

فصلنامه تحقیقات مالی

سال سوم - شماره ۱۱ و ۱۲ - تابستان و پاییز ۱۳۷۵

ص ص ۲۰۳ - ۲۱۸

SMALL BUSINESS FINANCING PRACTICES: AN EMPIRICAL STUDY

Sudhir K Chawla^۱
Zafar U Khan^۲
Mehdi Taghavi^۳

Small business play a very important role in the economy of many nations. An estimated 20 million small business are the hottest growth market for information and financial services in the USA. This has lead to a growing interest in small business.

Availability of capital is probably the most critical factor in translating the entrepreneur's dream into reality. The research presented here provides impirical evidence regarding small business financing practices, perceived importance of different sources of financing, and problems in obtaining capital. Results suggest that about 44% of small businesses rely on personal savings. Many small businesses are unable to get bank financing because bankers seem to focus on revenues alone.

Despite realizing the importance of a business plan, about 69 percent of the small businesses did not have a written business plan, and about 70 percent of the surveyed

1-Department of Business Administration , Angelo State University, U.S.A.

2-Eastern Michigan University , U.S.A.

3-University of Allame Tabatabai, IRAN.

small businesses did not prepare a formal loan proposal. Investment banks followed by Savings and Loan Associations were the most important sources of debt financing. The most frequent purpose for obtaining debt financing was for start - up capital followed by need to finance inventory. Implications of the results for information and financial services providers and government policy makers are discussed.

Introduction

Small business play a very role in the economy of many nations. The importance of Entrepreneurship, resulting in young and growing companies, to continued US economic expansion cannot be over-emphasized(Jones, 1990). At a time when many large corporations are restructuring and laying off thousands of employees as part of downsizing plans, many workers, particularly new entrants, are increasingly looking towards small businesses for employment opportunities. Small and midsize compaines created 80% of the jobs during the 1980s (Light, 1993). Small business continue to play a very important role in the US economy.

Despite the importance of small business for a healty and growing economy, till recently , economic and administrative science researchers have shown little interest in studying small business. They, perhaps, assumed that businesses did not pose substantive research questions (Raymond, 1985). Thus, empirical research on various aspects and problems of smll business is scarce.

However, the realization that the estimated 20 million small business are the hottest growth market for information and financial services has led to a gorwing interest in small business (Fiedelman, 1982; et al, 1986; Harper and Churchill 1987; Depke, 1989; Casey, 1991; Fitzgerald, 1993;

Bean, 1993). Availability of capital is probably the most critical factor in translating an entrepreneur's dream into reality. The research presented here provides empirical evidence regarding small business financing practices, and perceived importance of different sources of capital and problems in obtaining the capital. The results are based on a southwest regional survey for 118 small businesses. Survey research can provide valuable input for economic development (Duncan, 1993).

Important findings are that personal savings are still the main source of startup capital for a substantial proportion (44%) of small business. About 32 percent of small businesses obtained bank financing. Despite realizing the importance of a business plan, about 69 percent of the small businesses did not have a written business plan, and about 70 percent of the surveyed small businesses did not prepare a formal loan proposal. Investment banks followed by Savings and Loan Associations were the most important sources of debt capital. The most frequent purpose for obtaining debt was for start-up capital followed by need to finance inventory.

Methodology

A mailed survey instrument was used to gather data on several variables grouped into four broad areas concerning small businesses:

- * Demographics
- * Financing Practices and Problems
- * Accounting Practices
- * Cost Information for Pricing and Marketing

The instrument was pretested with about 20 local small businesses to

ensure reliability of the instrument. A random sample of 400 small businesses was selected from the yellow pages of southwest region states. A total of 118 usable surveys were returned (29.5%) and used in the statistical analysis. This paper presents preliminary results of the small business financing practices and problems sections of the survey only.

Results

Demographic Analysis

As shown in Table 1, the respondents are from a wide segment of small business. The size of the small business respondents varies from the very small to large both in terms of number of employees and total revenues. About 43 percent of the respondents are service small businesses. Retail small businesses represent 36 percent of the respondents and wholesale small business represent 18 percent of the sample. Sixty percent of the small businesses were organized as sole proprietorships ; about 27 percent as partnerships and 13 percent were incorporated. About 48 percent of the small business owners had some college education ; about 28 percent had completed high school. A sizable 17 percent were college graduates and another 7 percent had a Masters / Doctorate degree.

