

December 1991

Small Business Uniqueness and the Theory of Financial Management

James S. Ang
Florida State University

Follow this and additional works at: <http://digitalcommons.pepperdine.edu/jef>

Recommended Citation

Ang, James S. (1991) "Small Business Uniqueness and the Theory of Financial Management," *Journal of Small Business Finance*: Vol. 1: Iss. 1, pp. 11-13.
Available at: <http://digitalcommons.pepperdine.edu/jef/vol1/iss1/2>

This Article is brought to you for free and open access by the Graziadio School of Business and Management at Pepperdine Digital Commons. It has been accepted for inclusion in The Journal of Entrepreneurial Finance by an authorized administrator of Pepperdine Digital Commons. For more information, please contact paul.stenis@pepperdine.edu.

Small Business Uniqueness and the Theory of Financial Management

James S. Ang

Small businesses do not share the same financial management problems with large businesses. This paper shows that the source of the differences could be traced to several characteristics unique to small businesses. This uniqueness in turn creates a whole new set of financial management issues. The major implication is that, yes, there are new and interesting topics in small business financial management research.

I. INTRODUCTION

It is fair to say that the theory of modern corporate finance is not developed with small businesses in mind. For instance, the stylized theoretical firm is assumed to have access to external capital market for debt and equity. The shareholders have limited liabilities and own diversified portfolios. A most relevant question to practitioners and researchers interested in the application of finance to small businesses is: Will the extant theory of corporate finance still be applicable? And if not, in what way would the theory for small business financial management differ?

A reasonable starting point to develop the new paradigm for small business financial management is to identify features of small businesses that are not considered in the modelling of the large firm paradigm because they are deemed unimportant or unnecessarily complicated. These unique characteristics of small businesses could generate a different set of financial problems, or cause small businesses to look at the same set of financial problems in a different manner. As a consequence, different financial decisions, types of financial arrangements, institutions, and practices may evolve.

The paper is organized as follows: Section II gives a list of unique characteristics of small businesses that are relevant to financial management; Section III presents new interpretations of major financial management issues, such as agency and information, that incorporate these features; implications for small business financial management theory are discussed in section IV. Section V concludes the paper.

James S. Ang • Department of Finance, Florida State University, Tallahassee, FL 32306.

The Journal of Small Business Finance, 1(1): 1-13
ISSN: 1057-2287

Copyright © 1991 by JAI Press, Inc.
All rights of reproduction in any form reserved.

II. UNIQUE CHARACTERISTICS OF SMALL FIRMS

In spite of official classifications, e.g., businesses with less than 500 employees, there is probably no consensus definition of a small business. As a matter of fact, the term could be a misnomer since relatively large firms listed in the lower quintile or quartile of the COMPUSTAT and CRSP data tapes are often arbitrarily classified as 'small firms' for convenience in empirical studies. These are not really small firms and are not of theoretical interest in this paper. For the sake of being able to present a more interesting analysis and to stimulate discussions, a business is classified as small if it possesses most of the following characteristics:

- (a) *No publicly traded securities.* The business has neither debt nor stock traded in organized exchanges. This feature makes a small business unique in several ways; it does not have a ready market valuation for its shares, it has low information reporting requirements, and most importantly, it has fewer sources of financing. Access to public issue markets is relatively expensive for some, and impossible for the very small.
- (b) *Owners have undiversified personal portfolios.* Investment in the business often constitutes a major portion of the owner's personal wealth. A few owners may achieve some personal diversification via life insurance policies, bank accounts, small stock portfolios, and self employment pension accounts. Nevertheless, the assets of a small business are on the whole more product, customer or geography specific than a large business. A large holding in a risky business also translates to a riskier personal portfolio for the owners.
- (c) *Limited liability is absent or ineffective.* The limited liability provision is not available in the proprietorship and the partnership organizational forms. For small businesses organized as a corporation, it is often ineffective to protect the owners against personal losses from business failure since they are required by the lenders to provide a personal guarantee or put up noncorporate personal assets as collateral for loans.
- (d) *First generation owners are entrepreneurial and prone to risk taking.* Through the process of self-selection, those that are willing to take risks [7], to manage their own company and put in long hours, and to push through their ideas for new products, start new

businesses. These first generation owners prefer a potential high return, and are willing to tolerate the corresponding higher risks. This attitude, which is quite different from that of the managers of large firms, could affect the small businesses' choice of financial strategies, with regard to riskiness and time horizon.

