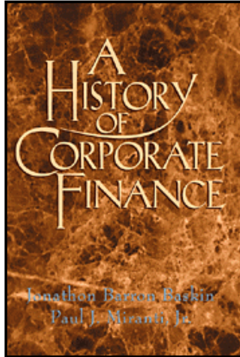
getAbstract
compressed knowledge



A History of Corporate Finance

by Jonathan Barron Baskin and Paul J. Miranti Jr.
Cambridge University Press, 1999
350 pages

Focus

- Leadership
- Strategy
- Sales & Marketing
- **Corporate Finance**
- Human Resources
- Technology
- Production & Logistics
- Small Business
- Economics & Politics
- Industries & Regions
- Career Development
- Personal Finance
- Self Improvement
- Ideas & Trends

Take-Aways

- Since ancient times, corporate finance has struggled with two issues: risk and information.
- Early financial transactions were personal partnerships and loans, not shared ownership.
- Until recent decades, investors preferred to be creditors holding bonds and debt securities, instead of owners holding equity shares.
- The imbalance of information between management and shareholders in early markets impeded the fair valuation of equity shares.
- The immensity of railroad operations led to the creation of modern corporate management structures and the development of broad, impersonal equity markets.
- The emergence of managerial capitalism permitted vast economies of scale.
- Innovation in communications and financial reporting enhanced available information and helped equity markets succeed.
- When investors are poorly informed, corporations will acquire more debt to maintain the flow of dividends to shareholders.
- Integrated operations and the extensive accumulation of research and development knowledge benefit the modern center firm.
- Short-term thinking hampers conglomerates and leveraged-buyout partnerships.

Rating (10 is best)

Overall	Applicability	Innovation	Style
7	6	8	7

Visit our website at www.getAbstract.com to purchase individual abstracts, personal subscriptions or corporate solutions.
getAbstract is an Internet based knowledge rating service and publisher of book abstracts. Every week, subscribers are e-mailed a short abstract of a different business book. Each abstract contains an overview of essential ideas from the entire book. Excerpts from this book are reprinted here with the permission of the publisher. The respective copyrights of authors and publishers are acknowledged. All rights reserved. No part of this abstract may be reproduced or transmitted in any form or by any means, electronic, photocopying, or otherwise, without prior written permission of getAbstract.com Ltd (Switzerland).

Review

A History of Corporate Finance

This thorough, scholarly study balances broad concepts with specific details of the history of finance from the 15th through 20th centuries. Though authors Jonathan Barron Baskin and Paul J. Miranti Jr. assume that the reader has some knowledge of finance and relevant terms, they avoid mathematical models and jargon in favor of plain language. Their book is accessible and valuable to lay readers as well as trained economists, historians, students of finance and anyone coping with an emerging market. The issues they examine remain surprisingly relevant, because — as they soon make clear — the problems that historical markets once confronted are the same issues of risk and information that markets face today, particularly emerging markets. As a historical study, this book presents no particular prescriptions for success or future action. However, *getAbstract.com* recommends its explanation of why some structures succeeded and others failed, because those forces have clear implications today.

Abstract

Centuries of Interaction

Two central questions of modern financial theory also shaped finance's history: the financing question — focusing on the elements that determine a firm's capital structure — and the dividend question — focusing on factors that control distribution of residual income to shareholders. These questions emerged over five centuries as risk, knowledge, organization and institutions interacted. Through time, four circumstances drove financial innovation:

- Firms could realize economies of scale and scope by attracting large amounts of capital.
- Financial innovations could help firms gain from external events, such as weather or war.
- Firms gained when financial innovations reduced the perception of risk.
- Financial innovations helped firms overcome costly imperfections in their markets.

"The influences that the perennial problems of information and risk have exerted on finance have been evident since the dawn of civilization."

The Pre-Industrial World

Even in ancient times, finance was influenced by the perennial problems of information and risk. In the 10th century, greater literacy and new forms of measurement — such as algebra, arithmetic and double-entry bookkeeping — spurred an economic revival in Europe. An increase in farm productivity provided a surplus that revived trade with the Byzantine Empire and the Levant. This trade was dominated by Italian city-states, especially Venice and Florence. Italian firms tried to control risk by associating themselves with the state, receiving a state monopoly in exchange for loans to the sovereign.

"Like many of the unsuccessful industrial mergers of the early twentieth century, the drive to form conglomerates originated from an incomplete understanding of the economics of giant business enterprises."