Other demographic information gathered shows that the average age of the respondent small business owners was about 32 years (standard deviation 8.3, median 30 and mode 27 years). The respondents with prior business experience had an average of 9.3 years business experience (standard deviation 11.4, median 6 and mode 3 years). The

Variable	Measure	Response	
Organization Size	Number of Employees	Frequency	Percent
	Less than 9	84	72.4
	10 to 19	13	11.2
	20 to 29	10	8.6
	30 to 39	4	3.4
	40 or More	5	4.3
	Total Revenues	Frequency	Percent
	Less Than \$500,000	75	67.0
	\$500,000 to \$999,999	21	18.8
	\$1,000,000 to \$1,499,999	7	6.3
	\$1,500,000 to \$1,999,999	4	3.6
	\$2,000,000 or More	5	4.5
Industry	Type	Frequency	Percent
	Wholesale	21	18.1
	Retail	42	36.2
	Service	50	43.1
	Other	3	2.6
Legal Organizational	Type	Frequency	Percent
	Sole Proprietorship	69	60.0
	Partnership	31	26.9
	Corporation	15	13.1
Education	Highest Level	Frequency	Percent
	High School	31	27.7
	Some College	54	48.2
	Bachelors Degree	19	17.0
	Masters / Doctorate	8	7.1

Table 1: Demographic Information

average numbers of years current small business was in operation was 9.6 (standard deviation 8.6, median 7 and mode 4 years). Further, about 36 percent of the respondents had conducted market research before starting their current small business.

Sources of Start - up Capital

Obtaining start- up capital is the most important and, perhaps, the most difficult for any small business entrepreneur. However, changes in the general economy, banking industry, and Small Business Administration (SBA) programs have made loans available to more small businesses (Clark, 1987), Hagaman, 1992; Anonymous, 1993).

The survey results (Table 2) show that about 44 percent of small business intrepeneurs used person savings for start- up. The result confirms earlier research findings that a major source of financing for small business is personal savings of the owners (Thannous and Sarker, 1993). Further analysis indicated that small businesses orgainzed as sole proprietorships (Chi - square 7, 2, $p = 0.03$), and having lower revenues (Chi- square 17. 0, $p = .0.002$) and less employees (Chi- square 10.4, $p=0.03$) are more likely to use personal savings as source of start- up capital.

Source	Frequency	Percent
Bank	50	32.3
Small Business Administration	8	5.2
Personal Savings	68	43.8
Family	24	15.5
Other	5	3.2

Table 2: Source of Start - up Capital

several multiple responses

About 32 percent of the small business respondents obtained start-up capital from banks and another 16 (approximately) from family. A Federal Reserve System sponsored study also found that primarily commercial banks and a few savings banks have been active in marketing small business loans (Melia , 1992). Banks were more likely to lend to small businesses that have high (more than \$1.5 million) revenues (Chi - square 9. 56, $p < 0.05$).

There was no significant relationship between receipt of bank loan and number of employees. A significantly greater proportion of bank loans were for three or more years (Chi- Square 49.9, <0.001). There was no significant relationship between receipt of bank loan and owners prior business experience or whether the small business was a first venture or whether the small business was a continuing business (bought) or whether the small business had conducted market research ($p > 0.1$ in all cases).

Further, there was no significant relationship between receipt of bank loan and whether the small business had a written business plan (Chi - square 0. 87, $p > 0.35$). However, a significant relationship existed between receipt of bank loan and preparation of a formal loan proposal. While small businesses preparing a formal loan proposal were twice as likely to receive a bank loan, small businesses not preparing a formal loan proposal were more than twice as likely to not to receive a bank loan (Chi-square 12.5, $p < 0. 001$).

