider whether the owners' position should be maximized and the employees' position satisfied, or the shareholders' position satisfied and the employers' position maximized we immediately enter into the political arena.

The theory of business finance (which was developed before the lean years for shareholders of 1973 and 1974) is based on the assumption that the company should seek to maximize the wealth of the shareholders. The shareholders own the company and it is therefore logical that the company should be run in their interests. A number of other parties are, however, interested in the company, and they must have their interests at least satisfied. The employees, the customers, the managers, the government, and in fact the rest of society are interested and affected by the way the company behaves. The company, like it or not, does not exist in a vacuum. There are many constraints on the objectives of the company, and these over time have increased in number. For example, the increasing concern with the dangers of pollution will result in an additional constraint on the ways in which companies can behave.

One way to look at the objectives of a company would be to say, therefore, that it should seek to maximize the shareholders' wealth, subject to a growing number of constraints. This, however, might not be satisfactory to the changing attitudes and values of society. Why should the providers of the capital have all the rewards that are left over after the other interests have been merely satisfied? Why, for example, should it not be the providers of labour who have their rewards maximized, who have all that is left over after the other parties (including the shareholders) have been satisfied. This is of course what the representatives of the providers of labour, the unions, would like to see as the accepted company objective. There are many interests represented in a company, and the importance attached to each interest depends on the political system, the attitudes of the community at a particular time, and the bargaining power of the interests at the time.

There are of course systems where the objectives of the production units are not expressed in terms of the providers of capital. There may be a time when in the western world, the objectives of companies are not expressed in terms of the shareholders' interests; when all shareholders will be satisfied with a reasonable return on their money. But we are not at that time yet. Until that time, investors can move their funds from company to company, influenced by the returns they expect. They will move their funds to where they expect the highest returns, which may not even be in equity investments. This means that as long as some companies see their objectives as the maximization of shareholders' wealth, it is difficult for other companies to survive, or at least to expand, with more socially-minded objectives. It means that if the corporate sector cannot earn a return on shareholders' money which is, after taking risk into account, at least as high as shareholders can obtain from investing in some other form of asset, then equity capital may not continue to flow into the corporate sector.

If the management of a company fails to recognize that fact that in the long run it is in competition for funds with other companies and other forms of investment, it can, particularly at certain times, put its own position and possibly that of the employees of the company, in danger. When the stock market is active, especially when prices are rising, a company that is not financially aware must live with the possibility of a takeover bid from a company that will offer the shareholders a considerably improved future under new management. When the stock market is declining, it is difficult for such a non aware company to obtain new equity capital and with constraints on a company's level of borrowing and possibly on its profit margins, liquidity problems can result which can endanger the company's future.

The Government have in recent years taken an increasing interest in the financial aspects of the corporate sector of the economy. They have shown themselves willing to intervene to provide funds for certain companies that were in financial difficulties, and have become an important provider of finance to industry. On occasions they have been willing to finance investments that the financial intermediaries, guided by normal commercial criteria, would not be willing to support. Successive Governments have felt justified in a policy of intervention in private industry as they have been interested in achieving certain objectives in the national interest, such as a high level of employment and a sound balance of payments position. Such objectives would not be taken into account by a financial intermediary when deciding whether or not to support a company.

We are concerned in this book with the possible sources of finance and making the optimum use of the funds the company does have available. It must be appreciated, however, that in order to produce or trade a company needs inputs in addition to finance, and it is no longer realistic to believe that the claims of any one resource have a right to dominate over the claims of any other resource. 'Economic entities (including companies) compete for resources of manpower, management and organisational skills, materials and energy, and they utilise community owned assets and facilities. They have a responsibility for the present and future livelihoods of employees, and because of the interdependence of all social groups, they are involved in the maintenance of standards of life and the creation of wealth for and on behalf of the community.'[1] This is not a quotation from a text on sociology or even political science, but it is from 'The Corporate Report', a discussion paper published by the Accounting Standards Committee. The authors of the Report argue that companies have a custodial role to play in the community, and although it is recognised that directors of limited companies have a stewardship relationship with shareholders who have invested their funds, in fact there are many other relationships to be considered, both of a financial and non-financial nature.