- (e) *The management team is not complete.* The management of small businesses lacks depth and versatility. The management team of a small business suffers from several related shortcomings.
1. It may depend on a single or a few key individuals to provide the technical talent, leadership, or customer contact.
 2. It may not have a contingent plan for succession to ensure continuity.
 3. It may lack a full complement of managerial talents with knowledge and skills in finance, marketing, production and international business.
 4. It may not be able to adjust to changes in the external environments, or to a different stage of development as the firm matures.

It is this lack of depth and scope of management that accounts for one of the major differences between a small business and a large but privately held firm.

- (f) *Experiences high cost of market and institutional imperfections.* Due to imperfections, the small scale and limited managerial resources, the cost of doing business is higher for small businesses. Small businesses are likely to pay proportionally more in bankruptcy/failure costs [1], cost of compliance with regulations, transaction costs of financing, negotiation costs, and litigation costs.
- (g) *Relationships with stockholders are less formal.* The relationships between small business owners and outside stockholders are more implicit and less contractual. Owners/managers personally deal with their stockholders and thus, depending on the frequency of past and potential future transactions, personal reputation could be of value. Information collected on small businesses is often fragmented and private. As a result, learning and previous track records could be important as well. However, cost of monitoring and bonding[4] could be relatively high.

- (h) *It has high degree of flexibility in designing compensation schemes.* A single proprietor could integrate income from the business and other sources into an aggregate function that maximizes long term personal consumption. Compensation and consumption could be postponed in the formative years of a small business by entrepreneurs who take a long term view. Owners in a partnership and subchapter S corporation could integrate personal incomes to minimize personal taxes. They would be indifferent between compensation or profit distributed from the firm.

Most small businesses, from mom and pop stores to a new high tech firm, are expected to possess most of these features. These characteristics lend themselves to identify the different types of financial problems by the small businesses which are discussed next.

III. FINANCE ISSUES: THE SMALL BUSINESS VERSION

This section reexamines some fundamental financial issues with the small businesses in mind. It shows that small businesses have financial management issues that are quite different from those of the larger businesses. Thus, new and different solutions would also be required.

Agency Problems

The incorporation of the unique characteristics of small businesses expands the topic of agency in several ways. First, allowing alternative organizational forms such as proprietorship and partnership introduces several new classes of agency problems. Although the combination owner/manager in a proprietorship resolves the manager vs. owner agency problem, the agency problem between the owner/managers and other stakeholders could actually be more serious. The absence of publicly traded shares, the risk taking tendency of entrepreneurs, the lack of management depth, the problem of succession, and the limited personal wealth of owners could imply a shortened expected duration for the firm and thus a shortened transaction horizon with the stakeholders as well, which in turn creates opportunities for agency problems. Examples include owners as fly by night operators, and lenders, unions, and suppliers exercising monopoly power over the small businesses.

The combination of partnership where there could be several partners actively involved in the business, and unlimited liabilities for the partners

could be a fatal combination in many circumstances. Each partner would be personally liable for every partner's actions. A good portion of the partners' resources could conceivably be expended on cross monitoring. Lack of ready market valuation also creates a serious exit problem for the partners. Anticipating departures, partners, maximizing their own utilities, may employ strategic decisions that may not be in the best interests of the firm. Even in the corporate firm, ineffective limited liability, lack of market valuation and high monitoring costs creates agency problems for small businesses. In a subchapter S corporation, for instance, since minority shares have to pay tax on current profit even if payout is zero, agency costs due to undistributed dividends could be quite real.

Second, solutions to agency problems, such as bonding and monitoring, are relatively more expensive to the small businesses, thus, raising the cost of transactions between the small businesses with their creditors, shareholders and other stockholders. Third, small businesses and their stakeholders would find new or different ways to solve the agency problems. For instance, small businesses would attempt to establish a good reputation with outside stakeholders by limiting their transaction to fewer stakeholders, this would increase the frequency of transactions with each stakeholder as well as voluntarily bond the firm from seeking out alternative opportunities. The outside stakeholders, such as suppliers and bankers, who must deal with many small businesses have the incentive to demonstrate good faith and build reputations too. To increase the value of the relationships and reduce agency costs, outside stakeholders may even encourage intergenerational transfer of reputation in a small business.