The SBA as the source of start-up capital, about 5 percent, also appears to be in - line with actual practice. Although the SBA has been very active in helping small business, and has earned a lot of praise for

its efforts (Saiki, 1992), its budget is too small. In 1992 the SBA reached 22, 000 companies only or 0.1 percent of all small busines (Valle, 1993). The SBA primarily helps small business obtain loans by guaranteeing a certain percentage of the loan and thus enabling other financial institutions to take the reduced risk and provide necessary credit (Owens, 1989; Davis and Moon, 1991; Hagaman, 1992). Analysis also indicated that SBA supported more small businesses with lower revenues and less number of employees .

Purpose of Loan

Table 3 presents data on the purpose of loan obtained by the small business respondents. As can be seen the most frequent (about 53) reason for obtaining a loan is to meet start up costs of the business. About 35 percent of the respondents obtained a loan for financing inventory. Loans for consolidating debt and other reasons amounted to about 2 percent and 9 percent, respectively. Other reasons for obtaining loans included purchase of business, purchase of building and equipment, and working capital.

Purpose	Frequency	Percent
Start-up Capital	47	53.4
Finance Inventory	31	35.2
Debt Consolidation	2	2.3
Other	8	9.1

Table 3: Purpose of Loan

Number of Loans Received in Last Two Years

Table 4 presents data on the frequency of loans received by the respondent small businesses in the last two years. A high frequency, about 64 percent, did not receive any loans in the last two years. The result underscores the difficulty faced by small business in obtaining debt capital. Despite the increased interest in financing small business by the nations banks and the efforts of the SBA, a large proportion of small businesses are unable to obtain debt financing. The fact that the small businesses not receiving a bank loan have on average been in business for 10.1 years, more than the overall average age of businesses of 9.6 years, highlights the severity of the problem, i.e., even well established small business received one loan and another 12 percent received two loans. In addition there were small businesses that received 3 and even 5 loans in a two year period very likely did not do a good job of planning and may have used excessive time and resources in obtaining the several loans.

Number of Loans	Frequency	Percent
Zero	76	64.4
One	18	15.3
Two	14	11.9
Three	5	4.2
Four	0	0.0
Five or More	5	4.2

Table 4: Number of Loans Received in Last Two Years

Importance of Different Sources of Loans

Table 5 presents rank-ordered data on the perceived importance of the various sources of debt financing by small business owners. The most important source of loans to small business are the commercial banks and savings and loan institutions. The results are consistent with earlier data on the sources of start - up capital and the few published reports (Melia, 1992; Jones, 1992). The average response for all other sources varied from 2.99 to 3.83, however, the mode (most frequent response) was 5 for all, thus suggesting that the respondents did not give much importance to these sources. The high standard deviation, on the other hand, suggests considerable individual response variation. The data probably also reflects the fact that most small business entrepreneurs have to use personal savings for financing their business venture and, therefore, the perceived importance of outside sources of financing is not too high.

Source	Frequency	Mean	Std. Deviation	Mode	Median
Commerical Banks	108	2.81	1.61	1	2
Savings and Loan Associations	106	2.85	1.55	1	3
Family	106	2.99	1.58	5	3
Credit Unions	105	3.16	1.49	5	3
Small Business Administration	106	3.36	1.44	5	3.5
Other Government Agencies	105	3.49	1.39	5	4
Friends	106	3.50	1.51	5	4
Venture Capitalists	105	3.72	1.29	5	4
Insurance Companies	105	3.83	1.26	5	4

Table 5: Importance of Different Sources of Loans*

* Scale: 1 Important to 5 Unimportant.

Severity of Different Sources of Problems

Table 6 presents the rank - ordered data on perceived severity of various problems in obtaining debt financing for the small business. Lack of knowledge of loan sources and lack of a business plan are considered to be the most severe problems. Both have a mode of 1 and median 2. Attitude of bankers was the next problem, however, with a mode and median of 3 it was considered sometimes a problem by majority of the respondents. Similarly, lack of right contacts and distrust on the part of the lender were considered sometimes a problem. Whereas, Lack of help from government agencies and local chamber of commerce were almost never a problem.

