

## CHAPTER - 5

## SMOOTHING AND CLASSIFICATION OF FIRMS

## 5.0.0 METHODOLOGICAL ANALYSIS :

A distinction is drawn between management controlled firms, MCs, and owner controlled firms, OCs, and it is suggested that "this separation causes the motivation of owners in many cases to be quite different from that of managers,"<sup>1</sup> and that "motivation is considerably more important in influencing efficiency in the economy as a whole."<sup>2</sup> A number of studies have empirically showed that the effects of separation of ownership and control on the performance is significant. This chapter attempts to show that the criteria used to classify the firms into MCs and OCs in the past have been less satisfactory and so inadequate. An alternative criterion is suggested for the purpose.

### 5.1.0 EFFECTS OF CONTROL TYPE ON THE PERFORMANCE OF THE FIRMS :

5.1.1 Traditional Firms (TFs)<sup>3</sup> :- The salient features of the Traditional model of the firm are :  
 (i) the firm is run by the owner cum manager whose objective is to maximise profits ;(ii) he has perfect knowledge on information which are cost-free;  
 (iii) free entry and exit in the market; (iv) price is decided at the point when the marginal revenue equals the marginal cost of the product.

The assumption (i) implies the absence of separation of ownership and control and that the resulting profits is solely due to the top management, the owner cum manager. The impact of those below the top manager on profit is assumed to be zero. The top management does not indulge in dissipating potential profits to smooth the profits stream i.e., he does not maintain, create and manipulate, organisational slack or Economic Leverage. "In conventional economic theory slack is zero at least at equilibrium. In treatments of managerial economics, attention is ordinarily focused on only one part of slack - payments to owners - and it is assumed that other slack is maintained at zero."<sup>4</sup> Since organisational slack is zero and income smoothing behaviour

is absent, no effort is taken at any level to smooth the profits stream it may imply that profit are maximised.

Various studies classify firms into MCs and OCs. By OCs they refer to the profit maximising (traditional) firm. These traditional firms are called as OCs may be because TEs are run by the sole owner.<sup>5</sup>

5.1.2 Modern Firms :- Criticisms of the traditional model of the firm lead to the formulation of alternative models of the firm. The main features of all these theories are (i) the ownership of the firm is separated from control i.e., the owner and manager is not one and the same person as is obvious from Figure-5.1, (ii) hence the motive of the manager differs from that of the owner, (iii) organisational slack is present and hence income smoothing phenomenon and (iv) profits are not maximised.

5.2.0 CLASSIFICATION CRITERIA SO FAR SUGGESTED :

Earlier studies classified the firms into OCs and MCs based on the percentage of equity holdings by a group / family / party etc.