As explained, there is a division of opinion in the financial management literature as to whether the basic goal of the company should be to maximize the shareholders' wealth or merely to satisfy the shareholders. Argenti argues that shareholder satisfaction should be the basic goal of a company: 'So great is the power of the board of directors of a publicly owned company and so diffuse and fragmented the voice of the shareholders that, although theirs is legally and ultimately the sole authority over the company, the directors have the effective power to determine the objectives of the company and the profit target. The objective of all companies is to make a profit and it must be sufficient, after meeting the cost of all the constraints, to allow a satisfactory return on the owners' capital'.[2]

One point that should be appreciated is that part of the return to shareholders is in the form of dividend payments. These dividends have to be paid out of profits; in legal terminology they are an appropriation of profits. The fact that dividends are paid out of profits does not mean that the shareholders are taking out of the business something that they are not entitled to. They are as entitled to some return as are the other interested parties in the company: the employees to wages, the bank to interest payments, or the providers of land to rent. The fact that the shareholders' return is treated as an appropriation of profits rather than as a cost, as are wages and interest payments, is purely a legal point. To think that all the profits of a company are available for 'grabs' by all interested parties is to misunderstand the nature of the term 'profits'. All interested parties in a company are entitled to some income, and the income flowing from the company to the shareholder is the dividend which has to be paid out of profits. If dividends could be thought of as a normal cost of being in business, that has to be paid to encourage those with capital and those with savings to risk their money by investing in a company, then a lot of the emotional reaction to paying out profits to shareholders would disappear. The argument whether the shareholders' position should be maximized or satisfied should be an argument concerning the distribution of profits that remain after the shareholder has received a fair return.

One of the reasons for Argenti's belief that satisfying the shareholders is a sufficient goal, is that the shareholders are fragmented and diffuse. But as they become less fragmented this argument loses some of its power. Whether the directors maximize or satisfy the shareholders' interests, at least they must be aware of the share price, for it is through capital gains, that is increases in share price, that the shareholders receive much of their return. They must be aware of how the decisions they take will influence the share price.

Not only must a company earn a return on its shareholders funds, it must ensure that its earning power is reflected in its share price. It is possible to have two companies with identical profit performance and potential, and yet for one to have a higher stock market value than the other simply because the one group of directors are more concerned than the other group about their stock market image.

The stock market price is possibly the most important single criterion by which the company is judged. An increasing share price, or one that is falling less quickly than the market index, will keep the shareholders content, and the management will have little reason to worry about survival or a takeover. If the company is prospering nicely but failing to reflect the fact in its share price, it becomes of course an ideal candidate for a takeover; and in the event of being swallowed up – or fired – the management would have none to blame but themselves for neglecting the shareholders' interests by failing to ensure that the company's true earning ability was reflected in its share price.

1.2 The shareholders

The importance ascribed to the role of the shareholders has changed in recent years. It was once common to play down their influence; though legally the owners of the business, it was assumed that they did not much concern themselves with the way the company was run. Some of them might make their opinions known at the annual general meeting, but usually few of them attend, and in any case the directors could well have obtained enough proxy votes to overcome any opposition.

This position has changed, partly because of a change in the type of shareholder, partly as a result of the hectic years of takeover activity in the late 1960s and early 1970s, and partly because of social pressure.

The characteristics of the typical shareholder have changed. No longer can he be regarded as an individual afflicted with a comforting inability to read a balance sheet. The growth of shareholding by institutions has been dramatic, and these institutions employ experts to advise on the investment of their funds. The financial performance of a company is thus judged by a knowledgeable body of people who may be either existing or potential shareholders. The company must accordingly be run in a way that guarantees the satisfaction of the shareholder – an increasingly sophisticated shareholder, who will be both competent and keen to assess for himself the the truth behind any conventionally optimistic statements.