Source	Frequency	Mean	Std Deviation	Median	Mode
Lack of Knowledge of Loan Sources	112	2.40	1.30	2	1
Lack of Business Plan	111	2.63	1.59	2	1
Attitude of Bankers	112	2.87	1.34	3	3
Lack of Right Contacts	111	3.08	1.39	3	3
Distrust on the Part of Lender	111	3.14	1.30	3	3
Lack of Help form Government Agencies	110	3.44	1.41	4	5
Lack of Help from Chamber of Commerce	109	3.65	1.17	4	4

Table 6: Severity of Different Sources of Problems*

*Scale: 1- Major Problem to 5- Never a Problem.

Conclusion

There are many significant developments in recent years that have made obtaining small business financing easier and more affordable. Many of these development have to do with the SBA. The SBA Credit Reform Act of 1993, for example, should allow the SBA to serve a

greater number of small businesses. However, many small business entrepreneurs are not aware of the several US government and SBA programs to help small businesses (Wilkinson, 1993). These include the Export - Import Bank, Overseas Private Investment Corporation (Smolensky, 1993), and economic development small business investment Companies (Curly, 1991). In order to increase awareness of the many SBA programs for helping small business, the SBA recently opened "SBA - On - Line," a national electronic bulletin board (Anthes, 1992). While lack of help from local chambers of commerce or government agencies seems to be not a problem, the attitude of bankers, the major source of debt financing, is another story. A large proportion of small businesses have not received a bank loan in the last two years. Bankers seem to focus only on the amount of revenues that the small business is generating. Important factors, such as small business owners' prior business experience, whether the small business is a first venture or a continuing business, whether market research has been done and even formulation of business plan or lack of it, appear to be ignored.

Other findings are that most small business entrepreneurs seem to rely heavily on personal and family savings, real estate, cash, securities, etc, for financing their business ventures. Although emphasis on personal savings as a major source of financing is a characteristic of small business, it may be more so for the small business that, because of low revenues and less employees, does not have recourse to bank loans. The major source of debt financing are commercial banks and the most frequent reason for obtaining a loan was for start-up capital followed by

need to finance inventory.

However, a major recent change in small business financing is the pooling of small business loans and sale on the open market (public debt markets) like and other asset backed security (Borowsky, 1993; Leibowitz, 1993; Taub, 1993). This effort at securing secondary markets financing for small business ventures should, if successful, make a lot more funds available to many more small business entrepreneurs.

Another major problem is the lack of a formal loan proposal and /or business plan. Analysis indicates that the problem is more severe for the smaller (both in terms of number of employees and dollar revenues) businesses,. It is ironic that the small business entrepreneurs understand that not having a business plan could be serious impediment to obtaining necessary financing, yet about 70 percent do not have written business plans and / or formal loan proposals. The importance of a business plan, even for investing personal savings, cannot be over - emphasized (Jones, 1990, 1992; Broome, 1992).

Implications

The study presents important empirical findings regarding financing practices, sources of capital and problems faced by small business in obtaining necessary financing. The results indicate that the small business respondents are aware of the difficulty that a lack of business plan causes, but for some reason (may be lack of personnel) a majority of them still do not have a business plan. There is probably an opportunity for accountants and other business consultants to help these small businesses with formulating business plans and preparing loan

proposals.

Major efforts by US government agencies, particularly the SBA, has promoted small business development in the US. However, easy availability of necessary capital, life blood of any business, through the private banking system is still a major problem. The results have significant implications for developing economies that have a large number of small entrepreneurs. It is unlikely that these small entrepreneurs will be able to obtain financing from private bankers looking for high current revenues. Thus, it becomes important that such nations have well formulated plans and policies to nurture these entrepreneurs. While the SBA and its programs could be used as a model, other options may include facilitating joint - ventures and providing a business environment that stimulates direct foreign investment.

References

- 1- Anonymous, (1993). "New Law Affects SBA Loan Guarantee Program", **Deloitte and Touche Review**, August 23, P. 5.
- 2- Anthes, Gary H. (1992). "Feds Set Up for Small Businesses", **Computerworld**, October 26, P. 105.
- 3- Bean, Randall, (1993). "Bank's Big Opportunities in Small Business", **Banker's Monthly**, January, PP. 35 - 36.
- 4- Borowsky, Mark. (1993). "Exploring the Secondary Markets to Increase Lending to Business", **Bank Management**, February, PP. 56 - 59.
- 5- Broome, Jr., J Tol. (1992). "Helping Small Firms Borrow Money", **Nation's Business**, January, PP. 34 - 35.

