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Financing—A Major Problem of Small Business

*Joseph T. Howell, Jr.**

I. Introduction

It is imperative that a definitive study of small business include a discourse on financing.[1] Generally, the first consideration of a prospective entrepreneur is the availability of sufficient capital, borrowed or paid-in, to support the activity of his business. Of paramount importance, however, to those who attempt to assess the prospects of survival and future growth of a company is the recognition that all considerations are secondary to the human factor. The careful banker, while requiring collateral to secure a loan, depends on his estimation of the applicant's personality traits. While the adequacy of captial contributes to the success of a business, without alert, imaginative, and competent management, the chances for survival are slight.[2] In essence the problems of financing a small business are problems of personalities, mutual confidence, and capacity; they are not merely problems of percentages, figures or working capital.

Defining "small" of course, is essential to a consideration of financing small business. Is there indeed any distinction between the large and small firm other than size? Congress, in the Small Business Act, defined a small business "as one which is independently owned and operated and which is dominant in its field of operation."[3] The

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1. The general subject of financing lends itself to treatment in depth, and the reader who is interested in exploring this subject in length will find a number of texts that may be helpful. Three which include a wealth of material are Davis & Gee, Analyzing Financial Statements (1951); Foulke & Prochnow, Practical Bank Credit (2d ed. 1950); Irons, Commercial Credit and Collection Practice (rev. ed. 1957).

2. In its annual study of business failures for the year 1963 (the latest available), Dun and Bradstrcet classified management weakness as being responsible for 90% of the casualties. These management deficiencies include lack of previous experieuce in the particular line, lack of managerial experience, nnbalanced experience (i.e., as to sales, operations, or administration, and general incompetence). In number, most occur in the small business sector, and Dun and Bradstreet's 1963 study shows that 35% were businesses that had been in operation three years or less.

3. Congress defined small business for the purpose of qualifying for defense contracts, and for eligibility under § 3 of the Small Business Act, 72 Stat. 384 (1958), 15 U.S.C. § 632 (1964).

Administrator of the Small Business Administration, pursuant to authority granted in the act, established specific criteria under this definition. A manufacturing concern is considered small if its average employment in the preceding four calendar quarters did not exceed 250 persons. It is considered large if the average employment in this period was greater than 1,000 persons. Where average employment was between 250 and 1,000, the company may be considered large or small, depending upon the standard developed by the SBA for that particular industry. A wholesale concern is classified as small if its annual sales are under five million dollars. Most retail businesses and service trades are considered small if their annual sales do not exceed one million dollars.[4]

This definition is necessary to the administration of the congressional act, but it overlooks a more basic distinction relating particularly to the problems of small business. The critical differential is access to the equity market. A business enterprise that can expand its operations by offering additional capital stock for public sale has a substantial advantage over a company dependent upon its own resources for expansion. The small enterprise must rely on its owner's resources or attempt to finance expanded volume entirely by retained earnings and/or borrowed funds. Being more dependent upon creditor support, small businesses have less margin for error than the larger firm. Both the owners and the creditors are interested in its profitable operation and realize the importance of success to their interests. Therefore, from all points of view, the financial success of the enterprise is the prime consideration.

What are the ingredients for the success of a business enterprise; for example, a manufacturing concern? They are a capability to produce a product, an ability to market this product, and sufficient capital to support the attained sales volume. Basically, small business encounters two financial problems: availability of capital, borrowed or equity, and the ability to plan intelligently for utilization of available capital. To illustrate, assume that Mr. Jones, having saved 5,000 dollars, decides to establish a machine shop. He knows that he can purchase equipment over a period of four years, and, since this is a service business, that he will have no inventory except what he is under contract to produce. His opening balance sheet then shows:

Cash	$4,250.00
Current Assets	$4,250.00
Machinery and Equipment	$5,000.00

4. U.S. SBA, HANDBOOK FOR PARTICIPATION LOANS WITH THE SMALL BUSINESS ADMINISTRATION 2 (1963).

Total Assets		$9,250.00
Notes Payable—Equipment		$4,250.00
Capital		$5,000.00
Total Liabilities and Net Worth		$9,250.00

At the end of his first year, if gross sales per month were 7,000 dollars and he earned ten per cent after taxes (which would be excellent for a new business), assuming accounts receivable represented thirty days' sales, inventory was turned four times, and cost of goods was seventy per cent of sales, his year-ending balance sheet would reflect:

Cash		($9,512.00)
Accounts Receivable		6,900.00
Inventory		14,700.00
Current Assets		12,088.00
Machinery & Equipment	$5,000.00	
Reserve for Depreciation	$ 500.00	4,500.00
Total Assets		$16,588.00
Notes Payable Equipment		$3,188.00
Capital	$5,000.00	
Net Profit	$8,400.00	13,400.00
Total Liabilities and Net Worth		$16,588.00

Thus, he has a cash deficiency of 9,512 dollars, necessitating creditor support for continued operation. While this is a hypothetical case, it is, nevertheless, a fair illustration of the need for financial planning.

II. Financial Planning

A sign on the stairway of a local bank reads, "Some people talk so much they say things they haven't thought of." A furniture manufacturer tooling up for a new product would be hopelessly lost without carefully planning the steps in his production line. The need for such planning is apparent and usually receives priority attention from management. What is not so obvious, however, is the financial planning necessary to support the anticipated increase in sales volume and the attendant increases in minimum levels of inventory and receivables. However, wise management, attentive to the foreshadowings of future events, attempts to predict the extent and nature of the financial requirements of the business. Management is not alone in recognizing this need and can obtain valuable assistance from several competent groups: bankers, accountants, attorneys, trade associations, and governmental agencies, to name a few.

A. *Assistance From Commercial Banks*

Commercial bankers comprise the largest single group of business and financial consultants.[5] With a current four per cent interest rate on passbook savings, the banking profession is necessarily committed to a high ratio of loans to deposits[6] in order that earnings will attain a sufficiently high level to cover interest and other costs. This not only demands intelligent lending, but a willingness to share financial acumen with small business. This is known in the banking industry as "constructive lending." It might as accurately be termed "enlightened self-interest." Nevertheless, the banker does appreciate the importance of financial planning and is willing to share new concepts in budgeting, industry operating comparison, sales and operations forecasting, and the projection of cash flow.

B. *Assistance From Accountants*

Another group, perhaps most sophisticated in the details of planning techniques, is the accounting profession. Without the development of accounting as an adjunct to the planning and presentation of information critical to the decisions of management, business would not have achieved its modern character. Unfortunately, the accountant is often limited in the scope of his employment to routine examination because many clients fail to realize the financial planning assistance available to them. Even so, the work performed by the accountant provides a basis for furnishing valuable additional information at a nominal cost compared to the expense of a subsequent independent study.

C. *Assistance From Attorneys*

Most businesses require legal counsel, either at the time of organization or incident to an unusual contract or other extraordinary event. While consultation with attorneys customarily involves legal matters, it also offers an opportunity for guidance of a more general nature. The lawyer, accountant, and banker all have a special interest in small business, and their services should be utilized jointly and severally. This is particularly apparent in situations where one may sense a difficulty developing which would require the coopera-

5. Over 95% of all businesses have some type of banking relationship—checking account, safe deposit box, loan, agency account, etc.

6. Considering all commercial banks, the ratio of loans to deposits as of June 30, 1965, was 61%. Federal Reserve Bank of N.Y., Monthly Rev., Aug. 1965.

tion of the company and all those interested. A patient with a peculiar malady welcomes a consultation of physicians to diagnose and prescribe. So, the owner of a business with growing pains or related problems should seek consultations with his banker, accountant, and attorney.

D. *Assistance From Trade Associations*

While competition is essential to American industry, there is, nevertheless, recognition of the underlying principle of interdependence and mutuality of interest. This is manifest in the trade association which performs a variety of services for many business segments.[7] It provides a forum through which individual members can express their views, exchange experiences, and benefit from the successes and failures of others. Cooperative studies compiled by the association are available to members in such areas as pension and wage incentive plans, group life and health insurance programs, cost-of-doing-business studies, industry-wide advertising, and legislative matters. To the small businessman, the trade association can be a particularly viable source of information and assistance. In the field of finance, for example, it can make an important contribution through common size industry studies of balance sheet and operating statement experience, which reveal industry averages without violating individual company confidence.