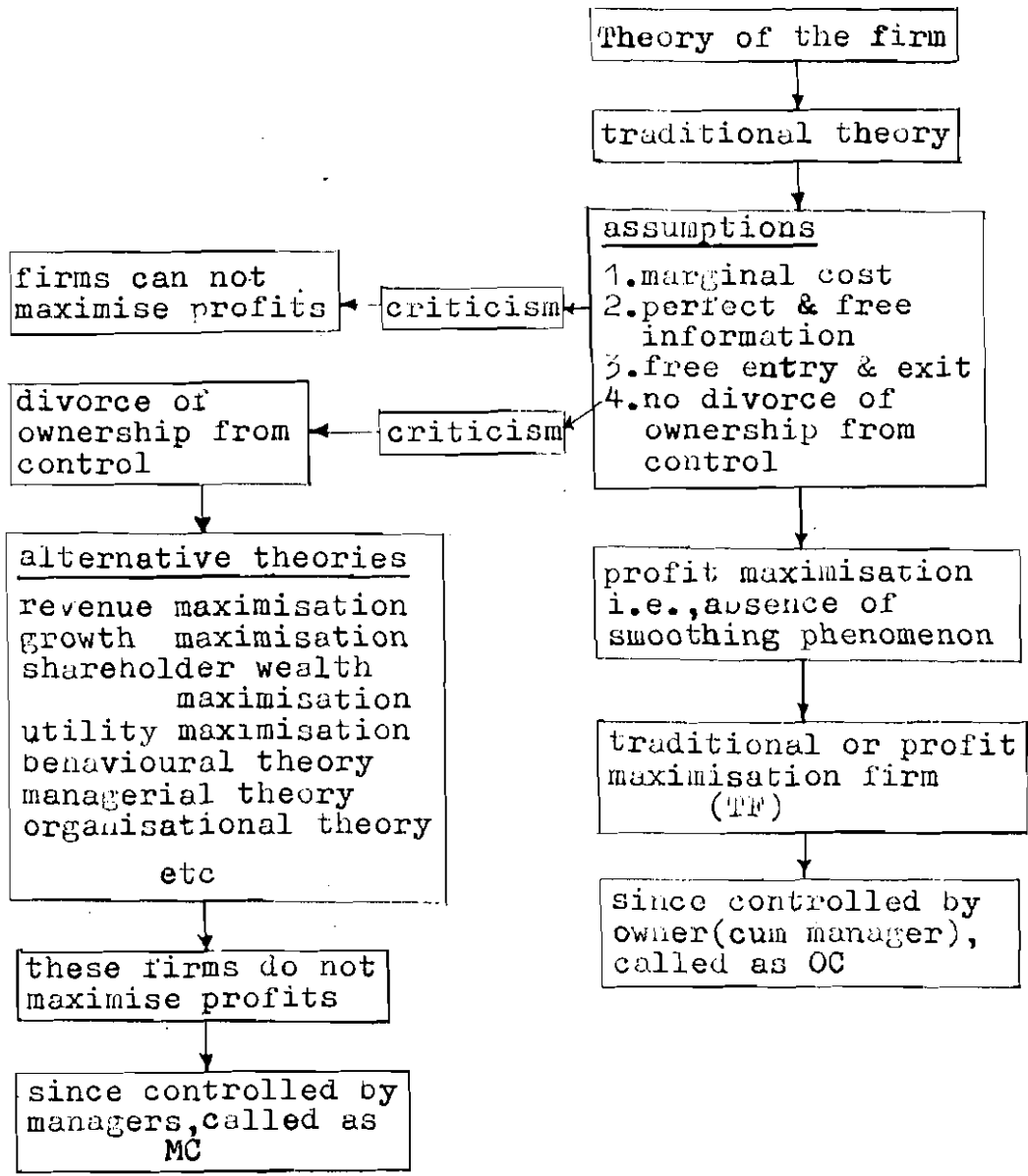


Fig-5.1 : Traditional and Non-Traditional Firms.

Table-5.1 gives the criteria used in the earlier studies. These studies seem to assume that (i) if a group of individuals can elect the top management of the firm, the top management will act on behalf of these equity holders, owners. The interests of these owners and the selected top management does not conflict and that the top management is considered equivalent to traditional owner manager. (ii) The profits performance is solely due to the influence of the top management and nothing else. Therefore these firms are called as OCs. If any particular group does not hold 20 % or more of the equity, as Berle and Means used, then it is assumed that there is no particular interest group to select the top management to act for their interests i.e., the interests of the owners and that of the top management may conflict. In this case, since the decisions are taken by the top management, these firms are called as MCs. Because by 'control of the firm' they refer to "the power to select or change management<sup>6</sup>....which is of latent nature and is determined by the distribution of the firm's voting securities."<sup>7</sup>

All these studies assumed that the ownership is separated from control, in the case of

Table-5.1: Classification criteria of firms.

Studies by	year	OC(%)	MC(%)
Berle and Means	1932	$H \geq 20$	$H \leq 20$
Monsen et al	1968	$H \geq 10$ (wbr) $H \geq 20$ (nbr)	$H \leq 5^{\S}$
Radice	1971	$H < 15$ (wbr)	$H < 5$
Boudreaux	1973	$H \geq 10$ (wbr) $H \geq 20$ (nbr)	$H \leq 5^{\S}$
Palmer	1973	$H \geq 30$ (soc) $10 < H \leq 29.9$ (woc)	$H < 10$
Amihud and Kamin	1978	$H \geq 30$ (soc)	$H < 10$
Kamin and Ronen	1978	$H \geq 30$ (soc) $10 < H \leq 29.9$ (woc)	$H < 10$
Amihud et al	1983	$H \geq 10$ (wbr) $H \geq 20$ (nbr)	$H \leq 5^{\S}$

$\S$  = if there is no recent evidence of owner control;  
 H = voting stockholding of a group/block/family etc;  
 wbr = with Board Representation; nbr = without Board  
 Representation; OC = owner controlled firm, MC = manage-  
 ment controlled firm; woc = weak OC; Soc = strong OC.