- 6- Casey, Robert W. (1991). "Today's Hottest Market: Small Business", **United States Banker**, June, PP. 14 - 18.
- 7- Clark, Daniel M. (1987). "Small Potatoes Have Appeal: Banks Eyeing the Small Business Market Can Learn from Experienced Lenders", **ABA Banking Journal**, June, PP. 55 - 59.
- 8- Curley, Michael. (1991). "The Small Business Investment Company (SBIC): A New Role in Economic Development", **Economic Development Review**, Winter, PP. 50 - 52.
- 9- Davis, Scott and Moon, Kent. (1991). "An Answer to the Credit Crunch", **ABA Banking Journal**, October, PP. 110 - 112.
- 10- Depke, Deidre A. (1989). "Software's Big Guns Take Aim at Small Business", **Business Week**, September 25, PP. 216 - 218.
- 11- Duncan, Ian D. (1993). "Eliminating Obstacles in the Road to Economic Development", **CMA Magazine**, April, P. 41.
- 12- Fiedelman, Lawrence. (1982). "Minis in Small Business", **Infosystems**, October, PP. 58 - 64.
- 13- Fitzgerald, Kate. (1993). "Calling Small Business", **Advertising Age**, March 29, PP. 29 - 34.
- 14- Hagaman, Carter T. (1992). "Small Business Loans: SBA to the Rescue", **Management Accounting**, August, P. 8.
- 15- Harper, B J and Churchill, Neil. (1987). "Serving Small Business: What CPAs Should Know", **Journal of Accountancy**, June, PP. 120 - 127.
- 16- Jones, Larry S. (1990). "How to Obtain a Small Business Loan", **Business and Economic Review**, Vol. 37, Iss. 1, October - December, PP. 21 - 25.
- 17- Jones, Larry S. (1992). "How to Obtain a Small Business Loan", **Economic Development Review**, Spring, PP. 74 - 77.
- 18- Liebowitz, Michael. (1993). "Fremont Fin'l Breaks the Ice With First Small -

Business ABS", **Investment Dealers Digest**, April 5.

19- Light, Larry. (1993). "Small Business: The Job Engine Needs Fuel", **Business Week**, March 1, P. 78.

20- Melia, Marilyn. (1992), "Lenders See Big Opportunities in Small Business", **Savings Institutions**, October, PP. 45 - 46.

21- Owens, Thomas. (1989). "SBA Loans", **Small Business Reports**, May, PP. 53 - 59.

22- Raymond, Louis. (1985). "Organizational Characteristics and MIS Success in the Context of Small Business", **MIS Quarterly**, March, PP. 37 - 51.

23- Saiki, Patricia. (1992). "The Advantages of Making Loans With the SBA", **Journal of Commercial Lending**, November, PP. 18 - 22.

24- Siegel, G, Shanon, D S, Stahl, C J, and Melchert, P R. (1986). "Marketing Consulting Services to Small Businesses", **Journal of Accountancy**, Vol. 162, Iss. 4, PP. 160 - 170.

25- Smolensky, Mary. (1993). "Financing and Insurance Programs for US Exporters", **Business America**, Vol. 114, Iss. 9, PP. 15 - 17.

26- Tannous, George F and Sarkar, Asit K. (1993). "Banks and Small Business Export Finance: New Targets for Services and Marketing Strategies", **International Journal of Bank Marketing**, Vol. 11, Iss. 2, PP. 10 - 17.

27- Taub, Stephen. (1993). "Cashing in on Small Business Loans", **Financial World**, April, 27.

28- Valle, Del. (1993). "Time to Turn out the Lights at the SBA?", **Business Week**, May 31, P. 78.

29- Wilkinson, Tony. (1993). "Your Franchises and the SBA Loan Program", **Franchising World**, January / February, PP. 20 - 21.