E. *Assistance From Government*

Government has long been interested in the quality and progress of small business. Today its general attitude is summarized by the former SBA Administrator, Eugene P. Foley, "One way of putting poverty out of business is by putting people in business and helping them, wherever possible, to grow and prosper and provide jobs for others."[8]

The Economic Opportunity Act of 1964,[9] which launched the "War Against Poverty," recognizes the vital role of financing by authorizing loans to eligible small businesses and prospective entrepreneurs. Consultation services for the benefit of such new businesses are also provided in the act by the authorization of Small Business Development Centers with boards of directors representing business, industry, professional and trade associations, banks, colleges and universities. In addition, the SBA does a substantial amount of consultative work as

7. Examples of some of the better known trade associations are the American Bankers Association, the National Retail Dry Goods Association, and the National Tool, Die and Precision Machinery Association. There are numerous others.

8. U.S. SBA, ECONOMIC OPPORTUNITY LOANS FOR SMALL BUSINESS 1 (1964).

9. The Economic Opportunity Act of 1964, 78 Stat. 508 (1964), 42 U.S.C. § 2701 (1964).

an adjunct to its primary function.[10] Further, the Department of Commerce supplies publications covering a wide range of businesses.[11] And finally the Service Corps of Retired Executives (SCORE) program, which is composed of retired or semi-retired executives who have volunteered to counsel small business, also gives consultative assistance. Instituted on October 5, 1964, it evoked immediate response and nearly 2,000 executives volunteered their services by the end of the year.

Small business has benefited from the enactment of new tax legislation, the liberalizing of depreciation allowances,[12] and the Uniform Commercial Code. Accelerated depreciation methods allow a company to retain a larger portion of its cash and, therefore, are particularly helpful to the company in need of liquid assets. The innovations provided in the Uniform Commercial Code reduce the problems and risks inherent in lending on such collateral as inventory and receivables,[13] thus permitting greater credit to the small and undercapitalized borrower.

III. THE AVAILABILITY OF CAPITAL

There are two kinds of capital, owner's capital and borrowed capital, and, correspondingly, there are two views from which this aspect of the subject should be approached: that of the owner or borrower, and that of the lender.

A. *The Entrepreneur*

Successful business management requires special personal qualities: a pleasant personality, the courage to make decisions and accept

10. Publications of the SBA include a volume of material in the area of finances and financial planning. The type of subject matter covered is made apparent by the following partial list of titles: How to Analyze Your Own Business, Financial Planning in Closely Held Businesses, The ABC's of Borrowing, Is Your Cash Supply Adequate, Financial Facts Which Lenders Require, and Planning and Controlling Production to Avoid a Cash Bind. For a complete list of titles, request SBA 115A and SBA 115B from the Small Business Administration, Washington, D.C.

11. These publications are entitled "Establishing and Operating a [Hardware Store, Metalwork Shop, etc.]." These fairly comprehensive presentations designed to aid the new entrepreneur in the planning process. Finances are an important feature in each publication. Write the Superintendent of Documentation, Washington, D.C., or any of the department's field offices.

12. Rev. Proc. 62-21, 1962-2 CUM. BULL. 418. Romak, Depreciation Reform: Using The New Guideline Lives, N.Y.U. 22nd INST. ON FED. TAX 465 (1964); Small, Depreciation Under Treasury Guidelines and Rules, 41 TAXES 59 (1963).

13. UNIFORM COMMERCIAL CODE §§ 9-101 to -507. The protection afforded the lender by collateral is often more imaginary than real. In the case of one well-known lending institution, approximately 90% of the loans charged off its books during a 35 year history were secured loans. The mere fact that a loan is secured does not insure collection. Collateral has a way of depreciating when it is offered for sale. Moreover, a physical asset can be depleted or become obsolete.

responsibility for them, and an understanding of people and their capacities. The entrepreneur must tirelessly endeavor to "know" his business and be prepared to sacrifice personal pleasures. There are numerous things that a prospective entrepreneur should do prior to engaging in business, such as surveying the trade area, acquiring suppliers, recruiting personnel, and selecting a business location. Here, attention is focused upon the accumulation of capital.

There are numerous methods of borrowing capital. Regardless of the one employed, the amount borrowed is directly related to the amount the borrower is investing in the project, as there is no substitute for owner-invested capital. This is the major financial problem confronting the small business, and the only solution is saving. Too often, a prospective businessman is unwilling to delay a business venture until adequate capital is accumulated, and is unwilling to make the sacrifices necessary for the creation of capital. Generally this is due to his lack of self-discipline.

