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Volume Author/Editor: Charles L. Merwin

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Chapter Author: Charles L. Merwin

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THE ECONOMIC CHARACTER OF SMALL BUSINESS

High on the list of the characteristic features of this country's economy is the impressive frequency of small business enterprises. In the United States today there are about 2.5 million business units (not counting the 6 million farmers or the 1 million professional persons), and of these the great majority are small, however we measure the size of an enterprise. Less than a tenth of these business units employ more than 30 persons each, or have total assets greater than $250,000. Although the career of the man who rose from a shipping clerkship to the presidency of a million-dollar corporation has been more widely publicized, the story of the tailor who became a clothing manufacturer or the cabinetmaker who set up his own shop as an interior decorator has a stronger ring of familiar truth. For every millionaire industrialist who first passed through his factory gates as an humble workman, there are thousands of unsung smaller-scale enterprisers who entered their chosen field of production with very little more in the way of resources than the will to succeed. It is the small establishments of such men that have been widely regarded as the "backbone of the American economy," and these owners and proprietors have constituted a very large section of the American middle class, with its vested interest in political democracy and free private enterprise.

Numerically the small business unit dominates the economic scene in this country, but not in terms of business volume. Even when farmers and professional persons are included, not much more than half of the total national income is produced by enterprises with total assets under $250,000; 1/ if farmers and professional persons were excluded the proportion would be far less. And this proportion has probably been decreasing, at least since the turn of the century, when the rise of industrial combinations served to diminish the market covered by the small concern, individually owned and operated. Moreover, the weighty total of small units derives partly from the high mortality rate among such enterprises; nearly half a million enterprises disappear from, and an approximately equal number enter into, the business population each year, and almost all these discontinued and new enterprises are small businesses. 2/

The present study is confined to small corporations engaged in manufacturing, with "small" interpreted to mean a corporation whose total assets are less than $250,000. Any dividing line is of course arbitrary, but this criterion has a basis in common usage and a definite advantage of convenience. A corporation with assets of $250,000 is certainly small in comparison with those whose assets run high into the millions or even amount to one or two billion. Moreover, even if the limit had been set at a lower level, say at $100,000, the results of this survey would probably not have been affected to any significant degree. Nor are total assets the only criterion of size that could be usefully employed. Other criteria in common usage are volume of business, number of employees and tangible net worth. A specific disadvantage of total assets is that they may be swelled by inclusion of intangibles, patents and the like at fictitious values. But even with this disadvantage they are the most satisfactory criterion of size for the purposes of the present study.

Manufacturing constitutes a sphere of our economy that is small numerically, comprising less than 170,000 establishments or plants, but important productively, accounting for a quarter of the total national income. The numerical importance of small business in this sphere, though less than in such fields as retail trade, is impressive: about 90 percent of the manufacturing establishments, producing about a fifth of the total output of manufacturers, have assets under $250,000. 3/ It is true that certain fields of manufacturing are virtually closed to the man with little capital, and in others the "shoestring" entrepreneur has slight chance of survival. But the small plant still predominates in some fields. Among these are baking, and the manufacture of men's clothing, furniture, stone and clay products, and machine tools - industries that form the subject of the present study.

About half of the manufacturing units in the country are incorporated, and since the incorporated units handle more than nine-tenths of the total volume of manufacture, 4/ it is clear that practically all of the unincorporated enterprises are small businesses. Among the unincorporated enterprises those with a single proprietor far outnumber the partnerships. In small concerns, however, the legal form of organization has not very much connection with operating practices or with financial structure.

GENERAL CHARACTERISTICS OF SMALL MANUFACTURING CORPORATIONS

It is by no means only in the amount of their assets that small manufacturing corporations differ from large ones. In fact, there are so many essential differences that the two types are scarcely comparable.

For one thing, the owners' relationship to the enterprise is quite different in large and small corporations. In the largest corporations, which constitute more or less quasi-public institutions, ownership and management are separated. In the small, private corporations, on the other hand (as in many of the medium-size companies), ownership and management are practically identical. Not only are such corporations closely held, but the owners themselves operate the business. There are enough legal owners to make up a board of directors, as required by law, 5/ and usually a full complement of officers; but there are rarely any outside stockholders, and even the directors' stockholdings are usually purely nominal. In these small corporations the officer-owners work in the plant and sell the product. Indeed, it is not uncommon to find close family ties among the officers: a man as president (factory manager and salesman) and his wife as secretary-treasurer (office girl and bookkeeper); or a man as president (sales manager) and his brother-in-law as vice president (factory manager). Very often the de facto owner is a single individual.