At the end of 1972 institutions owned approximately 42% of the shares quoted on the London Stock Exchange.[3] This had increased from 31% at the end of 1966 and 25% at the end of 1963. (Institutions being defined as insurance companies, pension funds, investment companies and unit trusts.) This dramatic growth in institutional share ownership is expected to continue. The savings of individuals have continued to flow into pension funds and insurance companies, and it has been estimated that at the beginning of 1978, the institutions owned just over 50% of all the quoted shares in the UK. If present trends in savings habits continue, which depends on, amongst other things, there being no major changes in the income tax system, Briston and Dobbins have estimated that by 1990 the institutions will own in the region of 70% of the total quoted shares.[4]

In Table 1.1 the ownership of shares is analysed by class of holder. 'Other shareholders' comprise private individuals, executors, trustees and overseas interests. It can be seen that Insurance companies are the largest institutional owner, at the end of 1972 they owned 16.3% of the shares, followed by pension funds which, with public and private funds combined, owned nearly 12%. The other large institutional holders were investment trusts with 8.0%. Overseas holdings shown in the other category account for about 7% to 8% of the total of all such quoted shares.

It is difficult to be precise about the percentage of equity shares owned by institutions. A slight change in the definition leads to a different percentage. There are a number of problems. One is that many shares are registered in the name of nominees and so it is difficult to ascertain the true owner. Another problem is that Insurance companies do not publish information on the market value of their equity holdings. The published book values are no use as these, over time, become out of line with the market

Table 1.1
Ownership of UK-registered and managed companies quoted on the London Stock Exchange at 31 December

	1966		1967		1968		1969		1970		1971		1972	
	£m	%	£m	%	£m	%	£m	%	£m	%	£m	%	£m	%
Insurance companies	2,600	11.7	3,366	11.8	5,313	12.9	4,724	13.6	4,595	14.1	5,885	15.1	8,359	16.3
Private pension funds	1,452	6.6	1,920	6.7	2,850	6.9	2,417	7.0	2,341	7.2	3,416	7.5	4,162	8.1
Public pension funds	421	1.9	602	2.1	893	2.2	828	2.4	917	2.8	1,484	3.3	1,981	3.8
Local authority pension funds	208	0.9	291	1.0	485	1.2	438	1.3	431	1.3	754	1.7	959	1.9
Investment trust companies	1,625	7.3	2,156	7.6	3,158	7.6	2,671	7.7	2,462	7.6	3,547	7.8	4,099	8.0
Unit trusts	453	2.1	664	2.3	1,142	2.8	1,095	3.2	1,034	3.2	1,635	3.6	1,892	3.7
Other shareholders	15,390	69.5	19,555	68.5	27,360	66.4	22,441	64.8	20,718	63.8	27,796	61.0	29,900	58.2
Total market value	22,149	100	28,554	100	41,201	100	34,614	100	32,498	100	45,517	100	51,352	100
Combined pension funds	2,081	9.4	2,813	9.8	4,228	10.3	3,683	10.7	3,689	11.2	5,654	12.4	7,102	13.8
Combined institutions	6,759	30.5	8,999	31.5	13,841	33.6	12,173	35.2	11,780	36.2	17,721	39.0	21,452	41.8

Source: Dobbins, R., and Greenwood, M. J., 'The Future Pattern of UK Share Ownership', *Long Range Planning*, 8, 4, 1975.

values. The percentage ownership of the institutions that is meaningful is the percentage of the total market value. This leads to a third problem. The figures quoted above all relate to the percentage ownership of UK registered companies and managed companies that are quoted in the London Stock Exchange. If the UK managed companies are ignored, then in 1975 the financial institutions owned in the region of 52% of all UK registered companies.[5]

In the middle years of the 1970s, in the average year the financial institutions, as a group, were adding approximately 2% to their holdings of UK registered quoted companies. This trend has caused concern because of the increasing levels of concentration of ownership. It has also caused problems because, as a result of the channelling of the funds available for investment into a few hands, certain businesses have been finding it increasingly difficult to obtain finance.[6] The institutions have had a preference for quoted shares and, in particular, for the shares of the very large companies. The reasons are perfectly understandable. The institutions wish to hold investments that are easily marketable and it can be difficult to dispose of the shares in unquoted companies. It is easy for them to obtain information on the large publicly quoted companies. The administrative costs are reduced if an institution invests in a few large shareholdings, rather than holding a few shares in many companies. It is not necessary to hold the shares of a large number of companies in order to spread risk. It has been shown that most of the advantages of diversification can be obtained from holding the shares of thirty to forty companies.[7] Yet another reason, if another is needed, is that the institutions wish to be in a position to unload a large number of shares on the stock market quickly without moving the share price by more than a few pennies, and this would not be possible if the shares were those of a smaller company where the one holding would be a large proportion of the total company shares.

