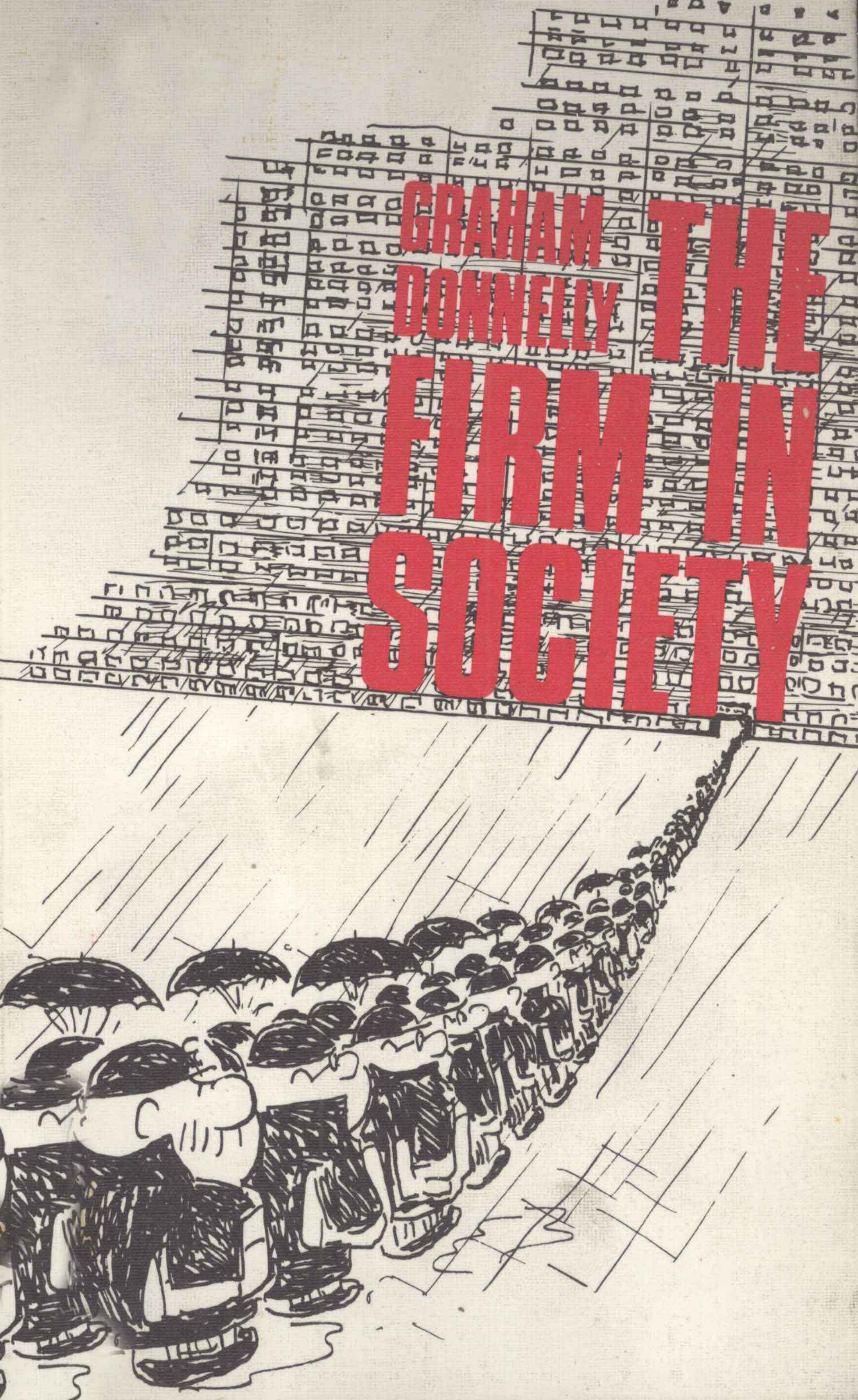
GRAHAM DONNELLY

THE FIRM IN SOCIETY



THE FIRM IN SOCIETY

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PREFACE

The aim in writing this book has been to produce an economics text suitable for students on management, business studies and professional courses, particularly those in the various sectors of higher education. In so doing I have tried to take account of the fact that most of these students study economics as part of an inter-disciplinary course rather than viewing it as a theoretical discipline to be studied for its own sake. The emphasis is therefore placed on those areas of economic activity directly related to the firm and the forces which act on the firm's activities. Important theoretical models are critically examined and the institutional framework is covered in depth. As the forces acting on the firm include political and legal constraints these environmental factors are also given attention while links will be found with marketing and accounting techniques. It is thus envisaged that the economic environment will be more easily integrated into other areas of study and the student's practical experience. While written with courses such as the DMS, IWM, Cert. Mktg and BEC Higher courses in mind it is hoped that this book will also be useful to undergraduate students in business studies and related areas and also to TEC students.

My thanks are due to the many people who have made helpful suggestions in the preparation of the manuscript, particularly to Stuart Wall for the helpful suggestions made in the preparation of the final draft and to Ian Cowley, Alastair Jackson and John Lockhart for their advice and comments. Finally my thanks to my family for their tolerance and support during the production of this book and to them this book is dedicated.

GRAHAM DONNELLY
1981

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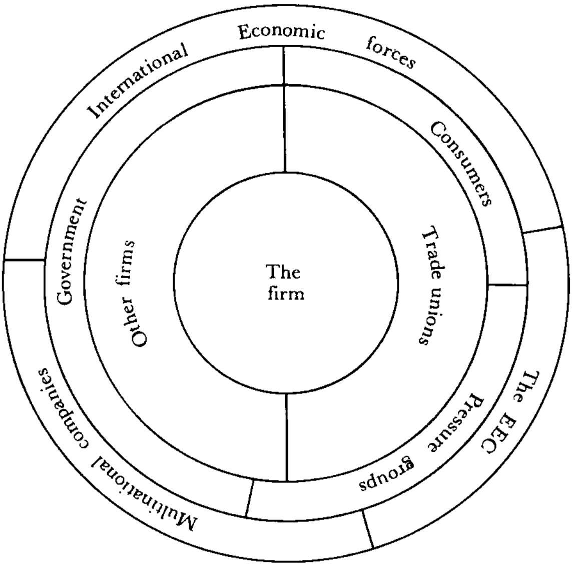
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CHAPTER 1

TYPES OF FIRM AND THE RAISING OF CAPITAL

