

Conceptual Model of Community-based Financial Participation for Business Development

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Abstract

No new business can function without capital; therefore financial need is essential for business development. Most businesses use different real assets (Issue of financial securities) and loans to finance their operations, which have pushed many businesses to suffer from liability capital (loan, due to financial pyramid of debt) or experience trouble working with liability capital. These are some of the reasons for the low level of business development. This paper presents a conceptual model of Community-based Financial Participation (CFP) for business development as a contribution for solving capital needs at the community-based level, which is an extension of the issue of employee stock ownership and sharing in profit of their enterprises at the community level. Some specific features of CFP are discussed in detail.

Keywords: Financial Participation, Business Development, Conceptual Model, Community-based Portfolio, Community Development.

1. Introduction

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The low level of business development in many countries in the world can be explained from the perspective of limit to growth (Edgeman, 2000), especially in developing countries. Limit to growth has been an issue of concern for a long time with one milestone being the presentation of the study “limit to growth” (Meadows, 1974; Brundtland commission, 1987). The limit to growth is developed from a main focus on limits of economic activities to lack of initiatives, which can be offset by fostering economic activities through business development.

Business development and new business creation is the practice of initiating, organizing, and developing new business opportunities and this function is based on strategies (Shiv and Kenyon, 1998). That is creating strategic partnership and long-term relationship with stakeholders (Krishnam, 2006). Generally, individuals and institutions often invest money in a company by purchasing one or more shares of the company (Win and Stuart, 2001). They can be theoretically involved in the decision-making of the company through participation in the annual general meeting and in the election of the directors, who will actually run the company. Additionally, in return the investors receive financial reward in terms of dividends. This is a yearly payout to each shareholder based on the profit made in that year (Win and Stuart, 2001). They also benefit from capital appreciation, if the value of the shares they purchased increase. More often, ownership of companies involve a number of people, therefore directors and managers take the responsibility to run companies and they are answerable to the shareholders at the end of each year (Win and Stuart, 2001).

Many corporations issue stocks and bonds to raise funds for their operations, known as primary issues, which are sold in a primary market, and bonds and stocks are traded later in secondary transactions (Krishnam, 2006). Despite these possibilities majority of the businesses especially Small and Medium Enterprises (SME) depend on loans from financial institutions for funding their businesses. Most of the literature

on corporate finance consider such a source of financing as a roadblock to business development and sustainability, simply because it carries a lot of liabilities (Krishnam, 2006; Baydas et al, 1994; Bester, 1987). Even though many businesses have been using liability capital (loans) to finance their business operations, it has not been easy for them working with such a form of financing. Therefore, there is a need for alternate sources of financing for businesses that are more sustainable. CFP can play a vital role in providing financial resources for businesses, especially for those businesses that are developed from community initiatives.

The term CFP did not exist till now, it is an integration of Community-based Participation (CFP) and Financial Participation (FP) to form CFP. Nevertheless, the concepts of FP and Community-based Participation exist in literature and it is practiced in many countries of the world today (EFES, 2001; Lowitzsch, 2007; Myezwa and M'kumbuzi, 2003; Pia et al, 2003; Kluge and Wilke, 2007). The term CFP is an extension of the concept of FP to the community level to involve all stakeholders and institutions in the community for financial portfolio.

According to the European Federation of Employee Share Ownership, the concept of FP is more common in U.S.A than in Europe, Japan and other countries of the world (EWCO, 2003), but has its origin and its relevance in the late 1980s (EFES, 2001). The idea is how the practice of Employee Share Ownership (ESO) can join with participatory management to have an impact on the economic and social dynamics of a corporation. Recently the phenomenon of ESO is growing within organizational structures, and it is suggested in the literature that an employee's relationship to its company is vital for the long-term organizational reputation of the company (Zoltan and Gerlowski, 1996; Lowitzsch, 2007). More so, one can think about the relationship between a business and its community, especially in terms of Corporate Social Responsibility (CSR) and distributive justice. Then there is a possibility

of extending the issue of FP to the community level and even beyond. It means that FP is not only what needs to be practiced within corporations, but can also involve the community as well.

Many research initiatives have been carried out in Europe and around the world on FP; like the Promotion of European Participation in Profit and Enterprise Result (PEPPER) schemes sponsored by the European Commission to promote FP and the Benchmark Project on FP by the European Commission, which is a follow up of PEPPER 4, Employee Stock Ownership Plan (ESOP) schemes in U.S.A and many others (Lowitzsch, 2007; EFES, 2001; EWCO, 2003 and 2007). But most research approaches on FP have not been able to involve the community in the financial portfolio, while some focus on inter-employees FP within corporations in a community, others are concerned with using financial incentives to encourage Community-based Participation in programs (Myezwa and M'kumbuzi, 2003; Pia et al, 2003; Kluge and Wilke, 2007).