In the case of large business enterprises one of the most important reasons for incorporating is the necessity for large amounts of capital; the original capital sum required by many of our large corporations can rarely be supplied by any individual or a small group, and must therefore be obtained by pooling funds from many sources.

Another basic consideration for large enterprises is the desire to assure continued existence; when many persons are interested in a company it is particularly necessary that the establishment be independent of the survival of a single individual. But small companies incorporate for quite different reasons. With them the pooling-of-capital motive counts for little, their main concern being to assure the owners a limited liability. There are many risks in the operation of a business enterprise, especially a small one, and the owners are under strong inducement to divorce as much as possible of their personal fortunes from the fate of their undertakings. 6/

In regard to financial characteristics the differences between large and small manufacturing corporations are not wholly due to size; some of these differences are undoubtedly due to type of industry and other factors. The statistical fact remains, however, that not only within manufacturing as a whole but also within each of the major subgroups of manufacturing, there are striking financial differences between large and small corporations.

The most striking of these differences is that the smaller corporations tend, on the whole, to record a lower rate of profit than the larger ones, if officers' compensation is regarded as an expense of doing business. It is true that among profitable companies there is a modest tendency for the profit rate to fall as assets increase. But among unprofitable companies there is a marked tendency for the smaller concerns to show the larger rates of loss, and this is the pattern that predominates when profitable and unprofitable companies are considered in the aggregate. 7/ In addition, the earnings of the small companies are less stable cyclically than those of large ones: the "giant" class of corporations, with assets of 50 million dollars or more, is the only asset-size group which, as a whole, showed a net profit in every one of the three depression years 1931-33. It should be remembered, however, that these observations are based on aggregate figures for groups of corporations; it is quite likely that some of the highest individual rates of profit are earned by the smallest companies, and some of the lowest rates by the largest companies. Furthermore, the tendency of large companies' profit rates to be higher than those of small companies disappears if officers' compensation is included in profits. 8/

Such comparisons as these do not indicate that small companies are less efficient than large ones. It goes without saying that profitability is related to many more factors than size alone. For example, the fact that large companies are more integrated than small ones, both vertically and horizontally, 9/ explains, at least in part, the greater stability of the large companies' earnings, and the smallness of their losses. Again, in small corporations it is more difficult than in large ones to draw the distinction between remuneration for labor services and return on capital, and therefore the respective profit ratios may not be comparable even if accounting definitions are identical. In short, it is practically impossible to find manufacturing companies that are the same in every important respect save asset size, and therefore the relationship between size and profitability can be only roughly indicated. 10/

The financial characteristics of large and small manufacturing corporations differ also with respect to various operating and balance sheet relationships. The small enterprise relies more heavily upon short-term funds for its financing than the large corporation: in relation to total assets the smaller company has less funded debt and less net worth than the larger company, and more accounts payable and more notes payable. In addition, the general credit position of the small corporation appears to be not quite so strong as that of the large enterprise. For example, the small company has a lower ratio of current assets to current liabilities, less owned capital in relation to borrowed funds, 11/ and a higher proportion of total debt represented by current items. 12/

These comparisons indicate that small manufacturing corporations are more susceptible to failure than large enterprises. The latter, since they have a stronger liquidity position, can "live on their surplus" 13/ for a longer time, and thus during periods of business strain they are more able to continue their former policies, both financial and economic. Furthermore, the ownership structure of large companies - with a great many persons directly dependent upon the enterprise - is such that a reorganization to forestall general liquidation is usually arranged before the threat of insolvency becomes immediate. This higher failure rate among small companies, with its consequent revaluation of properties, is perhaps not unrelated to the fact that during periods of cyclical contraction employment appears to decline more sharply in the large-scale sectors of our industrial economy than in those sectors where small concerns predominate. 14/