MCS, and that there is no separation of top management's control over decisions and the resulting performance i.e., the impact of those below the top management on the performance of the firm is zero which, in fact, is not. "All the managers realise that the managerial labour market uses the performance of the firm to determine each manager's outside opportunity wage... (and thus)..... each manager has a stake in the performance of the managers above and below him, as a consequence, undertakes some amount of monitoring in both directions... (and that)... all the managers below the top level have an interest in seeing that the top managers choose policies for the firm which provide the most positive signals to the managerial labour market."<sup>8</sup> Since "budget is the criterion by which they (below the top management) will be judged throughout the year and for resource allocation.... (and since).... budget preparation process is a highly participative effort on the part of all the managerial levels,"<sup>9</sup> they incorporate varying degrees of 'slack' in the budget deliberately. Because by doing so they smoothen the firm's performance and therefore their own performance. Schiff and Lewin (1968) have provided a strong empirical support for

the impact of the management (below the top) on the cost and revenue projections which significantly affect the profits, performance, of the firm. They have roughly estimated that 'slack' may account for as much as 20 to 25 % of divisional operating ~~ex~~ expenses which signifies, beyond doubt, the significant impact of the key managers below the top level, had on the profits of the firm. For instance they reported that " the group controller of division A estimated that slack in the administrative personnel category of the division was between 20 to 30 percent."<sup>10</sup> "This behaviour seems universal among managers : it occurs in profitable and unprofitable companies, whether stable or growing."<sup>11</sup> Now it may be obvious that all the managers at all levels below the top management also play a dominant or significant role in affecting the performance of the firm. This is supported by evidence presented by Kamin and Ronen (1978) wherein they found OCs, which also classified by the percentage distribution of voting stockholding criterion, smooth income more extensively than MCs under low barriers to entry into the market. The impact of the below the top management both in the traditional and the modern firms is portrayed in Figure-5.2.