The vague term 'firm' encompasses all those decision-making units which are concerned with the allocation of scarce resources for the production and distribution of goods and services on a profit-making basis. Firms can be classified under three main groups: sole proprietors, partnerships and joint-stock companies.

THE SOLE PROPRIETOR

The sole proprietor is a one-man business in which one person is alone responsible for decision-making and the raising of capital, though there may be several other people working in the firm. It is in this type of business unit that the entrepreneur, the organiser of production, can be most easily identified as it is here that the functions of the entrepreneur are united in one person – those of innovation, risk-taking and profit-earning. Not all sole proprietors are innovators, many take over established businesses, but they all risk their own capital and reap either the profits or losses which result from their efforts. Though the sole proprietor enjoys the unity of purpose and flexibility of a small organisation the price of failure can be very high. The sole proprietor has unlimited liability and is thus responsible for the firm's debts to the extent of his own property and possessions. The possibility of failure is a very real one as many sole proprietorships are begun by people with little or no commercial experience who lack the expertise necessary to achieve success. As a result all sole proprietors have difficulty in raising capital to set up their operation or even to expand a successful enterprise, because they do not provide an attractive risk to a bank or finance company which has already experienced frequent losses through backing a small firm.

Sole proprietorships are common in retailing, farming and other service industries where personal service is important. However successful a sole proprietor is, the point will eventually arrive when further growth will entail attracting capital from outside his own resources and thus he must seek a partner or form a joint-stock company.