Differences in the relationships of various operating items and of various balance sheet items are, in fact, a fundamental criterion for any comparison of business concerns, and the analysis of such relationships in the small corporations of certain selected industries is the primary purpose of the present study. But before proceeding to a discussion of these specific industries it may be well to indicate certain typical relationships of this kind in the entire body of small manufacturing companies. The data are made available by a compilation of income tax returns, prepared annually by the Treasury Department, which shows the distribution of corporation assets and liabilities (including net worth). The following description is based on the returns for 1936, 15/ the final year of the span covered by this study. In that year the manufacturing corporations that submitted balance sheets were classified in sixteen industrial groups, each group broken down according to asset size. The figures used here pertain to the aggregate of corporations in the under-$250,000 size class of each industrial group.

The assets of business concerns include the physical equipment necessary for the production of goods and services, and also such other items as cash, receivables and security holdings. To finance the acquisition and holding of these assets the concern acquires funds from various sources: owners, long-term creditors, short-term creditors. The relative importance of these various sources depends to some extent on technological factors, but other considerations, such as the personal wealth of the owner and the nature of the demand for the company's product, are also important.

In all but one of the sixteen groups of small manufacturing corporations distinguished in Table 1 owners' equity constituted in 1936 half or more of the total liabilities (including net worth), petroleum being the single exception. For most groups the proportion lay between 50 and 60 percent, but for a few - chemicals, tobacco and paper - it was slightly above this range. Long-

Table 1 - ALL MANUFACTURING CORPORATIONS WITH TOTAL ASSETS UNDER $250,000
Selected Financial Proportions, by Industrial Group, 1936 a/

Industrial Group	% of Total Assets			% of Total Sales b/			Compiled Net Profit c/	
	Notes & Accounts Payable	Long-Term Debt	Net Worth	Inventory	Net Capital Assets	Total Assets	In % of Total Sales b/	In % of Net Worth
Food & kindred products	26.5%	8.1%	58.2%	7.0%	19.3%	39.2%	0.8%	3.3%
Liquors & beverages	26.2	8.4	55.9	8.4	24.6	51.4	5.4	19.0
Tobacco products	29.1	3.3	62.2	20.4	11.5	60.1	0.1	0.2
Textile mill products	32.7	6.1	52.7	12.1	15.6	45.0	0.2	1.0
Clothing & apparel	38.7	2.3	52.1	8.0	3.1	25.4	0.2	1.2
Leather & its manufactures	35.0	3.2	54.7	11.9	7.2	35.9	0.1	0.4
Rubber products	27.5	5.8	57.7	11.0	20.0	52.9	2.3	7.5
Forest products	29.5	7.2	54.4	17.3	24.5	67.0	0.4	1.1
Paper, pulp & products	26.1	5.4	60.8	11.3	19.7	53.4	2.2	6.8
Printing & publishing	24.8	7.8	57.5	6.5	23.7	65.5	1.4	3.7
Chemicals & allied products	24.2	4.7	63.1	11.8	18.8	64.4	2.5	6.1
Petroleum & allied products	39.4	6.7	42.9	4.9	19.2	41.9	1.2	6.4
Stone, clay & glass products	23.7	8.4	58.7	15.1	43.0	91.9	1.6	2.9
Metal & its products	25.2	6.4	59.4	14.8	23.1	66.3	2.8	7.0
Motor vehicles & parts	29.9	10.3	50.0	13.9	18.1	55.2	0.5	2.2
Mfg. not elsewhere classified	29.0	6.7	54.4	14.7	15.8	58.7	0.6	2.0
ALL SMALL MFG. CORPORATIONS	28.0	6.5	57.0	10.8	17.8	50.6	1.3	4.4

a/ Based on Treasury Department, Statistics of Income for 1936, Part 2 (Washington 1939) Table 6.
b/ Sum of "gross sales" and "gross receipts from operations."
c/ Before federal income taxes and undistributed profits taxes, items not shown separately in the source.

term creditors held only a small proportion of the claims on the total assets of these companies, their share amounting to as much as 10 percent only in the case of motor vehicles, and running around 6 percent for most of the groups. Notes and accounts payable, on the other hand, constituted a large part of total liabilities in every industrial group. Even in stone and chemicals the proportion was as high as 24 percent, while in clothing and petroleum it reached 39 percent. This difference between the relative importance of short- and long-term credits for small manufacturing corporations has important implications for the analysis of credit requirements presented in a subsequent chapter.