Information

Outside stakeholders of small businesses face several information problems. The first is the familiar asymmetric information problem where the insiders are expected to be more informal about the prospects of the firm. This problem is more serious in small businesses than in large businesses because of

- (1) the relatively high fixed cost of gathering information for a small transaction,
- (2) the smaller number of repeated transactions,
- (3) the smaller incentives for a third party, such as outside analysts and rating agencies, to collect information for sale since the market of this type of information is also smaller, and
- (4) the small businesses may have greater difficulties in making their claims or signals credible. One reason is that they have fewer

instruments to signal and the other is their lack of significant bonding or ex-post settling up costs that could be offered.

The second information problem concerns the quality of data generated by the small businesses for review by the stakeholders. Small businesses may not have the managerial talent and staff to come up with data useful to the stockholders. Since they do not have publicly traded securities, they are not under legal or institutional constraints to produce verifiable information. Finally, there is a problem with differences in expectations. Owners/entrepreneurs are expected to be more optimistic about the firm's prospect than outside stakeholders. The outside stakeholders are also expected to discount the more optimistic projections. However, the owners are aware of such discounting, and the outside stockholders are also aware that the owners are already expecting a downward revision. The process, therefore, becomes a gaming situation where accurate information could only be unraveled under certain circumstances where conjectures and counterconjectures could be properly modelled and accounted for.

Failure Costs

Several unique features of small businesses affect failure costs. The probability of failure could increase with the risk taking entrepreneur, incomplete management team, limited alternative sources of financing, lack of alternative measures of value due to the absence of traded securities, agency conflicts and succession problems. The costs of failure are also higher as the small businesses face higher costs of market imperfections and frictions such as higher proportional legal, accounting, trustee and auctioning fees. On the other hand, lack of effective limited liability could cause a transfer of failure costs at the firm level to the personal level of the owners. Owners who are averse to the stigma of business and personal bankruptcies as well as the loss of personal reputation for future business ventures, would have the incentive to take actions to reduce the probability of failure by deferring compensation, or contributing their own capital to relieve cash flow shortage. The lenders have a similar incentive to reduce failure costs. They may demand more frequent reporting and access to private information so that early warning for potential failure could be identified, and lower cost alternatives could be worked out. Thus, the issue of failure for small businesses is more complex. Owners integrate the consequence of failure at both the firm and the personal levels. The effect on bankruptcy probability could depend on the owner's willingness to risk personal failure as well as the generosity of the personal bankruptcy law with regard to the amount of assets the bankrupt is allowed to keep.

Taxes

There are several differences in the taxation of small businesses vis-à-vis large businesses. First, the progressiveness of corporate and personal taxation at certain low income levels is relevant to small businesses and not to large businesses. Gains in tax planning near the jump in marginal tax rates could be worthwhile. Second, owners would integrate business and personal incomes to compute the marginal tax rates on business investment and financial decisions. Third, estate tax considerations and the lack of market valuation could affect the type of financial decisions made. For example, there are alternative means of transferring an estate to heirs that may affect the firm's capital structure, ownership composition, and asset mix. A case in point are the tax breaks on estate tax if the transfer is to establish an ESOP [6].

Transaction Costs

The price of high transaction costs to small businesses is to preclude them from certain financial choices or services. The high fixed costs of preparing a public issuance of securities, the high costs of compliance to government regulations, the costs of securing the service of top notch investment bankers or financial consultants, or even the costs of investigation to be incurred by potential stockholders could all shut the firm out of some financial and product markets, as well as types of investors.

IV. IMPLICATIONS FOR FINANCIAL DECISIONS

The challenges to finance researchers interested in small business finance are to identify problems that make small firms unique, formulate testable hypotheses, collect new sets of small firms specific data, and verify the hypotheses empirically. Eventually, this process will produce an inventory of new knowledge about small business financial management. This section makes some educated conjectures concerning possible differences in the financial management decisions made by small businesses in comparison to the more familiar large firms. Small businesses are too heterogeneous to be lumped into a single category, they differ in terms of history or track record, availability of growth opportunities, organizational forms, etc. Thus, whenever possible, specific predictions or conjectures concerning a particular type of small businesses are in the discussion.