PARTNERSHIPS

A partnership is a legal relationship of any number of persons between two and twenty for the purpose of carrying out a business. Partnership provides more capital than a sole proprietor could raise on his own and permits specialisation of expertise and area of operation. Some partners are taken into the business purely for the capital they contribute and they take no part in the running of the business, i.e. they are dormant or sleeping partners. A major disadvantage of the partnership is that, like the sole proprietorship, it has unlimited liability and each partner is liable for the debts of the business, whether incurred by himself or his partner. The risk to a potential partner of losing not only his investment but also his other assets may be a deterrent to his participation in the business and so, in some partnerships, there are limited partners who are liable for the debts of the firm only to the extent of their investment. These limited partners are not permitted to play an active role in the business.

For a partnership to be successful each member must be able to trust both the integrity and the ability of his co-partners and even then the risks are so great as to make partnerships a relatively unattractive form of business organisation except in the professions where the capital required is small and the risks slight. Even when partnerships are successful one last disadvantage is that they are not legal entities and end with the death of any partner so that a new partnership will have to be formed. So the partnership has largely given way to the joint-stock company since the advent of limited liability in the middle of the last century.

A joint-stock company is an association of people who contribute capital jointly for the purpose of carrying on a business. Each member of the company possesses limited liability (except in the rare case of the Unlimited Company) and is only liable therefore for the shares he holds in the company. Limited liability is an attractive inducement to potential investors and thus makes the raising of capital much easier than is the case with sole proprietorships and partnerships. It is, however, a disadvantage for debtors of the firm who may have difficulty in realising their assets should the company go into liquidation. Joint-stock companies were distrusted in the eighteenth and nineteenth centuries after the scandal of the South Sea Bubble in 1720 had exposed the potential abuses of this form of business organisation and it was not until the Acts of 1855 and 1862 that limited liability was generally permitted. Since then limited liability companies have become by far the most important form of business organisation and there are now some 600,000 of them registered in the United Kingdom.

There are two types of joint-stock company, private and public. Private companies are much more common and there are over 550,000 of them registered, many of them small family businesses with two or three shareholders enjoying the advantages of limited liability. The shares of private companies, which can have up to fifty shareholders, are not allowed to be offered for sale to the public and cannot be transferred without the consent of the other shareholders. There are thus limitations on the expansion of private companies but these can be overcome by going public. Public companies, which must have at least seven shareholders but any number above that, are permitted to advertise issues of shares to the general public and all shares are freely transferable. Both public and private companies are required to file accounts annually with the Registrar of Companies but public companies must publish more comprehensive accounts than are required of private companies.

When joint-stock companies are formed they are required to lodge with the Registrar of Companies a list of directors together with the Memorandum of Association and Articles of

Association of the firm. The Memorandum of Association gives such details as the name, registered office, nominal capital and objects of the firm while the Articles of Association detail the internal rules of the firm in such matters as the powers of directors, the election of officers and the calling of company meetings. Public companies are also required to submit another document, known as the Prospectus. The Prospectus is also published when the company offers shares to the public by advertisement and contains a brief outline of the company's record with information on profits and losses for previous years, the company's assets and future projections of the company's performance. Only when the Registrar is satisfied that all these documents are in order will he issue a certificate of trading to authorise the company to commence its activities.

The growth of the joint-stock company as the major form of business unit reflects the ability it possesses to raise capital for launching a firm and for expansion. In the case of the public company this ability to raise funds is further promoted by its having access to the capital markets.

OTHER FORMS OF BUSINESS ORGANISATION

Until now the types of firm discussed have shared the common characteristic of being established for the purpose of making profits for their owners who, as in the case of the public company, may be neither actively working in the firm nor consuming its products. Yet, in certain fields, a number of successful business organisations have been established during the last century or so which have sought an alternative role for the profits earned by the firm. Thus there are those joint-stock companies registered under the Building Societies Acts, Friendly Societies Acts, etc., which are governed by strict rules supervised by the state and which operate with a different scale of priorities from other firms so that profits are used for the benefit of the members of the society rather than being distributed as a dividend. The retail co-operative societies link their distribution of profits not to the size of the shareholders' investment but to the amount of their purchases with the society: ownership is tied therefore to consumption rather than to capital. Similarly the mutual and friendly societies, common in insurance, plough all profits back into the business for the benefit of savers and policy-holders. A number of attempts have also been made to establish workers' co-operatives where the benefits of a large-scale enterprise are allied to the principle of a sole proprietorship in that the owner and the worker in the firm are the same. Unfortunately such workers' co-operatives have rarely been successful in Britain though they have in other parts of Europe. Finally the twentieth century has seen the rise of the public corporation in which ownership is vested in the state acting on behalf of the citizens and therefore, by implication, of both consumers and workers.