In evidence to the Wilson Committee, the National Association of Pension Funds stated that, for reasons of marketability and caution, pension funds were tending to concentrate their investments upon the 200 largest companies.[8] The investments of the insurance companies do not appear, however, to be so concentrated in the larger companies. In 1970 Moyle found that insurance companies do tend to avoid the smaller business. At a time when the insurance companies owned 10.6% of the shares of all UK quoted equities, they only owned 6.8% of the shares of those quoted companies with a market value of less than £3.7 million.[9] However their holdings were not concentrated in the very large companies: they invested quite heavily in the medium size quoted companies. Briston and Dobbins have found that during the period 1950 to 1970, the insurance companies invested in all size groups of companies, but they also found that they tended to avoid the very small. There was, however, no tendency for them to invest mainly in the largest companies.[10] When the Wilson Committee produced an interim statement towards the end of 1977, in which the troubles of small and medium size companies in obtaining finance were highlighted, a number of institutional investors did announce that they would, in the future, be more willing than they had in the past, to supply funds to smaller companies.[11]

The institutions own very large blocks of shares in some companies. In these companies, voting power is concentrated in the hands of the institutions. It has not always been the case. In an earlier period, 1936 to 1951, Sargant Florence found that the trend was for the twenty largest shareholders in a company to hold a smaller proportion of the votes, year by year.[12] This trend has now been notably reversed. Imperial Tobacco, for instance, who publish an analysis of their ordinary shareholders, recorded in 1951 that personal holdings accounted for 85.4%; in 1971 they accounted for 54.73%, and in 1975 they held just under half of the share capital. It is indeed no longer meaningful to think of shareholders as being uninformed, uninterested people.

The trend outlined applies to Britain, and here a word of warning is necessary. Most of the ideas on this subject, and most of the empirical research are based in the USA. American experience is of no relevance to the British situation. The institutional holding of equities in the USA is at a much lower level than in the UK. In 1968, the institutions in the US held only 19% of the total shares of US quoted companies, whereas British institutions held practically twice that percentage of the total shares of UK quoted companies. (The difference is primarily due to US government restrictions on the proportion of funds life insurance companies can invest in equities.)

The divorce of ownership and control is now firmly established in most companies. The directors of the large companies are not usually big shareholders. In a study of the shareholdings of the boards of directors of the hundred largest manufacturing companies in the UK in 1972, it was found that 'for half the companies, the board held no more than approximately a half of one per cent of the ordinary capital'.[13] There was, however, found to be considerable variation between companies, with the boards of eleven companies holding over 10% of the ordinary shares. This separation of the owners of the company from those running it has many important implications. It raises questions about the objectives of the owners and those of the managers. The communication of information between the two groups becomes of considerable importance, both from the managers' point of view and the shareholders. What, for example, are the expectations of the shareholders?

There has been very little research to determine what shareholders expect from a company. Why do they buy a particular company's shares? What return would satisfy them? Perhaps the most comprehensive British studies on this subject have been those undertaken by Fisons Limited in 1969 and 1972 amongst their own shareholders.[14]

The second survey was taken in July 1972, and showed that the number of shareholders had fallen by 4% between 1969 and 1972. This is in line with the general position in the UK where the number of shareholders is falling each year. The changing pattern of share ownership is reflected in the Fisons survey, where as can be seen in Table 1.2, the proportion of the shares held by institutions increased between 1969 and 1972.