The distribution of a company's assets is more directly and more decisively influenced by technological factors than is the distribution of its liabilities: one type of production requires a much greater investment in plant, for example, than another type. But it is also true that in a dynamic economy, where frequent technological and price changes render it difficult for business enterprisers to make any long-time price and cost calculations, the longer an entrepreneur must keep his business funds tied up in physical assets the greater are the production risks that confront him as a result of cyclical fluctuations in general business. He is at the mercy of technological changes if he has a large investment in equipment that will not wear out for ten or fifteen years. And another entrepreneur with a large investment in inventory will stand to lose if prices decline sharply. Therefore a fundamental distinction between business enterprises is the relative amount and distribution of their physical assets.

Among the sixteen industrial groups in Table 1, clothing manufacture had by far the smallest investment in physical assets (inventory plus net fixed property) in relation to sales - only 11 percent; leather, next to clothing, had a percentage of 19. The industrial groups with the heaviest investment in physical assets were stone, clay and glass products, with a proportion of 58 percent, and forest products with 42 percent. Stone and forest products showed relatively heavy investments in inventory as well as in land, plant and equipment; clothing and leather registered a fairly average proportion of inventory, but a far less than average proportion of net fixed property. Among the sixteen groups the inventory ratio varied less than that of net land and plant, but in general the figures in Table 1 are an inadequate indication of these variations because many of the industrial groups are so broad that they conceal or average-out important differences.

The total assets of small manufacturing corporations averaged about half their sales in 1936. The figure was as low as 25 percent in clothing, and definitely under the 50 percent mark in leather, food, petroleum and textiles. On the other hand, it was over the 60 percent level in tobacco, forest products, printing, chemicals and metals, and as high as 92 percent in the stone group, whose volume of business in 1936 had not recovered from the depression to the same extent as that of the other manufacturing groups.

In each of these industrial groups net income (before income taxes) was positive in 1936, but it represented only a small proportion of sales. The liquor group's 5.4 percent profit on sales was the highest proportion; the profits of the other groups were around 2 percent or lower, and in textiles, clothing, leather and tobacco they were 0.2 percent or less. The rate of return on owners' equity ran considerably higher, of course, but with little change in the comparative position of the various industries. In this relationship, too, tobacco, leather, textiles and clothing (also forest products) were at the bottom of the list, with percentages of 1 percent or less, and liquor was high, with 19 percent; rubber was a far second, with 7.5 percent return on net worth. These figures, however, are an inadequate representation of the return on the owners' actual investment, because in many instances the net worth figure reflects sizable accounting revaluations and because in small companies the officers' compensation sometimes includes what could more properly be called a return on equity. This last point will be elaborated presently in reference to the profitability of the sample corporations.

THE SAMPLE INDUSTRIES

Adequate data are not available for a detailed analysis of the financial structure of all small manufacturing corporations over a period of years. But special data permit a detailed study, for the period 1926-36, of samples of small manufacturing corporations in the following five industries: baking (principally bread, but also pies and cakes - classified in the "food and kindred products" industrial group of Table 1); men's clothing (men's and boys' suits, coats and overcoats - classified in the "clothing and apparel" industrial group); furniture (chiefly for household use - classified in the "forest products" industrial group); stone and clay products (mainly brick and tile, but also cement blocks and cut stone - classified in the "stone, clay and glass products" industrial group); and machine tool manufacturers (including machine tool accessories - classified in the "metal and its products" industrial group).

These five industries were selected not only because they are characterized by small enterprises and constitute fairly homogeneous industrial divisions, but also because they exhibit fundamental differences in financial structure and represent significant classes in economic goods. The baking, men's clothing and household furniture industries produce consumer goods; stone-clay is both a consumer and a producer goods industry; machine tool manufacture is exclusively a producer goods industry. Both furniture and stone-clay are closely related to the important construction division of our economy, while machine tool manufacture is so vital to our heavy industries that it plays a key role, especially in a war economy. And in still another important respect the industries treated here are broadly representative: the product of the baking industry is perishable, that of men's clothing semi-durable, and that of the other three industries durable. Finally, the five chosen for study include a rapidly expanding industry (machine tool) and a declining industry (stone-clay).