CFP requires cooperation with all stakeholders in the community to pull financial portfolio for investment in business development and allowing them to benefit in the results (profits) of the business according to their contributions to the business (Distributive justice and CSR). A conceptual model of CFP can be used to present how business initiates and development can be fostered at the community level using FP involving community's stakeholders, not only employees. Therefore it can be a useful tool for fostering economic activities at the community level and beyond.

2. Financing Businesses

The overriding purpose of most businesses is to create financial value (Zoltan and Gerlowski, 1996). A business can become a substantial value-builder because of its efficiency in financial resource allocation and budgeting (Shiv and Kenyon, 1998). This means that a business can

create substantial value by bringing the capability of employees and its community stakeholders into cooperation as partners, who can help in financial portfolio for its development and reduce its financial liability. On the other hand allowing the community to benefit in the profits of the business. This can create good relations between business and its community (CSR).

Business financing through CFP can be one way to change the gearing of a business's capital structure by raising the ratio of equity and reducing the ratio of liability capital (debts) thereby reducing the burden of interest on debt and hence increase earnings. This means, a small amount of increase in earnings because of debt reduction can lead to a high value creation to a business, while a small reduction of business profit from interest on debts can ultimately throw the business into insolvency thereby making a company more vulnerable in the future. Reduction of business debts and increase in the level of equity capital can be achieved through FP with employees and community stakeholders in a business community landscape or beyond. This is, by giving community stakeholders the opportunity to own stocks and benefit from the profit, leading to increased financial size of businesses and reduced cost of capital formation. An increase in the financial size of business can improve its ability to fund itself (Win and Stuart, 2001). The greater the financial size of a business, the lesser is its risk of bankruptcy or the cost of acquiring capital. When a business reduces its debts (through reduction of credit) it can self-finance itself, meaning it has better access to capital and reduce their cost of capital. This reduction in cost of capital gives a business the advantage to benefit from cheaper financial resources that can be used on projects with high Net Present Value (NPV) and short payback time.

Therefore CFP can provide businesses with such an advantage because it encourages them to use community stakeholders in forming financial resource for capital acquisition and only depend on loans for projects with high NPV.

3. Community-Based Financial Participation for Business Development

Analysis of business structures in some industrialized countries such as Germany, Japan and U.S.A provide an insight on how strategic financial decisions influence business structures, which can be useful for the conceptualization of CFP. This is because a conceptualized model of FP for business development at the community level has to take into account financial patterns, legal systems and ownership and control structures due to different corporate governance patterns in different countries. The patterns in industrialized countries of North American, European and some Asian countries are similar, but there are some striking differences across highly successful industrialized nations such as U.S.A, Germany and Japan as compared to lesser industrialized ones (Krishnam, 2006).

The U.S.A corporate structure is dominated by large publicly-held corporations with widely dispersed shareholding and actively traded shares held by individual investors (Krishnam, 2006). In addition, American companies get a large part of their financing through the stock and bond markets. To some extent a similar system exist in the UK, even though there are some significant differences. More so, corporate ownership and financing are prevalent in most European countries, Japan and other Asian countries, but the structures are different. This is because in some nations, banks play a dominant role in providing finance as well as an ownership and control (Krishnam, 2006).

Putting all the financial patterns together, there are some relationships that can be conceptualized from a financial participation point of view to a community-based prospect for business development. These relationships can be captured by using a holistic approach for understanding the issue of FP and then extending it to the community level.

3.1 Fundamental Principles of Financial Participation (FP)

The basic principles of FP started with ESOP, which did not exist in U.S.A and many parts of the world until San Francisco attorney Louis Kelso designed a leveraged ESOP to buy out the founder of Peninsula Newspapers INC, in 1956 (Menke and Hanisch, 2007). Between 1956 and 1986 the Kelso law firm went on to design buyouts for another 500 or more privately held companies (Menke and Hanisch, 2007). Therefore, Louis Kelso in U.S.A developed the fundamental principle of ESOP and FP, in which ESOPs are being legally implemented in some companies in U.S.A. The basis of Kelso, 1991 thesis is that “every nation’s capital assets must and can be broadly owned by its own citizens not collectively, but as a private property of individuals”. Therefore, people have to supplement wages and salaries with capital-earning source of income like interest and dividends so that everyone participates and enjoy the fruits of private property in a free market system (Kelso, 1991).