One part of the Fisons survey was concerned with the length of time which shares were being held. It was found that in 1972 over 35% of the total number of shareholders had held their shares for over 10 years. Only 13% of all shareholders had made their first purchase of Fisons' shares between the dates of the two surveys. The holding pattern of institutions and private individuals does of course vary, with the institutions being less loyal than the private individuals. Only 15% of institutional shareholders had held their Fisons' shares for more than 10 years, and a third of institutional shareholders had acquired their shares after 1969. The impression must not be given, however, that institutions flit in and out of their shareholdings, for 47% of the value of the holdings of shares by institutions were held by those who first bought these shares more than 10 years before the survey.

The motives for buying shares in Fisons varied by the type of investor. For the institutional shareholder, 41% acquired the shares mainly for capital growth, 17% wanted mainly income and 35% were looking for income and capital growth more or less equally. The way in which these institutions judge Fisons, the criterion they used for deciding whether to hold on to the shares, was mainly the prospects for growth in earnings per share. The second most important factor they looked for was return on capital employed. These criteria for judging future performance differ in weighting from those used by private shareholders. The most important factor looked for by private shareholders was a safe investment; growth in earnings per share was given less importance by private shareholders.

Table 1.2
Registered holders of Fisons ordinary shares

	1969	1972
Institutions	45.1%	51.4%
Individuals	54.9%	48.6%

1.3 The relationship between the company management and shareholders

The Companies Act is explicit, in that the directors of a company are supposed to run the company in the interests of the shareholders. As the major shareholders in many quoted companies, the institutions have for many years been in a position to influence company management. In the past they chose not to do so. Understandably acting in their own interests they preferred not to interfere, but to remain at arm's length. They were then free to buy and sell a particular company's shares as they saw fit; not being involved in the management of the company, they could sell when for investment reasons they thought it best to do so.

Partly as a result of the large amount of funds institutions had available and partly as a result of the unhappy state of UK industry, pressure on the institutions to encourage them to influence management decision making began to mount in the early 1970s. This was by no means a new idea. Keynes in 1928 also suggested that shareholders should do more to influence managers. Finally, in 1973, as a result of a Bank of England initiative an Institutional Shareholders Committee was formed, and it is expected that this committee will in the future represent the shareholders interests more forcibly than has happened in the past.

Undoubtedly the institutions could use their position in companies to good effect, they could help strengthen the financial position of companies, remove many of the uncertainties which affect the decisions of companies, and use their financial expertise to assist companies. Companies of course are not necessarily going to welcome increased interference from institutions; it would have to be demonstrated that such interference would be for the long term good of the company.

Whether institutions do become more involved in companies in which they have a shareholding is something which will only be known in the future. In 1974, institutions began to make medium-term loans available to companies in which they were shareholders.

They could become of increasing importance as providers of other forms of finance. This could either be direct investment from a particular institution to a particular company or money channelled through an intermediary. For example, in 1974 Finance for Industry was created, with £1 billion to be made available to British industry. Some of this money was provided by the clearing banks and the financial institutions. This is a common way of financing industry in other countries; in the past it has operated on only a small scale in the UK, but it can be expected to grow.

One other group in the economy that has, from the early 1970s, increased in importance as a provider of capital to industry is the Government. The City and the banks have, perhaps wisely, shown a reluctance to become over involved with certain companies. From Rolls Royce to British Leyland, there have been companies who have run into financial difficulties and the Government, to varying degrees has become financially involved in these operations. In 1974 the decline in the level of stock market prices and the financial pressures on the banks, arising at a time of an increasing need for working capital, meant that in some companies there was a need for other than the traditional sources of finance.

In late 1974, the Government took steps to set up a National Enterprise Board, with the objective of strengthening the position of industry or at least of certain sectors of industry. The Board was to take a financial interest in some companies with the hope that through this interest it would be able to work from within the companies to improve performance. This, when it was introduced, was seen by many as an attempt at back door nationalization. However, there are companies (that is shareholders and managers) who have been pleased that a new source of financial backing has become available – those who find the traditional sources not forthcoming.