There are numerous reasons, varying in significance in the different industries, why small companies are predominant in the fields of manufacture represented by the present samples. For one thing, these industries demand the relatively flexible management which is generally characteristic of small businesses. Another reason is that in the industries studied here a small investment is usually all that is necessary. Further relevant factors affecting size in greater or lesser degree are the bulk and perishability of the product in relation to its market, and specialization of the manufacturing process.

This report is the first analysis of its kind devoted to small corporations. Heretofore studies of the financial structure of manufacturing corporations have been confined to the larger enterprises, simply because data on the smaller companies have not been available. It is not necessary for small concerns to publicize their financial statements, partly because there is no large body of outside investors to be kept informed, and partly because government regulation of their affairs has been relatively slight. Thus the only institutions likely to have information on their financial conditions are the governmental taxing authorities, the banks and other lending agencies, certain trade associations and mercantile credit organizations.

For corporations the income tax authorities can provide the most complete source of data, since every incorporated business is required by law to file an income tax return with the federal government. This return calls for a complete balance sheet, a rather detailed income statement and various supporting schedules. Although business accounting has grown rapidly since the turn of the century, there are undoubtedly many very small corporations today whose only financial statements are the duplicates of their tax returns. The data collected on income tax returns are not, of course, ideally suited to economic analysis. They are collected primarily for administrative reasons, and their use in such studies as the present one is subject to certain qualifications which will be elaborated in subsequent pages. They do, however, provide a very detailed and significant body of information.

The tabulations of federal income tax returns on which the present analysis is based were compiled for the Department of Commerce by the Income Tax Study, an undertaking of the Work Projects Administration sponsored by the Treasury Department. These tabulations were published in a monograph prepared by the Department of Commerce for the TNEC, 16/ and were made available to the National Bureau in advance of publication. Two samples of corporate financial statements were drawn, one from the 1926 tax returns and one from the 1930 returns. The first drawing consisted of 939 corporations, divided fairly evenly among the five industries; the second consisted of 262 corporations. The 1926 drawing represented, originally, perhaps about a tenth of the number of small corporations in these industries and about a fifth of the volume of business. 17/ For both drawings returns for succeeding years through 1936 were then taken from the files. It was found that some of the corporations continued to file returns through 1936 and that a great many others ceased some time during the period covered.

Every attempt was made to ascertain whether these companies actually ceased filing returns. Companies involved in mergers and consolidations had been excluded from the drawing, a process that was comparatively easy because the tax return requires information concerning the predecessor business of the reporting corporation. Verification of apparent discontinuances was somewhat more difficult. It involved, first, a thorough search of the Bureau of Internal Revenue files in Washington. On the basis of this search a list was prepared of all companies that apparently ceased filing returns. This list was then sent to the various Collectors of Internal Revenue, who searched their records for further information on the listed corporations. As a result of these investigations it may be said that the companies finally remaining on the list of discontinuances are corporations that actually ceased filing returns, according to all the available records of the Bureau of Internal Revenue. This does not mean that all these companies were failures in the legal or even in the economic sense; some may have discontinued business voluntarily, and others may have changed to a sole proprietorship or partnership form of organization. Nor did the owners of these enterprises necessarily disappear from the business scene: of the many small enterprises that are launched every year, a considerable number are started by men who have failed in other ventures. But the corporate entities were dissolved, and probably in the great majority of instances the owners lost most, if not all, of their equity.

The following figures, on the 1926 drawing, show the total number of companies in the various industries that ceased filing returns at some time during 1927-36, and also the number that discontinued during the prosperity years 1927-29, during the depression years 1930-32, and

	Total 1926 Drawing	Total Discontinuances	Discontinuances in 1927-29	Discontinuances in 1930-32	Discontinuances in 1933-36
Baking	185	104	38	37	29
Men's clothing	191	145	66	55	24
Furniture	174	128	58	44	26
Stone-clay	184	114	49	36	29
Machine tool	185	67	26	17	24
TOTAL	939	558	237	189	132

during the recovery years 1933-36. 18/ Three-fifths of the 939 corporations in the original 1926 drawing discontinued some time during the succeeding decade - a period marked by severe depression. Except in the machine tool group at least a fifth of the original number of companies went out of existence in the first three years after the drawing, and in men's clothing and furniture this proportion was about one-third. These high proportions of early discontinuances - especially since they occurred during the prosperous years 1927-29 - are evidence of the high mortality rate among small corporations, stressed above.