Florence's strategy focused on importing woolens from Northern Europe to correct the chronic trade imbalance between Italy and the North. Most financial transactions in this period were based on personal contact and relationships. Passive investors of that era wanted debt instruments instead of equity; they preferred being creditors to being partners. Initially, the Florentines retained the Greco-Roman partnership structure, the

 © Copyright 2001 getAbstract.com

"The South Sea Company experience improved the position of those in the British government who believed that full disclosure of prospective financing plans was essential for effective financial markets."

"The most compelling issue in the recent history of U.S. financial markets is not whether there should be regulatory regimes; it is whether these regimes come within the purview of professional or governmental agencies and what the boundaries of supervisory authority are."

"Concerns about risk encouraged efforts during the Middle Ages and the Renaissance to connect the credit of the firm with that of the state."

"Broad, anonymous markets first arose for debt securities because they faced fewer impediments than equity instruments and thus could be more readily sold to distant investors."

societas, a single-voyage arrangement in which partners contributed either equity or labor and each member was potentially liable for the enterprise's debts. During the 12th century, though, a new structure arose, the *compagnia*, which had a more flexible capital structure. It was financed by long-term liabilities, which paid 5% to 10%. The large capitalization of *compagnias* allowed Florentine banks to expand in scale and scope, diversify their risk, build efficient internal administration structures and experiment with different business strategies. In a different approach to trade, Venice used naval power as leverage to coerce trade concessions from foreign powers. Venetian merchants used the *colleganza* form of partnership, a single-voyage arrangement similar to the *societas*, in which one partner contributed funds and remained home while the other contributed time and labor to transporting and selling goods abroad.

From 1450 to 1720, oceanic exploration and discoveries, such as the discovery of America and the circumnavigation of the globe, opened new trade channels. In response, the joint-stock company was invented. This form benefited from a stable capital base financed by liabilities with varying maturities, which were supported in turn by transferable equity shares. Equity shares now entered much wider use. By selling stock, these companies increased investor liquidity, reduced transaction costs and concentrated vast amounts of capital, allowing them to achieve previously unattainable economies of scale and scope. Joint-stock companies developed effective management structures for their far-flung operations, which reduced their information costs. Joint-stock companies allied with the state and used private capital to extend state power. In return, they received Crown monopolies.

Starting in the 17th century, England became the leader in creating securities markets. The arrival of mathematical economics and banking's growing flexibility fueled innovation. A public debt market arose to help finance England's wars with France. Dangerous "bubbles" formed, with England's South Sea Company and then with France's first efforts to create a stock market. Both bubbles ended with crashes that spread across Europe and shattered public confidence in equity markets. Markets struggled with high risk and poor information, especially about share valuation. Investors preferred government debt securities because their fixed interest payments helped determine their fair market value. Concerns about risk led the English East India Company to establish limited liability status for shareholders in 1662, but the policy did not become general practice until the 19th century.

The Rise of Modern Industry

The rise of railroads, then the world's most capital-intensive industry, fueled the development of modern corporate financing and management structures. Early railroads and canals were financed locally, but the railroads' vast expansion required more capital from a larger geographic area, which created broad, impersonal financial markets. Widespread insider trading and a lack of timely, reliable information retarded the growth of securities markets. Limiting stockholders' liability became standard in the U.S. and Britain in the mid-19th century, while the introduction of the telegraph and telephone facilitated transmission of corporate financial information. Specialized business publications began to appear.

 © Copyright 2001 getAbstract.com

“The development of large-scale trading enterprises was an essential part of the growth of national economies.”

“The substitution of the rule of law for the divine right of a monarch made investor interests more secure. The guarantee of the nation-state was better protection than the personal promise of the sovereign.”

“The ordering of corporate affairs was made more effective by modern professional management techniques that were perfected in the railroad industry beginning in the 1860s.”

“Unlike the small, family-controlled firms characteristic of the pre-industrial economy, there was a high degree of separation of ownership and control in the modern corporation.”

“The lack of a clear body of accounting standards encouraged manipulative financial reporting, and this enhanced the perception of the riskiness of equity investment.”

These markets needed to offer a way for investors to have confidence in the valuation of securities. Initially, equity investors were often required to contribute additional funds after their initial purchase. Promoters had to screen out potential investors who might not be able to deliver more funds if needed. This impeded the growth of broad markets for common shares. Markets also still struggled with information problems, especially the asymmetry of information between management and investor/owners. Management often manipulated the financial press for its own gain. Poor knowledge increased the perception of risk, in turn threatening to frustrate the development of finance. Investors preferred debt securities, because they seemed less risky. Preferred stock, with its fixed-income guaranteed dividend, addressed this concern and became the most popular vehicle for railroad finance.