Capital Budgeting

An important research question here is whether small businesses would make the correct investment decision. Specifically, in the absence of market valuation, would small businesses accept all positive NPV projects only, or would they overinvest by accepting too many negative NPV projects, or underinvest by rejecting too many positive NPV projects. The answer depends on several factors: (1) whether small businesses could obtain capital at the same costs as the large firms, otherwise, underinvestment could occur, (2) whether small businesses are capable of performing the optimizing calculations as the large firms; if not, both under or over investment could be observed, (3) whether the unique characteristics of small businesses induce a built-in bias to the estimation of cash flows? Optimistic estimates by the entrepreneurs, for instance, may result in overinvestment. Another source of potential upward bias could arise from the small businesses' lack of a complete management team. There could be a gap between what a small firm could achieve for a project if it had the marketing and distribution channels, production technology, etc. (the normal or large firm NPV), and what it could reasonably achieve (the realizable or small firm NPV). Decisions made by the small firm on the basis of the former measure would overestimate the project's benefit and result in overinvestment.

A serious information problem would arise in a capital budgeting situation when an asymmetric information problem is confounded by heterogeneous expectations. An assumption implicit in a signaling equilibrium is that the firm as the signaler knows the true value of the new project without bias such as rational expectations. When this assumption is violated, there are more optimistic owners/entrepreneurs as well as more informed owners. Both types are equally willing to pay the cost of signaling such as, quit existing job, take a pay cut, dip into own savings or pension, mortgage residence, etc. Lenders who are aware of such behavior would make less funds available. Many projects would not be funded, including some good projects, while some inferior projects may be financed since the lenders do not have the perfect ability to discriminate between the two types. Thus both over and underinvestments could be observed among small businesses.

There are other instances where small businesses would underinvest. Succession problem, potential cash drains due to estate taxes, or the possibility of exit by some partners could lead to a reluctance to invest and bypass good projects. Also, projects with multiple future options are worth less to small businesses if they do not have the resources to fund or implement the future options if exercised. One solution is a merger of the small firm and a large firm with a 'deep pocket', more managerial talents, or organizational resources, thus providing a rationale for acquiring small firms.

Finally, when compared to large firms, some small firms may underinvest due to a shortage of internally generated funds under a pecking order regime. Other small firms may also overinvest in very risky projects when the amount of personal wealth under unlimited liability is small. In contrast, large firms with a portfolio of a large number of assets would hesitate to invest in the same risky project since, instead of exercising its limited liability option, the rest of the firm may have to subsidize the short fall of the risky project. Thus limited liability, if it is effective, is more valuable for small firms than for large firms. The lenders, being aware of this difference, would rationally charge the large firm a lower cost of borrowed funds for a smaller likelihood of exercising the limited liability provisions (a put option). The small firm, facing a higher cost of capital, would end up not investing in some risky projects.

In sum, over and under investment could occur in small businesses. Overinvestment may occur in projects in which small businesses hold optimistic expectations, or underestimate their ability to execute a project with high degree of complexity, in which large amount of managerial and organizational resources are required. They may also accept very risky project when personal wealth and liability is limited. On the other hand, succession and exit problems, underestimating the value of projects with multiple future options, and lack of internally generated funds under a pecking order regime could result in underinvestment by the small business.

Capital Structure

The capital structure issue for the small firms differs from their large firms' counterpart in several ways. First, small businesses rely on different sources of funds. For a new business, the primary sources are: owner's own savings and personal borrowings, friends and relatives, local banks, and small business related sources (venture capital companies, SBIC, Minority SBIC, SBA, etc.). In addition, there are also implicit equity contributions in the form of reduced or below market pay and overtime. The exact cost of funds from these sources is not well understood and is left as an empirical undertaking. However, there seems to be a pecking order for these funds as well. Second, the value of limited liability is reduced. One way the providers of funds to the small businesses could minimize agency costs from the owners is to make potential gains to opportunistic owners less attractive by increasing their potential loss. As a solution, the limited liability provision at both the firm and personal level is weakened. Banks would often require personal assets, guarantees, and insurance policies as collateral. Even friends and relatives, who may provide the financing based not exclusively on financial considerations, would expect payback beyond the declaration of

firm or personal bankruptcy via the court system. Making the limited liability provision less valuable may be a major reason to explain why some small businesses could obtain financing from these sources or any financing at all.