Over the entire period the highest proportion of discontinuances - three-fourths of the original drawing - occurred in the men's clothing group, and the smallest - about a third of the original drawing - in the machine tool group. The intermediate proportions found for the other industries were somewhat nearer the higher than the lower of these extremes; of this intermediate group baking fared best, and was followed by stone-clay and furniture. The industries appear in the same order whether the entire period 1927-36 is considered, or only the prosperity years 1927-29, and they appear in substantially the same order also in the depression years 1930-32. It should be remembered, however, that the samples become more biased each year in favor of the successful companies, and therefore it is not justifiable to calculate from these data a discontinuance rate purporting to show what proportion of all the companies in a given industry is likely to go out of business in a given year. This success bias makes it particularly noteworthy that practically as many of the machine tool companies disappeared in the 1933-36 recovery years as in the 1927-29 prosperity, a finding quite at variance with that for any other industry. And conversely, only one-fourth of the machine tool discontinuances occurred during the depression years

(1930-32), while for all the other industries a third or more of the total discontinuances occurred during this period. The relatively large number of discontinuances in the machine tool sample during 1933-36 suggests that in this industry the owners are able to postpone liquidation longer than in the other industries studied here. Men's clothing and furniture companies, on the other hand, liquidate quickly when business conditions become adverse, as is indicated by the fact that four-fifths of the discontinuances in these groups occurred before 1933.

Although these data do not permit temporal comparisons of discontinuance rates it is possible to compare such rates for a prosperity period (1927-29) and a depression period (1931-33) by examining the discontinuances found in the first three years after the 1926 drawing and those found in the first three years after the supplementary 1930 drawing. The following figures show these discontinuances, in percent of the number of companies in the respective original drawings. 19/ In every

	Discont. 1927-29 (1926 Drawing)	Discont. 1931-33 (1930 Drawing)
Baking	21%	28%
Men's clothing	35	46
Furniture	30	47
Stone-clay	27	20
Machine tool	14	20

industry except stone-clay the rate of discontinuance was higher in the 1931-33 period of depression than in the 1927-29 period of prosperity. The stone-clay exception is glaring, but it may be partially explained by the fact that in this industry a good deal of liquidation and consequent weeding-out occurred before the deflation of the 1930's. The postwar peak in the stone-clay industry was reached in the middle 1920's, and thereafter many of the weaker enterprises in this industry began to drop out.

This survey of the discontinuance record of small manufacturing corporations suggests that the present analysis of the capital and credit requirements of such enterprises suffers from an important limitation. Because the number of small manufacturing corporations did not decrease notably over the period covered, there must have been a heavy influx of *new* companies into these groups. The financial requirements of these new companies cannot be studied by means of the present data, and there is no way of knowing whether they differ significantly from those of the surviving companies in the samples.

There is one more point of general interest regarding the companies in the present samples. Among the small corporations that continued to operate over the entire period profits, regarded as net income, were extremely low, especially in furniture, stone-clay and men's clothing. For the different industries the average net income 20/ over 1926-36 amounted to the following percentages of average net worth: 21/ baking 4.3; men's clothing 0.3; furniture -0.8; stone-clay 0.2; machine tool 1.8. The baking group's 4 percent return on owners' equity was high in comparison with the rates for the other groups; for furniture the rate was actually negative, and in the two other low industries it barely escaped being negative.