This thesis can be useful because majority of the citizens in different societies do not own any kind of productive property (Herwig, 2007). Thus, they are impeded from wider participation in civil society, and from access to economic opportunities, as well as from attainment of economic security and sustainability. Financial participation through a society of functional owners can incorporate those who have been excluded by a closed system of ownership (Herwig, 2007). Therefore Kelso (1991) believes that the problem of poverty in the society can be understood as an inevitable consequence of the closed property system. The appropriate remedy is to open the closed property system so that eventually all individuals and families gain the effective right to acquire private capital on market principle (Binary theory). Instead of eliminating private property and thereby destroying the market economy (formal Marxist way), non-owners of property in the society can be encouraged to acquire income-producing property.

3.2 Benefits to Society

When there are broader forms of FP in a society, it can reduce the conflict of agents of society and provide greater benefit to society (Herwig, 2007). This can be acknowledged, especially in the case where the role of business in the society is also considered as providing CSR. When there is a broader CFP for business development, it can ensure that businesses practice CSR. This is because it is through participation that the integration of an individual into civil society can be realized (Herwig, 2007).

Participation in benefits of social welfare state and results of the working process at all levels of society can be a basic human right, but without participation, no democratic civil society can be formed (Herwig, 2007). Democracy in a civil society also requires a wide distribution of wealth, which is widely accepted by both social justice and market distribution (Herwig, 2007). This argument requires a minimum standard of democratic equality and maintenance of the market system that can be achieved through CFP.

3.3 Social Attention in the Society

Social attention so far has been focused on growing wealth of a few, (for instance anti-monopoly legislation) without acknowledging the corresponding increase in the number of those who do not own (Kelso, 1991). Therefore, there is a need to recognize that the “society of owners” is simultaneously a “society of non-owners”. It is on this basis that non-owners of property in society can be made owners of property (Kelso, 1991). This argument requires an active promotion of participation of all the stakeholders of society to create asset formation and innovative initiatives.

Nevertheless, a Society of Owners was found in America almost after 100 years of founding the American republic (Menke and Hanisch, 2007). Ownership of farms, ranches or small businesses was the main norm in society at that time. But, in 1924 and 1974, the U.S.A economy was characterized by an abysmal lack of purchasing power, leading to an extreme low rate of productivity, confrontation within agents of society and lack of capital growth and expansion. Also, interest rates were at all-time high and few banks were willing to lend in any event. The stock market was at its lowest since 1929 and public participation was non-existent (Menke and Hanisch, 2007). The stock bonus plans and profit-sharing plans that existed since 1926 were invested primarily in shares of company stock.

It is based on such types of financial difficulties within the society that a conceptual model of CFP has been developed to rescue communities or involve countries from lack of economic potential and trigger sustainable community development. CFP has been designed for community financing and investment, especially in regions with declining economic activities, lack of opportunities and growth possibilities. The model involves all potential stakeholders in a community for investment in buyouts of existing private ownership companies which are facing a lot of challenges, in investment in existing businesses or for new start ups to encourage a society of ownership and business development.

Also the model encourages new start ups like a group of people may have an idea and start building financial value for a new start up through FP from the community level. An example is the case of IBM, where some individuals left big corporations and established a new start up to take advantage of market situations (Shiv and Kenyon, 1998). Some individuals can come out with a business plan for business development and cooperate with their community to pull financial portfolio for establishing a business, thereby providing employment for them and for

their community. This thesis of CFP for business development can be very useful, when there is a possibility of cooperation within society.

The contribution to financial portfolio need not only be cash based, but can also be asset based. For instance, according to financial accounting principles if an individual, company or government offering an asset or property for a business initiative, it increases the equity capital by the amount worth the asset or property (Hornngren et al, 1994 and 1999). This can be explained using a biogas production operation to present the possibility of applying a CFP for business development at the community level. For example, for a biogas initiative (Mousdale, 2008; Deublein and Steinhauser, 2008); the government might offer a landfill, industries offering cars, equipment and machinery. An individual might offer land, building or any private assets and even current capital stock asset such as raw materials, like needed waste for biogas production, which can lead to an increase in the capital stock for the business. This is a strategy that can make it possible that all community stakeholders participate in capital contribution either in financial asset or other capital assets and intangible assets. The example can be supported by arguing that if a person wants to develop a business either as one person or a group of persons with a unique idea or knowledge about the business performance (market analysis), but they have no capital resource for the business. While some have fixed assets like land, equipment and machinery, others have current assets like raw material for which they have a little value for themselves. If, all the persons with the various capital resources cooperate to put their resources together, then business development will be possible and is likely to lead to value creation for those resources. But, if those resources remain idle then their value addition will be zero.