SOURCES OF FINANCE

The sources of finance available to the firm can be classified into a number of types, some of which are available to all firms and all of which are available to the public company.

Internal finance

For large firms a major source of funds for new investment is the reserve of retained profits built up over preceding years and not distributed to shareholders. The firm must take a balanced view of its dividend policy however, as a poor dividend record will hamper its ability to raise external finance through future share issues.

External finance

Long-term external funds

Public companies can seek to raise finance by the issue of shares or loan capital to the public, which issue will become freely transferable on the Stock Exchange. Not all public companies have acquired a Stock Exchange quotation and this may be detrimental to the attractiveness of the issue as it will be more difficult to strike a price in the shares when the buyer wishes to dispose of them. Shares give part-ownership of the firm and take several forms, the two most important being ordinary shares and preference shares. Ordinary shareholders are entitled to the distributed profits of the company after all other claims have been met and there is thus no guarantee that a dividend will be paid. Their shares carry a vote each at the annual general meeting and they therefore have some control over the management of the company. Preference shares rank before ordinary shares in the payment of dividends but normally the rate of return is fixed, however well the firm is performing. *To give more flexibility some preference shares are* 'Participating Preference' shares and these do share in the higher profits earned after ordinary shareholders have been paid. If the firm encounters a loss even preference shareholders receive no dividend except in the case of 'Cumulative Preference Shares' which are entitled to arrears of dividends when eventually a profit is made. Naturally in return for their greater security preference shareholders must sacrifice their say in the running of the company and they do not usually have a vote in the company's affairs unless they have not received their dividend.

Loan capital may also take a number of forms but the commonest is the debenture, which is a secured loan against some of the firm's assets. The debenture-holder is not an owner but a creditor of the firm. He therefore receives a fixed-interest payment on his capital rather than a dividend. His interest must be paid before any distribution to shareholders is made and if his interest is not paid he has the right to put the company into liquidation and recover his money from the sale of the security pledged against the debenture.

The issue of capital can be made in a number of ways:

1. *The offer for sale*. The company sends the shares to an issuing house (a merchant bank specialising in the flotation of new issues). The issuing house then disposes of them at a profit to the public.
2. *Public issue*. The company is advised by an issuing house on the size and form of the issue and the bank advertises the shares by prospectus in at least two newspapers. Usually the issuing house underwrites the issue, thereby guaranteeing to buy any unsold part of the issue. If the issue is over-subscribed the issuing house decides how best to allocate the shares using a ballot or proportional allocation, etc.
3. *Placing*. Both of the first two methods are costly and are not viable if the issue is below a certain size since costs do not fall proportionately with the size of the issue. One alternative is for the issuing house to place the shares with selected clients, often investment trusts or insurance companies.
4. *Rights issue*. The cheapest method of issuing new shares is for

the firm to offer existing shareholders the right to buy new shares in proportion to their existing holding. Such rights issues are attractive as they offer the new shares at a lower price than those quoted on the Stock Exchange. Furthermore, they will not involve the payment of stockbrokers' commission should the offer be taken up.

Short- and medium-term external funds

1. *Bank credit.* Traditionally banks have been important sources of short-term finance for firms in the form of overdrafts and bridging loans. Bank credit represents a much smaller proportion of the assets of large quoted public companies than of small private companies but for all firms it is a minor source of finance. In recent years, however, banks have shown a greater interest in long-term finance in the form of debentures and mortgages.
2. *H.P. debt.* For the smaller firm a common source of finance is the purchase of capital equipment on hire purchase.
3. *Trade Credit.* The practice of suppliers of giving purchasing firms goods on credit terms is again of great importance to the small firm and amounts to a short-term loan of three to six months.