B. *The Lender*

How much is enough? Abraham Lincoln once said in response to the question how long should a man's legs be, that "they should be long enough to reach the ground." The adequacy of the capital investment is relative also, and, perhaps, can best be approached from the vantage point of the lender.

While there may be many reasons for borrowing and many purposes for borrowed money, the lender recognizes, regardless of the size of the borrowing business, only two basic types of loans. The first type, a seasonal loan, finances the accumulation of inventories and receivables during the peak season and is retired when the business' activity returns to normal. The second type, a long term loan, extends beyond the seasonal cycle. The adequacy of invested capital must be related to the character of the business, the expansion plans of management, and the earnings history and potential of the company. The availability of borrowed money depends on the proper relationship between the type of loan on the one hand and the source of repayment on the other. The lending officer recognizes only three sources from which any loan can be repaid: the conversion of assets, the addition of new funds to the business, or refinancing.

1. *Seasonal Loan—Conversion of Assets.*—The importance of the relationship between the type of loan and the sources of repayment becomes apparent when the sources are defined. Conversion of assets is the sale of any asset, thus converting it into cash. However, the conversion of assets normally is a routine part of a seasonal cycle which most businesses experience annually. As the busy season

approaches, inventory is accumulated. It is then sold and is represented by accounts receivable. The accounts receivable are paid, thereby converting inventory into cash. A business should have sufficient capital without borrowing to carry the minimum receivables and inventory at the base of the annual cycle. In anticipation of the cycle, a company borrows in order to acquire an adequate inventory for the increased activity. After the inventory is consumed, the company liquidates the loan from the collection of the accounts receivable. Therefore, a company with adequate paid-in capital has no loan obligations at the beginning of the cycle, borrows as needed during the season, and retires its obligations at the end of the cycle.

2. *Term Loan—Addition of New Funds.*—The foregoing is the classical example of short term, or seasonal, bank credit. But suppose that the company had to dispose of its inventory at a loss, and as a result was unable to completely liquidate its bank loans. What will be the source of funds with which to rctire the debt? Either the owners must increase their investment, enabling the business to retire the indebtedness, or the bank must extend credit for another season, as well as continue the existing loan. The difficulties surrounding such a situation are obvious. The business has experienced an unprofitable season and yet must seek even greater credit support to carry the same volume of business for another year. In this instance, the following pertinent questions should be asked: What were the reasons for the unprofitable season? Have the necessary steps been taken to correct the deficiency? Is there an economic change in the market which is affecting this particular industry? Are competitive forces relegating the company to an unprofitable status? Do overhead expenses necessitate a higher business volume to produce a profit? If so, are even greater credit requirements necessary to increase inventory and maintain receivables? Assuming a generally favorable answer to these questions, will the company's earnings be sufficient to fully liquidate the carry-over loans, or will more than one year's earnings be required?

The above questions must be resolved if borrowed capital is to be obtained. Since the credit requirement is not in the normal course of business, and repayment thereof is extended beyond one year, term credit is applicable. The following situation illustrates an appropriate occasion for term credit. A profitable company, having outgrown its present quarters, desires to enlarge its facilities and expand its sales volume. Management feels that with new and larger equipment it can contract for more profitable jobs, thereby increasing its earnings. However, a substantial capital investment is required in plant and equipment, and in inventory and receivables if the anticipated sales volume develops. Also, additional personnel will be needed and overhead expenses will be increased by higher taxes, insurance, and increased operating costs.

Every business, as it expands, experiences similar problems. Those who have observed the growth and earnings pattern of business realize that earnings reach a peak, relatively, when output approaches maximum capacity, other factors being favorable. Therefore, when sales approach the optimum under existing physical facilities, excellent earnings should be reflected. Since in the initial stages new or enlarged facilities are not totally utilized, however, maximum earnings are not realized. A time lag is inevitable in the transition period during which earnings may suffer. Therefore, invested or borrowed capital is required to reduce the burden of the transition period.

The availability of borrowed capital for this purpose is dependent on a favorable answer to numerous questions. Can the business compete in the larger market? Will it be able to maintain its overhead expenses at a reasonable level? In the event of death or incapacity of key personnel, is there managerial depth to continue efficient operation? Does the larger market offer the profit potential which management envisages or is management overly impressed by volume? Have studies been conducted on profit potential at various sales levels so as to equate attained results against anticipated performance? What will be the company's cash flow under the new conditions? How much new capital is ownership prepared to invest? How much borrowed capital is required? How much can the company allocate to reduce borrowed funds and pay interest thereon? What time period is required to liquidate the borrowed capital?