Third, the role of strategic bargaining and gaming between owners and their sources of financing assumes even greater importance in small businesses. Lacking access to public security markets, the owners of small businesses deal with their lenders in two-party transactions, which involve negotiations and renegotiations. Here, the strength of each party's bargaining position is important. The lenders are often in a stronger bargaining position. They are refrained from fully exploiting it because of the desire to maintain a long term relationship and the possibility of competition from other lenders. It is nevertheless an empirical question whether the term of the loan reflects the relative strength of the bargaining positions. The small businesses, although in an inferior bargaining position due to limited access to funds, may learn to behave strategically, such as when to renegotiate and what information to reveal. In the extreme, when the probability of negotiation to fail is high, the firm may also need to accumulate slacks, and contacts with alternative sources of funds for strategic reasons.

Fourth, since for many forms of small business organizations, such as proprietorship, partnership, and subchapter S corporation, taxes are integrated at the personal level. A weakened limited liability would also make bankruptcy costs at least partially chargeable to the personal level as well. Consequently, optimal capital structure will in most part be determined at the personal level. Furthermore, because the relevant firm level tax rate is the owner's personal tax rates, it is not likely to be higher than the personal tax rates of their wealthier friends and relatives with excess funds, or the corporate tax rate of the banks. The grossed up portion of interest rate at equilibrium would exceed the owner's personal tax shield from borrowing. Thus, we have a potential puzzling result: There seem to be no tax incentives for owners of small businesses to use debt. In the case of a small corporation with sufficient profit to pay the higher corporate tax rate for large firms, some owners may designate some equity investment as debt (most likely subordinated) to realize an immediate tax advantage vis-à-vis dividends, and an offset to tax on personal interests received. Fifth, small businesses may use debt for various purposes not related to the capital structure decision. For instance, they may borrow funds for the owner's consumption or retirement needs, to buy back partners' shares, or pay estate taxes. Sixth, willingness to take risks, including using debt to obtain funds, varies among small business owners in a wide spectrum—from conservative, mostly self-financed firms to impatient entrepreneurs. Combining the difference in the tolerance for failure and degrees of optimisms among owners, a large cross

sectional variation in capital structure could be observed even if all other variations are controlled.

Seventh, a small business goes through several stages of change in its evolution into a large firm. Consequently, there may not be a single theory explaining the capital structure of small businesses. Indeed, a more plausible view is that there could be many versions of the capital structure theory appropriate for small businesses at each stage of development. For instance, a version for the formative stage of the firm, where financing sources are from owners, friends and relatives, may indicate a rather low cost of funds. Solutions to agency problems are by means of implicit contracts, or social conventions. The asymmetric information problem is probably low. At the next stage, when outside funds such as bank loans, are obtained, new monitoring mechanisms are installed. Small businesses have the incentives to acquire a reputation through repeated dealings. Legal remedies may be called upon to enforce explicit contracts, including claims on owners' personal assets. When small businesses acquire funds from private lenders such as venture capital firms, different financing instruments are employed to reduce agency and asymmetric information problems. For instance, equity participation and multistage financing [3] are used to reduce potential gains to agency incentive and to reduce exposure as more information about the firm's prospects and management is acquired over time. If market imperfection, agency and information problems are serious enough, the cost of capital could be a lot higher than in the earlier phase. The graduation of a small firm to a publicly owned company via an initial public offering (IPO) changes the choice and availability of financing. It also entails a new set of monitors for the outside shareholders, and new means to solve asymmetric information via signalling. Eighth, organizational forms could affect the small businesses' ability to carry debt. Since debt could magnify the already large agency problems in a partnership, such as leaving the remaining partners the debt burden, it would be expected that partnership would carry little or no debt. On the other hand, a franchise could carry a lot more debt. A franchise, via the franchise fee, purchases the franchiser's know-how, experience, proven track record, management and organization that will lead to a reduction in business risks. The more valuable the franchise, and the greater the monitoring and quality control effort expended by the franchisor, the larger the amount of debt the franchisee could obtain.

