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What is a Small Business?

Jerome S. Osteryoung and Derek Newman

This paper argues that a definition of small business is important for both research and governmental policy. A chronological history of definitions is discussed along with their limitations. A new definition of small business is advocated when a business has personal guarantees and has no public stock. This definition is measurable, meaningful, and congruent with the perceptions of the market system.

I. INTRODUCTION

A small business definition is important for two reasons. First, researchers must insure the item being studied is the same as other researchers use in the field. If this is not the case, then any cumulative knowledge from any similar research will be lost. Second, government policy makers for small business must have a clear and concise definition in order to insure that any funds spent are targeted correctly. For example, if a government policy was to help small businesses deal with their health insurance problems, then a firm with 100 employees is going to have significantly different problems than the firm with no employees except for the owner.

The purpose of this paper is to define a small business in measurable terms. The first section reviews the historical development for definitions of small businesses and the second section suggests a new taxonomy for this definition.

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DEFINITIONS OF A SMALL BUSINESS

The Nineteenth Century

One of the earliest studies of small businesses was the Philadelphia Social History Project entitled "Immigrants and Industry: The Philadelphia Experience, 1850-1880." In this study, firms with less than 50 employees were considered small and medium sized.¹ Even in 1880, firms with more than 50 employees were considered large by the standards of that time. From the 1870's to the 1960's more than eighty percent of all manufacturing firms were considered small or medium sized under this definition.²

The 1930's

Definition by employee size was (and is) simple and appealing. However, such a set definition would not be able to remain viable as business grew and changed in America. In the 1930's looking to businessmen and leaders of that time, did not help clarify the definition. At the 1938 conference of small businessmen held in Washington, D. C. prominent businessman Jesse H. Jones of Texas and then chairman of the Reconstruction Finance Corporation addressed the meeting. A self proclaimed "little business man" who owned large business interests, Jones stated: "by little business is meant something comparative or relative. Organizations like General Motors, big Steel, little Steel, and so forth are big business—the rest of us are little business. We're happy when we're making a little money, when we're getting along. We're not happy when we're not making money."³ In other words, Jones' definition is that a small business is smaller than a large business. This ambiguity could even be found in the small business community. The founder and president of the National Small Business Men's Association in the February 13, 1938 *New York Times* stated, "Some say anything except General Motors, United States Steel and those outfits and others say anything under a million dollars. We leave it pretty much up to the business man himself".⁴

Within two months of these very broad definitions, the Assistant Secretary of Commerce, Ernest G. Draper said that small businesses in the manufacturing industry were those with less than 500 employees. Using this definition of small business at that time comprised more than ninety percent of the manufacturing firms.⁵

In 1939, the Bureau of Census published the *Census of Business* in which census information was used to classify small business by output of capacity. The following distinctions were made to identify small businesses: manufacturing—less than 43 employees, individual retail stores—less than

\$20,000 annual net sales, chain retail store—less than \$74,000 annual net sales, and service businesses—less than \$5,000 annual net receipts.⁶ Using this definition, seventy-nine percent of individual retail stores and eighty-eight percent of service establishments were considered small.

The 1940's

The mid 1940's produced a plethora of definitions of small business, especially due to World War II when the government tried to ensure that small companies received their fair share of the wartime business. The Smaller War Plants Corporation (1942-1946) used an arbitrary definition of less than 500 employees.⁷

The Senate Small Business Committee of the 78th Congress defined a small business as any manufacturing firm with less than 500 employees. Net sales limits for small businesses were also set with wholesale establishments having to make less than \$1 million annual net sales and retail, amusement, services, or construction establishments with revenue less than \$250,000. This definition included eighty-eight percent of all manufacturing firms in the small business category.⁸

In that same year, the 2nd session of Congress enacted the War Mobilization and Reconversion Act of 1944. This act cut the required number of employees to 250 in order for a business to qualify as a small business.⁹

Small business definitions not related to the war effort were also numerous in the 1940's. In 1943 the Retail Credit Survey used classifications of small firms ranging from less than \$50,000 annual sales volume for heating and plumbing equipment dealers to less than \$1 million annual sales for department stores.¹⁰ The Department of Commerce, also, set varying classifications in 1943. By its definition, small businesses varied by industry: manufacturing—less than 100 employees, wholesale—less than \$200,000 annual net sales volume, and retail, services, hotel, amusement and construction—less than \$50,000 annual net sales/receipts. These definitions included 93% of all business in operation at that time, but only employed 45% of all workers, and covered 33% of the total business of the country.¹¹ In 1944 the Federal Trade Commission adopted more flexible classifications of small business in its study *The Relative Efficiency of Large, Medium-sized, and Small Business*. This study also acknowledged that a different classification of size was needed for every industry since size is relative to the industry in which a company operates.¹²