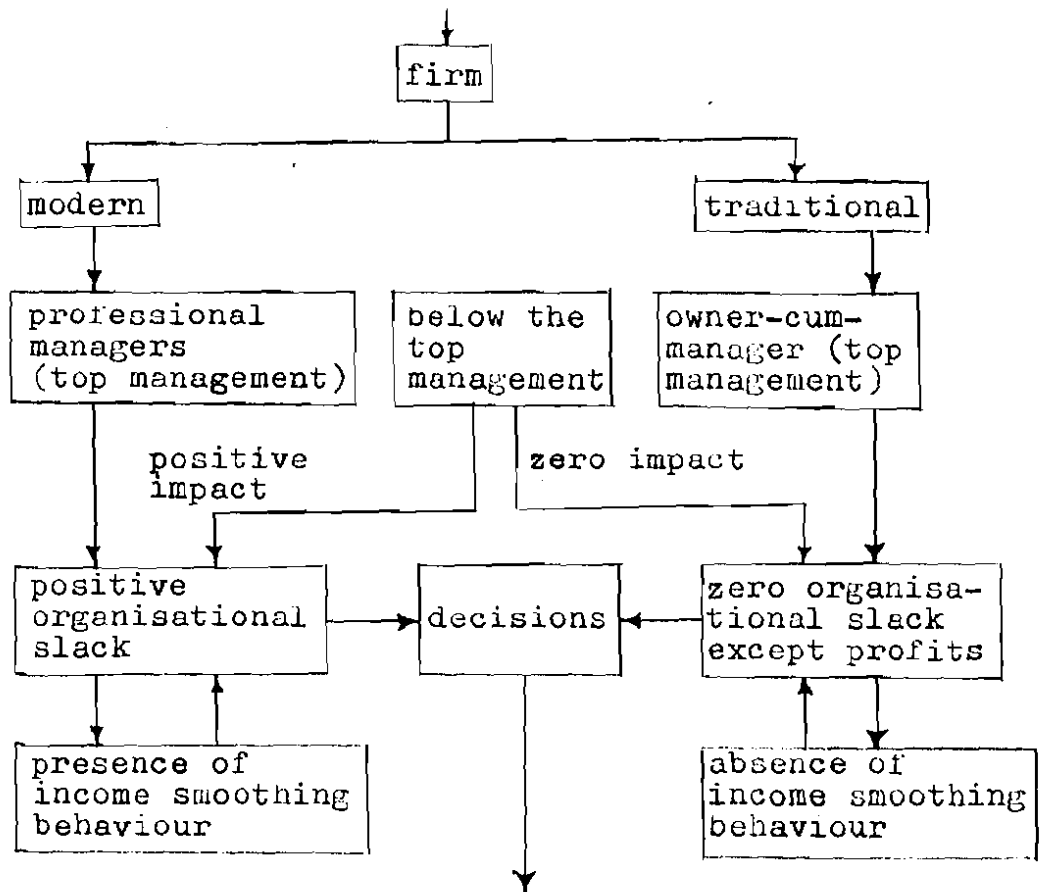


Fig - 5.2 : Traditional and Modern firms and the impact of below the top management.

The top management is being selected by a specific interest group owning a significant percentage of equity is hardly refutable. However there are evidences that the top management also has a certain percentage of equity, whatsoever small may it be, as sometimes required by the Laws. In this case the top managements are also the owners of the firm in a strict sense, often a neglected fact in the earlier studies. Therefore calling any modern corporation as MC raises serious doubts.<sup>12</sup>

(i) A modern firm, classified as OC implies that the interests of the top management and that of the owners coincide and that zero organisational slack, hence absence of income smoothing phenomenon, is incorporated in the decisions to influence the profits performance of the firms, (ii) a modern firm classified as MC implies that the interests of the top management differs from the interests of the owners and that positive organisational slack is incorporated by the top management and hence results in income smoothing behaviour. In both the cases (i) and (ii) the impact of the management below the very top level on the profits performance is not taken into account of, which will add a newer

insights. At an earlier stage it was found that the income smoothing behaviour is universal with all the managers at all levels in all the firms. Therefore, whether the interests of owners coincide with the interests of the top management or not, the below the top management engages in creating and incorporating organisational slack and thus effect income smoothing significantly implying non-maximisation of profits. That is even if the firm is owner-controlled, classified by the equity holding distribution criterion, profits are smoothed rather than maximised. Moreover the equity holding criterion does not cover the impact of the below the top management on the profits performance. Thus classifying firms, which exhibit non-owner behaviour i.e., non-maximisation of profits, by equity holding criterion alone, into OCs becomes less satisfactory and less valid. After all, it was only to distinguish the non-profit maximising firms, exhibiting income smoothing behaviour basically due to the divorce of ownership and control, from the owner controlled profits maximising firms, that the concept of 'management controlled firms' was given birth to. This idea has been portrayed in Figure-9.3. However it is to be noted that it is the resulting profits