3.4 Conceptual Model of Community-Based Financial Participation (CFP)

The concept of ESOPs, from a micro perspective (level of firms) can be extended to a meso-perspective, involving the community and even to a macro-level involving a whole country. From the perspective of the community, ESOP can be essential for community-based initiatives involving all actors of the community for their common benefit. This can make non-owners of capital in the society to become owners of capital, hence making the poor and rich to grow richer, based on cooperation and performance of everybody involved in the community.

Figure 1. Financial Participation for Community-Based Business Development

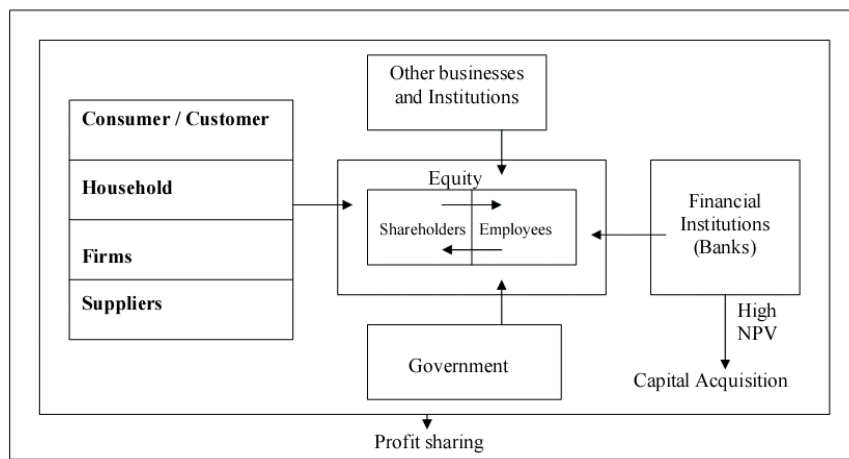


Figure 1 above is a conceptualized diagram of CFP for business development. It shows that shareholders and employees come together to provide equity and present other contributions to equity coming from financial institutions (banks), consumer and customers to a business, other businesses and institutions, and the government. Therefore, the capital acquisition of the business is formed by summing up all the contribution to equity and loans from financial institutions in the case where credit is being given to the businesses in the case of projects with high NPV and short pay-back time. All the various agents contributing to equity take part in the sharing of the business's profit according to their

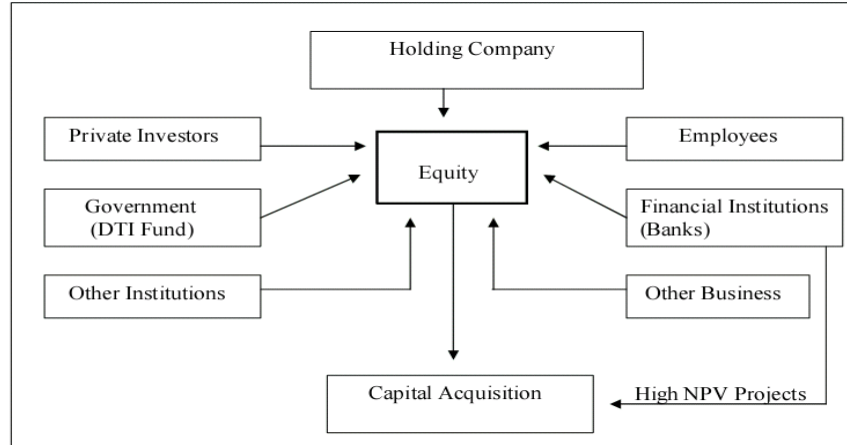
contribution (Social Justice). In addition, the business can be a holding company investing in other businesses in its regions, supplying capital, and investment opportunities for new firms, research and technical assistance.

Figure 2 below is a conceptual diagram of FP with a holding company contributing to equity for capital formation, either for development of new businesses or investing in existing businesses to encourage their sustainability. It shows various sources of equity contribution for business development in a community by means of FP. That is a company with a FP strategy provides equity for new businesses or existing businesses as a holding company, while employees also contribute to equity by means of retention of some of their earnings. Government contributes to equity through its Department of Trade and Industry Fund (DTI Fund) for new business set ups or existing businesses. Private investors, other businesses and institutions contribute to equity by investing in the shares that exist in the business. On the other hand, financial institutions (Banks) can play a dual role of contributing to equity by investing in micro-projects and large-scale projects in the business or contributing to capital formation by offering credit to the business in the case of projects with high NPV and short pay-back period.