These low ratios of net income to net worth suggest that officers' compensation must be considered in any appraisal of the profitability of these corporations. In small manufacturing corporations officers' compensation is far more important in relation to net income than it is in large ones. Its dominating magnitude in the present samples is illustrated by the following figures, which show its percentage relationship to net income plus officers' compensation (1926-36 averages): 22/ baking 79; men's clothing 99; furniture 109; stone-clay 98; machine tool 91. These figures do not represent the situation that existed in each year, but they do mean that over the entire 1926-36 period the total compensation of officers amounted to virtually the entire amount (except in baking) of the aggregate net profits minus net losses plus officers' compensation. In other words, the return that accrued to the owners of these enterprises, whether for their labor services or their capital investment or their entrepreneurial activity, consisted almost entirely of the item referred to as officers' compensation on the records of account.

Probably the owners of these enterprises, and of small enterprises generally, regard their compensation as officers as part of the return on their investment. The owner usually has the option of retaining his earnings in the business, thereby letting them accumulate, or disbursing them as dividends or officers' compensation. His decision as to which alternative he will follow is undoubtedly influenced by tax considerations. In the choice between retaining the earnings in the business and paying them out as dividends, the fact that the latter course involves taxation of the earnings both as corporate income and as individual income will carry considerable weight. A further determinant will be the size of the earnings: the tax on individuals in the upper income brackets is higher than that on corporations, whereas the income tax on corporations is higher than that imposed on individuals in the lower brackets. 23/

Because of these difficulties in measuring the profitability of our samples of small corporations, where the officers are also the owners, it is advisable to add officers' compensation to net income whenever it is desired to determine an upper limit of profitability. 24/ The question arises, however, as to how much of officers' compensation should be added. Since there is no satisfactory answer to this question two sets of figures have been computed, the one including all, and the other one-half, of the officers' compensation. The average net income of the five industries, plus these respective additions, represented the following proportions of average net worth over 1926-36: 25/

	(Including Entire Officers' Compensation)	(Including One-Half of Officers' Compensation)
Baking	20.5%	12.4%
Men's clothing	26.1	13.2
Furniture	8.7	4.0
Stone-clay	8.7	4.5
Machine tool	19.0	10.4

These figures - even those that include only one-half of officers' compensation in profits - suggest that these companies did not provide their owners such a meagre return as was indicated above: a handsome return is shown here for each industry except stone-clay and furniture. The ranking of the industries by profitability is not noticeably affected by the inclusion of only half instead of all the officers' compensation with profits, but the ranking shown in the present figures is markedly different from that shown when profits are regarded as net income alone. In the present computation men's clothing shifts from third to top place, baking drops from first to second place and machine tool from second to third. In comparison with the other industries the men's clothing companies represent a small investment on the part of owners, and this fact may contribute to their shift from third to first place in the broader computation of profits. Furniture and stone-clay are at the bottom of the profitability listings regardless of whether officers' compensation is included in profits. 26/

During this period profit ratios showed a striking variation from company to company. Some corporations in these samples reported a net loss of 18 percent or more of tangible net worth 27/ in the same year that others reported a net income of 30 percent or more. The wide variation is illustrated by the following figures, which show, for a prosperous and for an unprosperous year, the number of companies for which net income or net loss amounted to 12 percent or more of tangible net worth.28/

		(Net Income) 1928	(Net Loss) 1928	(Net Income) 1932	(Net Loss) 1932
Baking	(81 cos.)	30 cos.	7 cos.	5 cos.	30 cos.
Men's clothing	(46 ")	7	0	1	24
Furniture	(66 ")	14	10	1	42
Stone-clay	(70 ")	16	6	0	33
Machine tool	(118 ")	44	13	1	58

Even in the trough of the depression some of the companies were very profitable; some incurred serious losses even in prosperous years.

In another study under the Financial Research Program 29/ evidence is presented showing that among small manufacturing corporations the dispersion about the average profit rate is greater than that among large. It is because of this tendency that the average return of profitable small corporations is about as high as that of large corporations, even though small corporations in the aggregate have a lower earnings rate than large ones.

The foregoing discussion of profits suggests the conclusion that small corporations' earning power, and their success from the owners' point of view, are inadequately appraised if officers' compensation is ignored. The owner of a small corporation values the company for the job it provides him as well as for any return it may make on his invested capital. In fact, most such owners probably make no attempt to break down their return into that on managerial services and that on capital. They set up in business primarily to provide themselves with a job, and from the relatively high number of discontinuances among small corporations it appears that many of these would-be entrepreneurs pay a stiff price for that objective.