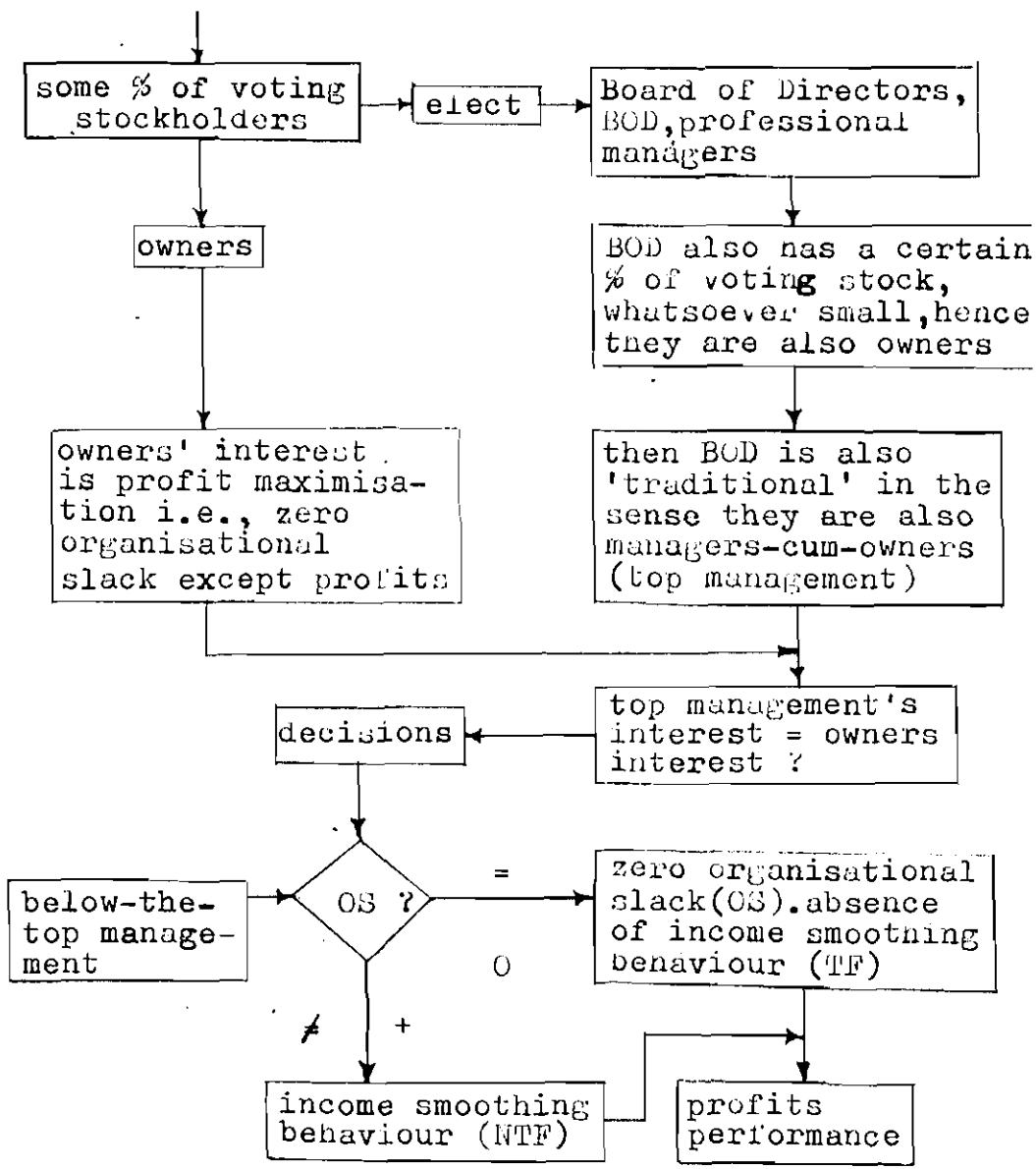


Fig - 5.3 : Owners, Management and performance.

performance behaviour basically lead to the distinction between owner controlled (profit maximising) and management controlled (non-maximisation of profits) firms.

### 5.3.0 PROPOSED ALTERNATIVE CRITERION :

An alternative criterion is proposed to classify firms into Traditional ones (TFs), profit maximisation, and Non-Traditional ones (NTFs), non-maximisation of profits, rather than OCs and MCs because of four reasons : (i) the basic purpose of classifying firms into OCs and MCs is to distinguish the nature of the firm's profit maximisation behaviour, (ii) the Traditional theoretic firm was, run by the owner cum manager, called only as OCs; whereas in modern firms the top management also is a owner, since they too have voting stocks, was called only as MCs. The former case ignores the managerial role of the owner whereas the later suppresses the ownership role of the managers. Thus the terms OCs and MCs are less appropriate to use, (iii) in the "'nexus of contracts' perspectives ownership of the firm is an irrelevant concept. Dispelling the tenacious notion that the firm is

owned by its security holders is important because it is first step toward understanding that control over a firm's decisions is not necessarily the province of security holders."<sup>13</sup> "The corporation is a legal entity that serves as the nexus for a set of contracts among independent agents. One implication of this view is that the corporation has no owners. Instead, stockholders are agents in the nexus of contracts who specialise in risk-bearing."<sup>14</sup>

(iv) Almost all the modern firms are managed by professional managers at least below the very top level management.