The complexity of these questions illustrates the importance of identifying the type of credit and distinguishing between the sources of repayment. Seasonal credit extended for a short duration does not produce the variables inherent in a consideration of term credit. Contrast the accuracy of forecasting price swings, market reaction, and competitive products and labor conditions for the next season's production, with the precariousness attendant in predicting the pattern of the same variables for a four-year period.

As the repayment period increases in length of time, the risk correspondingly increases. Therefore, to compensate for the greater risk, term credit is customarily secured by collateral. The character and acceptability of collateral is necessarily dependent on the general financial strength of the company and the nature of the company's business activity. Since experience has demonstrated that acquisitions 100 per cent financed by borrowed capital have a high default rate, lenders are reluctant to extend credit unless the borrower is also investing in the venture. This is most noticeable in the retail sales, where the loss ratio varies inversely with the per cent of down payment. Since the funds which the company must invest constitute operating capital, additional funds must be substituted for those withdrawn. Only by saving can a smooth and effective transition into increased production and sales be accomplished. An expansion program requires not only advance planning, but accumulation of owner capital. Borrowed capital is not a substitute for, but a supplement to, the minimum investment of ownership.

IV. Conclusion

That the commercial banking system appreciates the long-term capital requirements of business and is responding to meet these requirements, is reflected in the data compiled weekly by the New York Federal Reserve Bank. This data reveals that the major New York City banks have been experiencing a strong, steady expansion of term loans.[14] While data of this type is not collected for banks in other sections of the country, "institutions from coast to coast disclose that their experiences parallel those of the reporting member banks."[15] In its Monthly Review for August, 1965, the Federal Reserve Bank of New York reveals that loan-to-deposit ratios for all commercial banks have risen to their highest point since World War II. The central bank notes that at the end of June, the ratio for all commercial banks as a group was 61 per cent, with the uptrend due largely to increases at banks outside New York City.[16] Of the 13,761 banks as of December, 31, 1964, the vast majority are classified as "country banks," located in the smaller cities and towns and serving the small businessman.[17] A study of the growth pattern of country bank loans reveals that the annual increases for the past several years have substantially exceeded the growth pattern of the National Index of Industrial Production.

Year	Loans*[18]	Amount of Incr.	Per Cent of Incr.	Index of[19] Ind. Pro.**	Amount of Incr.	Per Cent of Incr.
1960	$ 9,499	$		108.7		
1961	10,165	666	7.0	109.7	1.0	.9
1962	11,299	1,134	11.1	118.3	8.6	7.8
1963	12,831	1,532	13.5	124.3	6.0	5.0

14. American Banker, August 6, 1965, p. 1.
15. *Ibid.*
16. Monthly Rev., *supra* note 6.
17. 51 Fed. Reserve Bull. 1124 (1965).
18. *Id.* at 1128.
19. *Id.* at 1160.

1964	14,556	1,725	13.4	132.0	7.7	6.2

*Country bank loans for commercial; and industrial purposes in millions
**Index of Industrial Production (1957-1959=100)

The inference to be drawn is that the smaller country banks, as well as metropolitan banks, are responding constructively to the need for business capital. Indeed, the rapid expansion of credit for commercial and industrial purposes by the country's bankers suggests greater mutual confidence and a closer working relationship between borrower and lender. For the past thirty years, the banking profession has fostered and gradually expanded graduate educational programs which are reaching and increasing the number of young officials in smaller banks.

The small businessman will continue to have the disadvantage of less, and perhaps inadequate, capital. However, his financing problems are being shared to an increasing extent by his banker, who realizes that the economy is dynamic, presenting a continuous procession of challenges and opportunities. The extent to which those challenges are mutually recognized and solved will be reflected in the strength, progress, and profits of both the banks and the small businessman.

A noted research scientist has said that the secret of cancer will be discovered by a philosopher, rather than a doctor. By this, he meant that within the thousands of tests and the minutiae of information, we already have the answer to the secret of cancer. To find this secret will take the patience, the reasoning, the methodology of the philosopher. And so, perhaps in the more mundane world of the small businessman the answer to his financial problems lies not in the field of economics or accounting or finance, but in the field of philosophy. It is in this area that integrity, motivation, discipline, and determination combine with logical purpose to produce successful leadership and profitable business.