From the discussions above, it would be far too simple to characterize small businesses as possessing higher or smaller cost of capital or amount of debt. A capital structure theory for small businesses would likely not be very complete. There would still be loose ends, such as why owners are willing to take on large debt with undiversified personal portfolios, or why some investors are willing to advance funds based on low quality information.

Dividends

The rationale and use of dividends in small businesses are also quite different. Owners of small businesses integrate the firm's distributions, salary and bonuses, with personal incomes into a personal consumption function. Dividends received is only a component. Founders/entrepreneurs are willing to postpone consumption by accepting no or low dividends, while heirs with no control rights and alternate sources of income may prefer high dividends. Second, dividends may be the major means to solving the agency problems in a partnership (including subchapter S corporations for both agency and tax reasons). In the traditional theory of dividends, where it is implicitly assumed that dividends will ultimately be paid, the question is a matter of when, whether paid early as dividends or late as capital gains. The dividend question in a small business with several owners is whether dividends would ever be paid at all. Third, the role of negative dividends in the form of additional owners' contributions in time of growth as well as in crisis is also unique to small businesses. In a modified pecking order theory of small business financing, owners contributions is probably second to internally generated funds, ahead of outside debt in the order of financing preference. Large asymmetric information and perceived agency costs by the outsiders, and high transaction costs would make costs of outside funds greater than the owners' returns from alternative investment opportunities.

Liquidity

Finance practitioners know that the single finance item that occupies the greatest amount of small businesses' time is the management of working capital, including the management of slacks, or excess liquid funds. There are good reasons why owners pay so much attention to the liquidity of the business[2]. They would prefer to have stock at both the corporate and personal level to be free from closer monitoring by the lenders, to reduce the costs and risks of renegotiation, to minimize the probability of premature liquidation by the lenders in the case of temporary financial difficulties under asymmetric information. Small business corporations may use slack to accumulate excess profit as well.

The case for using financial slacks to invest in projects with private information is more relevant in small firms when the possibility of large discrepancies in information and expectations is higher. Of course, if the higher valuation of a project is due to overly optimistic expectations accumulated by the small businesses, slacks would instead encourage suboptimal overinvestment.

V. CONCLUSIONS

This paper shows that starting from the unique features that characterize small businesses, a different set of finance problems could be developed. Out of this set, small businesses are shown to make financial decisions differently from the large firms. Some potentially testable conjectures are discussed. Mindful that small businesses are a heterogeneous group, a more detailed modeling of small firms would have to be more firm type/organization specific. Nevertheless, there are enough differences between large and small firms' financial management practices and theory that justify the research effort to study the latter.

REFERENCES

- [1] Ang, J., J. Chua and J. McConnell, "The Administrative Costs of Business Bankruptcy," *Journal of Finance*, March 1982.
- [2] Ang, J., "The Corporate Slack Controversy," *Advances in Working Capital*, JAI Press: Greenwich, CT, forthcoming.
- [3] Chan, Y., D. Siegal and A. Thakor, "Learning, Corporate Control and Performance Requirements in Venture Capital Contracts," *International Economic Review*, 1990.
- [4] Fama, E. and M. Jensen, "Aging Problems and Residual Claims," *Journal of Law and Economics*, June 1983, pp. 327- 349.
- [5] Fama, E. and M. Jensen, "Organizational Forms and Investment Decisions," *Journal of Financial Economics*, March 1985, pp. 101-120.
- [6] Irish, L., R. Ludwig and R. Rizzo (eds.), "The New Attractions of Employee Stock Ownership Plans," *Law and Business*, Prentice Hall: Clifton, NJ, 1988.
- [7] Kihlstrom, R. and J. Laffont, "A General Equilibrium Entrepreneurial Theory of Firm Formation Based on Risk Aversion," *Journal of Political Economy*, August, 1979, pp. 719-748.
- [8] Myers, S. and N. Majluf, "Corporate Financing and Investment Decisions When Firms Have Information that Investors Do Not Have," *Journal of Financial Economics*, June 1984, pp. 187-222.