Positive organisational slack implies the dissipation of potential profits to smooth profits stream of the firm i.e., non-maximisation of profits. Conversely non-non-maximisation i.e., maximisation of profit will be implied by the absence of income smoothing - zero organisational slack or Economic Leverage - behaviour.

Since profit maximisation-non-smoothing of profits-behaviour is termed as TFs and non-maximisation -smoothing of profit - behaviour is termed as NTFs, the proposed criterion may be logically derived as :

If the income smoothing behaviour is present the firm may be classified as a non-traditional one ,NTF . If the smoothing behaviour is absent, the firm may be classified as a traditional one ,TF .

If the smoothing behaviour is absent it may imply that the top management is 'traditional' oriented and that it could also effectively control the smoothing effects of the below the top management.

The smoothing phenomenon i.e., creation and manipulation of Economic Leverage can be found out by the following procedure : (i) the observed net operating income, NOI, of the firm over a period of time may be detrended by the following equation :

$$NOI_{it} = a + B T + e$$

where  $NOI_{it}$  is the net operating income of the  $i$ th firm of the  $t$ th year;  $a$  and  $B$  are parameters,  $e$  is the random term or the deviation of the NOI from its trend;  $T$  is the year, (ii) the observed net operating costs, NOC, over a period of time are detrended by the following equation :

$$NOE_{it} = c + d T + f$$

where  $NOE_{it}$  is the net operating expenditures of the  $i$ th firm for the  $t$ th year;  $c$  and  $d$  are parameters;  $f$  is the random term or the deviation of NOE from its trend. (iii) Correlation coefficient technique may be applied on the deviations  $e$  and  $f$  to test for the smoothing behaviour.<sup>15</sup> Smoothing (of reported income series) would be implied if the above (below) trend value of NOI were associated with the above (below) trend value of NOE.<sup>16</sup> (iv) Appropriate test of significance could be applied to test the significance of the computed coefficients.

One possible objection for this criterion may be that the firm could be classified into TF and NTF only after a period of time. That is a newly born firm could not be classified using this criterion. However we maintain that after all the behaviour of the firm could be studied, as all the studies do, to get significant results, only by observing the firm over a period of time. Thus this criterion stands as a better alternative.

NOTES

1. For example, Mason (1958), Williamson (1964) and Monsen and Downs (1965).
2. Monsen et al (1968), p.435.
3. The firm in the Traditional theory of the firm i.e., profit maximising firm has been called here as a traditional firm.
4. Cyert and March, op.cit. p. 37.
5. In the Traditional theory of the firm, the owner is also the manager (top management) i.e., the same person plays a dual role of being the owner and manager.
6. Monsen et al, op.cit., p.437.
7. Ibid.,
8. Fama, op.cit., p.293.
9. Schiff and Lewin, op.cit., p.56.
10. Ibid., p.62.
11. Ibid.,
12. It is to be remembered here that though the Traditional firm was run by the owner cum manager it is called as Owner controlled (OC) neglecting his role as the 'manager' which would be justified if it is called as owner cum manager controlled ones.
13. Fama, op.cit., p.290.

14. Jensen and Ruback (1983), p.43.
15. It is assumed that finding the smoothing behaviour by the suggested procedure indicated the deliberate creation and manipulation of organisational slacks. That is the NOE (total manufacturing costs may also be taken ) is assumed to indicate the presence, and constitutes, of organisational slacks or Economic Leverage.
16. There is a possibility that the positive correlation coefficients may be attributed to the functional relationship between income and expenditures. To minimise this problem, the costs of sales may be excluded from the NOE as Amihud et al (1983) have suggested.