THE FINANCING OF SMALL BUSINESSES

Private companies cannot raise finance through the capital market and the cost and practicalities of the new issues market make it difficult for small public companies, especially those without a Stock Exchange quotation, to use this facility. These firms have difficulty in raising finance, therefore, and this presents a problem which concerns the whole economy, since it is frequently small firms which are developing the new products and dynamic new ideas which promote economic growth. The use of internal funds is one solution but it is an inadequate one since small firms are unlikely to generate large enough profits to build up the internal finance for major expansion. If they attempt to raise external funds they will find themselves paying more for loans than larger firms and the short-term facilities offered by banks are risky as they can be recalled, or at least not renewed, at short notice. The result is a capital structure unattractive to potential investors, thus making the raising of equity capital even more difficult. In an effort to deal with these problems various institutions have been established to cater for the needs of smaller firms.

In 1931 the Macmillan Committee on Finance and Industry reported that a gap existed in the capital market for the supply of finance to small and medium-sized firms. This was followed by the establishment, in 1934, of the Charterhouse Industrial Development Company by a group of banks and an insurance company to give loans of up to £100,000 to small firms. However, those which seemed likely to grow sufficiently to make a public issue received most of the help available. It was not until 1945 that the spirit of the Macmillan Report was implemented with the setting up of the Industrial and Commercial Finance Corporation. The ICFC had an initial capital of £15 million subscribed by the deposit banks and the Bank of England and had borrowing powers of £30 million, solely by advances from the member banks. Its purpose was to provide long-term and permanent capital in amounts ranging from £5,000 to £200,000 (later raised to £300,000). The ICFC tended to give its support a little over-cautiously but the many succesful projects it helped launch did show that investment in small companies could be highly profitable and this encouraged the growth of private finance houses specialising in the provision of finance for small companies. In 1959 the Radcliffe Report drew attention to the need for finance to develop technical innovations and in 1962 an associated company of ICFC, Technical Development Capital Ltd, was launched with this aim in mind. Another associated company is Estate Duties Investment Trust Ltd, which buys shareholdings in private family companies to avoid large blocs of shares having to be sold at an adverse price to pay Death Duties (now Capital Transfer Tax) when a principal member of the family business dies. This company has proved highly successful and has a quotation on the Stock Exchange. In 1974 ICFC was merged with its sister organisation, the Finance Corporation for Industry, to form the new organisation Finance for Industry.

Despite these attempts to cure the problems encountered by small firms in the raising of finance and their relative success the majority of small companies still find it difficult to attract capital. The fact that the risks attached to lending to small firms are greater is not conducive to attracting funds, especially from those potential sources which are concerned to ensure that their investments are safe, such as the insurance companies and investment trusts. Similarly, one traditional source of capital, funds supplied by local traders with spare capital, has virtually died out now that small investors can obtain a reasonable return through the specialist institutions operating in the capital market. Nevertheless small firms must take some of the blame themselves. Too often they are unwilling to part with anything but the smallest share of equity for fear of losing control and potential investors are unlikely to put up substantial sums of money without some say in the running of the firm. The vast majority of small entrepreneurs have limited financial expertise and this may explain why so many of them never even seek outside financial assistance. Finally the Bolton Committee on Small Firms (1971) reported that small firms are less able than large firms to satisfy the requirements of lenders on financial data and the competence of management. The institutions for financing small firms are now adequate but