The power that the institutional shareholders have over a company rests on the effect their investment decisions can have on the share price of a company, on the fact that at times of a takeover bid the decision of a few shareholders can have a major influence on whether the bid succeeds or fails, and on the fact that the institutions have large amounts of funds that can be made available to a company. The type of shareholder and the way shareholders behave is changing. Traditional relationships are altering. The institutions need the companies, as they need good investment opportunities in a healthy economic climate, in order to be able to meet their future pension and assurance obligations. There is political pressure on the institutions in that the Labour party in a number of policy documents have made mention of the fact that one way to control the collection and allocation of funds would be to nationalise certain financial institutions. It can be seen, therefore, that the relationship between the shareholders of a company and the management is one which is changing. In addition to the above points, there is also the change in the social climate which means that company management can no longer automatically assume that their prime responsibility is to their shareholders.

1.4 The capital market

The information system between the company, its shareholders and its potential shareholders is far from perfect. Even a company's bankers, who are usually in a better position to obtain information from the company than the shareholders, can misinterpret the financial position of a company. Those who operate in the capital markets, in the stock market do not have all the information about a company that they would like. Each company supplies them with a certain amount of information, and they attempt to find out more about a company's future prospects by discussions with those involved, by studying the statements of the company and the performance of companies in similar industries. The capital markets are faced with incomplete information, and they are influenced by the statements and actions of a company or its directors.

The investors can make two types of error. One is to believe a company is performing better than it actually is, with the result that funds are channelled into this company whereas if truth were known the funds could have been better used elsewhere. The second type of error is to fail to provide financial support for a company that is in fact in a healthy and promising position.

The first of these types of error can be caused by companies deliberately setting out to mislead the financial community. There were many occasions in the late 1960s and early 1970s where the capital markets were misled by the opportunistic representations of individuals and companies. Many of these cases have subsequently received much publicity. The heroes of one year became the villains of the next. In 1973, Mr Heath, the then Prime Minister, described certain of the financial practices that were being employed at the time as the unpleasant and unacceptable face of capitalism. This summed up the feelings of many who were becoming disillusioned with certain practices of some of those who operated in the financial system. Ways in which certain individuals were able to make money for themselves without benefiting either the investor who provided the funds, or the companies that used the funds, were coming to light with monotonous regularity.

The authorities took steps during the 1960s and early 1970s to eliminate many of these practices. It is good that things are put right where they are wrong. The trouble is that not enough people realize things are wrong until the full publicity machine is turned on to the offending practices. The City is able to withstand a large amount of criticism. In the past it has only been when a practice became so obviously offensive that criticisms appeared in the news media and there is a threat of government legislation being introduced that the City has acted to put its own house in order.

Clearly company directors and shareholders have to follow the provisions of the various Companies Acts, but it is in the area where there is no legislation that problems of reporting, interpretation and financial behaviour give cause for concern. Company legislation only changes at infrequent intervals, and by necessity changes in the law tend to lag behind changes in practice.

The financial community in the UK prefer self regulation to the more formal legal regulations that exist in the USA. In 1978 a Council for the Securities Industry was establised in the UK. The parties in the discussion that led to the formation of this Council were the Bank of England, representatives of City organisations and the Confederation of British Industry. This Council will continue with the policy of self regulation and will take responsibility for the control previously exercised by the Stock Exchange council over listed companies, and for the rules of the Take Over Panel. It is hoped that the new Council will restore the confidence in the City, some of which had been lost in a few dramatic years.

Even where there is no question of deliberate manipulation of information to mislead the money and capital markets, there is still a question of whether the markets are efficient in the allocation of funds.

There are those who argue that the market is less efficient than the firm when it comes to allocating resources. There is a limit to the information that is available to those operating in the market. To take the case of the capital market, those who operate in it are forever trying to obtain better information from companies and to interpret more accurately the information they do receive. There is greater uncertainty when the receivers of information do not know the weight to attach to it than when they are fully aware of the information's strengths and weaknesses.

A large company operates very much as a mini capital market.[15] The subsidiary companies supply the headquarters with information, and the headquarters then allocate capital where they think it can be best used. There is less uncertainty in the interpretation of the information by headquarters staff than there would be by those operating in the stock market if it was to this place that the subsidiary had to apply