There are some countries like UK providing regional venture capital funds (Win and Stuart, 2001), a cohesion fund that are in the form of Public-Private Partnership (PPP) provided by the Department of Trade and Industry's (DTI) for enterprise funding. These partnerships are to encourage equity venture capital investment by the private sector in small firms across the English region (Win and Stuart, 2001). The first bids for government support were made in early 2000 with a total venture capital of about 500 million British Pound, which has helped to create the presence of more dynamic SMEs in UK. More so, other countries have introduced Venture Capital Trust (VCT) for regional investment, which is still the same as regional venture capital (Win and Stuart, 2001).

4. Evaluation and Discussion

CFP was evaluated using a strategic evaluation technique of Strengths, Weaknesses, Opportunities and Threats (SWOT), in which the various Figure 2. Equity and Capital Formation for Business Development



community stakeholders shown in figure 1 and 2 were interviewed randomly in the city of Cottbus-Germany on their position about CFP. The results show that the strength for the implementation of CFP for business development can encourage social integration of a community and businesses, which can lead to a productive and innovative society. Nevertheless, the weakness lies with the legal and taxation systems (double taxation) that might not permit its effective implementation. Therefore, to encourage FP in the community, the structure of legal and taxation systems need to give incentive to the community stakeholders to be able to participate in CFP. However, CFP has the opportunity for sustaining businesses and community development activities due to increased financial means and increased community participation in business activities. In addition, CFP can lead to increased economic activities and hence increase in the general welfare of the community. Furthermore, CFP can solve the conflicts that exist between many agents of the community due to the potential cooperation that will exist between them leading to better understanding. But on the other hand, there are

still other threats, like banks are afraid of losing their customers and business opportunities, while trade unions fear the loss of power, if CFP is being practiced in the community. However, the benefit to community is enormous as compared to individuals and institutions. This lies on the fact that it will encourage every community actor to join the development of the community and benefit from the common resources of community that might arise (Distributive Justice). It does not encourage interest groups, especially the apex in which finance rule businesses, nor does it encourage the working of a community that influence interest groups such as trade unions and political activists.

More so, the conflict between business and its community can be resolved through the application of CFP for business development, since broader community members will be involved, which can lead to cooperation and mutual understanding leading to CSR. This can bridge the gap between business as an investment project and business meeting up with CSR on the community level. Therefore, CFP for business development needs to be supported by everyone in the community. Thereby encouraging people to earn income in the community and reduce poverty. To some extent, the concepts of FP can be used to inform local governments and developmental organizations on the need to establish possible arrangements on community-based development involving broader community participation and financing. This will limit their role in developmental activities and encourage local ownership. Nevertheless, due to different point of views from community stakeholders on CFP, further research needs to be carried out to model the concept for better understanding and implementation.

5. Conclusion

Most developmental assistance guides, such as that of the European Commission (EC) on the delivery of aid to developing regions insist on sustainability criteria like good governance, local ownership and capacity building, economics and financial viability, and a broader public

participation in developmental activities (EC, 2004). CFP has the possibility of meeting sustainability needs and promoting economic activities in the community leading to increased community welfare. Therefore, CFP needs a broader scale of acceptance and support to encourage its application and implementation in the community. CFP can be encouraged and supported in the community by participation of the population in the following ways:

Local governments can make information available to the community on the potential benefits of CFP and provide appropriate corporate governance structures that can encourage the effective implementation of CFP in the community. In addition, local governments can support and encourage the application of research results from university and research centers in their locality that can be used for business development. More so, local governments can use their developmental budget to draw businesses in their region by giving them incentives to establish a new venture.

Universities and research centers can play an important role by working on results from research available to the community, especially on roles and experiences gained elsewhere that might have an impact on the development of the community. Also, they can be encouraged to carry out practical application of their research results in the community, so that businesses in the community as a whole can benefit from the results, hence encouraging community development.

On the other hand, businesses and institutions in the community can support researchers in universities and research centers by creating a forum for discussion of problems and challenges in their operations to encourage research in those areas.

The community as a whole can support CFP for community development by participating fully in FP for community-based business

development and developing new norms and ethical rules that can encourage the diffusion of the concepts of CFP in the community.

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