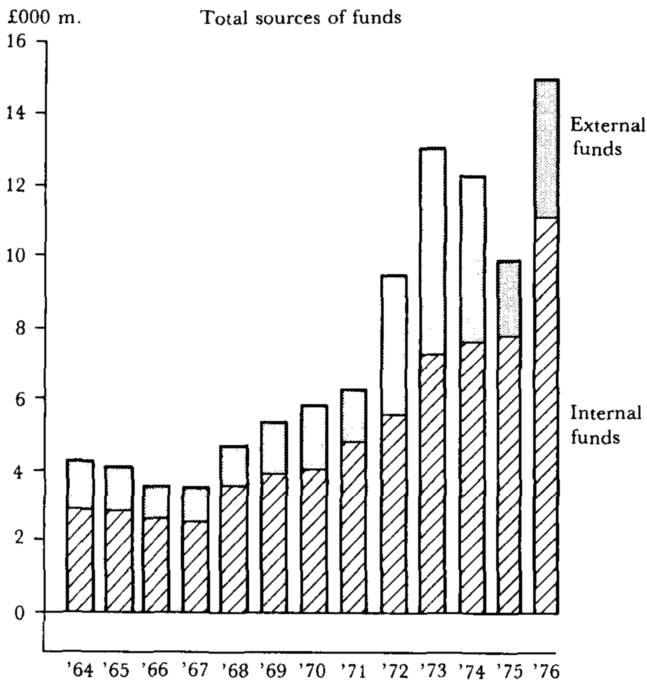

Fig. 1.1 (*Source:* Treasury Economic Progress Report)

small firms do not always have the ability to make the best use of them.

THE IMPORTANCE OF VARIOUS SOURCES OF FUNDS

As can be seen in Fig. 1.1 internal sources of funds are far more important than external sources. In the case of small firms this is probably a reflection of necessity as much as choice as they would be unable to raise all the finance they need from external sources. For larger firms it often reflects a desire to maintain maximum control over the company. Furthermore internal funds can be used for more risky projects than could external funds though there is here the danger that projects financed from internal funds will not be costed as efficiently as those using external sources. A further incentive to internal financing is the British system of Corporation Tax which has usually discriminated in favour of retained rather than distributed profits and thus encouraged the building up of substantial reserves. The economic argument that internal funds are not used as efficiently as external finance and that more profits should be distributed for reinvestment via the market has some validity. However, this can be countered by the equally valid point that not all distributed profits are available for further investment and so the total amount of investment would be diminished if the proportion of profits retained by companies were to be reduced.

The major component of external funds via the capital market is long-term loans which amount to some 10 per cent of total funds while cash issues of ordinary shares account for only 5 per cent of the total. The ratio of an individual company's loan capital and preference shares to ordinary shares is known as its gearing. Thus a newly floated public company will probably have raised a large proportion of its capital through the issue of debentures and preference shares, with relatively few ordinary shares, and it is therefore 'highly geared'. The advantages of high gearing are that the proprietor can retain control of the business by ensuring that he holds the voting capital and that, if the firm is successful, there will be comparatively few ordinary shares to share in the high profits available for distribution. On the other hand, high gearing may also present difficulties. As the interest on debentures must be paid each year, high gearing places a considerable strain on the firm during periods of financial difficulties when it can ill afford to pay out substantial sums in interest. Furthermore high gearing makes the company a less attractive proposition to future investors when it wishes to raise further capital through the sale of ordinary shares. Generally the investor will be less inclined to buy shares in a company which has a large amount of fixed-interest bearing securities on which it will have to pay interest before the ordinary shares can obtain a dividend. As firms get larger their gearing tends to become lower and the majority of public-quoted companies have a relatively low gearing.

One other major source of funds for firms is the state or state-sponsored bodies. The role of the Industrial and Commercial Finance Corporation has already been discussed in connection with small firms and in 1945 the Finance Corporation for Industry was founded with a capital of £25 million subscribed by the Bank of England and a number of insurance and investment companies. It had borrowing powers of £100 million provided mainly by the deposit banks. The finance was usually provided as a long- or short-term loan though the FCI could buy equity capital in businesses it decided to help. It was particularly useful to industries which were experiencing difficulties and therefore could not raise capital easily, such as steel and shipbuilding. The nationalisation of some of these industries reduced its role and, as stated previously, in 1974 it was merged with ICFC to form Finance for Industry. Other government assistance to industry will be examined in Chapter 11.

INVESTMENT APPRAISAL

For all economic decision-making units, the consumer, the firm or the government, the over-riding problem is how best to allocate scarce resources. For the firm the most vital decisions it takes are concerned with the allocation of the capital it has raised by the various means outlined above. The firm can choose to allocate its capital either for consumption or for investment, that is, either as working capital in the direct production of goods or into long-term capital projects entailing a short-term sacrifice in return for higher long-term rewards.