Preferred stock introduced the lasting idea that stock should provide a fixed dividend. This idea actually leads to the accumulation of more corporate debt, under the “pecking order hypothesis,” which says that because investors poorly understand financial structures, corporations can retain investor confidence by establishing a steady, rising trend of dividends as the base of their financial policies. In some cases, this means that firms take on debt when they need more capital, rather than issue more equity shares.

Managerial capitalism and common stock finance rose from 1900 to 1940. Professional managers, who typically owned only a small percentage of their companies, became the primary decision-makers for large corporations, supplanting founding families. Large corporations could achieve economies of scale through vertical integration, lowering transaction costs by controlling their vital services and supplies, and maintaining demand by controlling marketing. Corporations widened the scope of their businesses and achieved economies through research and development. The management structures inherited from railroads helped create economies of scale in these complex corporations, but new, more decentralized management structures arose to exploit economies of scope.

Investors only gradually came to accept and embrace common-share investing. Markets still struggled to set values for shares. Attempts to price shares according to the value of investment in the corporation proved unreliable. Investors were so much more accustomed to bonds (not shares) that dividends were expressed as a percentage of the par value, as if the stock were a bond. Investors sought calculations of par value returns, not capital gains. The public frowned on undistributed profits, feeling that reported earnings should be paid.

More and more corporations began to issue common stock. At first investors were attracted because stocks seemed to share the properties of debt instruments. With better financial reporting, greater financial disclosure and improved accounting practices, investors began to look at book value and other methods of stock valuation instead of dividend patterns. In the 1920s, the public realized that equity shares were the best tools for sharing the gains earned by managerial capitalism. The crash of 1929 and the ensuing depression shook investor confidence but led to reforms that further improved disclosure and transparency.

 © Copyright 2001 getAbstract.com

Transition to the Contemporary Era

Three leading classes of enterprise dominate contemporary finance: the center firm, the conglomerate and the leveraged-buyout partnership. Center firms diversify across many areas of production, expanding into complimentary areas. Ideally, this diversity creates reduced risk and increased return. The huge industrial capacity of center firms fueled the growth of national economies. Center firms have been leaders in research and development, product innovation and the production of capital goods; this has given them great dynamism.

"Center firms were able to achieve dramatic cost savings by establishing organizations that made possible more effective coordination and control of many interdependent operational elements."

After World War II, markets were bolstered by more and better financial information. Accounting principles were standardized and more specialized periodicals appeared, sharpening investors' knowledge of business affairs. New electronic media spread more information, and spread it faster, helping the market's price-searching function.

"The enhancement of managerial capacities through improved communications also made possible the concentration of great amounts of financial capital in business enterprises of great scale and scope."

Conglomerates created vast, diversified companies based upon portfolio theory. Rather than the center firms' economies of scale and scope, conglomerates sought economies of financial transacting. Aided by loose accounting practices, they hedged risk and tried to balance cash flow by investing in unrelated enterprises. The goal was to create "synergies," or efficiencies, by applying advanced management techniques. In theory, this was bolstered by advancements in management science, computer technology and data processing. High corporate tax rates encouraged the acquisition of firms with net operating losses. In time, though, conglomerates proved unsuccessful. Their thin central management proved inadequate to maximize returns from their diverse divisions and the promised efficiencies did not materialize.

Leveraged buyouts (LBOs) arose from the belief that managers were acting primarily in their own interests, not in the interest of the shareholders. The partnerships took on large amounts of debt and concentrated ownership among a few general partners, limiting outside investors to the role of creditors.

About The Author

Barron Baskin held degrees from the University of Chicago, Columbia University and Harvard University. From 1985 until his death in 1989, he was associate professor of Finance at Baruch College. Paul J. Miranti holds degrees from Johns Hopkins University and New York University. He is the associate dean in the faculty of management at Rutgers University.

Buzz-Words

Bubbles / **C**enter firm / **C**olleganza / **C**ompagnia / **C**onglomerate / **J**oint-stock company / **L**everaged-buyout partnership / **L**imited liability / **M**anagerial capitalism / **P**referred stock / **S**ocietas / **V**ertical integration

© Copyright 2001 getAbstract.com