In the 1944 *American Economic Review* Theodore W. Beckman suggested that small enterprise be classified as having up to 250 employees, \$250,000 value of assets, \$100,000 in net worth, or \$1 million in business volume. As long as one of these criteria were met a business should be

Table 1

<i>Size</i>	<i>Annual Sales</i>	<i>Profits</i>	<i>Net No. of Employees</i>	<i>Total Assets</i>
Small	To \$250,000	To \$25,000	To 100	To \$250,000
Medium	\$250,000 to \$5,000,000	\$25,000 to \$500,000	100 to 2,500	\$250,000 to \$5,000,000
Large	\$5,000,000 +	\$500,000 +	2,500 +	\$5,000,000 +

considered small.¹³ In his publication, "The Financial Problem of Small Business", Peter R. Nehemkis, Jr. used classifications similar to Beckman's with small businesses having total assets less than \$250,000 and intermediate businesses having total assets in the \$250,000 to \$5 million range.¹⁴ In 1949 the Department of Commerce raised its previous criteria for classifying small business. Wholesale limits rose from \$200,000 annual net sales to \$500,000 and retail limits rose from \$50,000 annual net sales to \$100,000.¹⁵ Rudolph L. Weissman used classifications similar to the ones previously mentioned, but he included four classification which must be met. Table 1 exhibits Weissman's classifications.¹⁶

The 1950's

The 1950's continued to see much research into the area of small business. One of the most cited works at that time was by A. D. H. Kaplan. His study, "The Economic and Industrial Importance of Small Plants" was published in *Small Plant Management* (1950). For his analysis of the economics of small business Kaplan considered four criteria: size, management, finances, and area of operations. Size limitations restricted a small business to less than \$1 million sales volume, \$500,000 total assets, and 250 employees. The management was to be a single independent organization directly under the supervision of its owner (who was usually also a manager). The financial structure of the small business should have equity capital held within the inner circle of owners/managers. Small businesses generally did not go into the open market to sell securities but used commercial credit, bank credit, and retained earnings. Finally, the area of operation for a small business was defined as local in character, but integrated with the growth of the community in which the business resides.¹⁷

In 1953, the government created the Small Business Administration (SBA). The SBA defined a small business as one independently owned and operated and not dominant in its field. Ceilings for assistance from the SBA were \$2 million annual volume in mercantile and service trades, \$5 million in construction, and varying employee limits that ranged from 250, 500, and

1000 employees depending on the industry.¹⁸ One author, after studying previously established definitions came up with his own distinct definition comprising four points: small business has (1) an absence of paid labor or its limitation to an assistant; (2) direct participation by the proprietor in the work process; (3) a lack of any specialization in management and superintendence by the proprietor; and (4) a restriction of the expansion motive through the inability of the proprietor to save and because of the primary concern with the production of a family subsistence.¹⁹ In 1959 the Department of Commerce made modifications to its 1943 definition of small manufacturing firms. The earlier definition classified small manufacturing firms as having less than 100 employees. The revision kept the employee requirement and added that the small business had to have less than \$1 million annual sales, less than \$250,000 total assets, and less than \$100,000 net worth. This definition classified 90% of manufacturing firms as small, and accounted for 26% of employees in the manufacturing industry.²⁰

The Bureau of Labor Statistics has always used the number of employees as its measure of business size. The Bureau averages the volume of employment for all industries and defines all business which are below this average, as small.²¹ In 1959, the Select Committee of Small Business of the House made a statement concerning its views on the concept of small businesses. This committee stated that the existence of small business was crucial in the maintenance of free competition and the integrity of independent enterprise. Any definition of a small business should therefore be flexible and adapt to various requirements that might arise in a given policy decision. The definition must vary over industries and should be left to be determined by the administration which is working at the current time.²²

The 1960's

The 1960's saw a trend toward more flexible definitions of small businesses. Although size measures were often used, people began to consider the changing economic and social environments which lead to changes in the small business community. A good example of a more dynamic definition of a small business is seen in *The Future of Small Business*. In this book Edward D. Hollander and others study small businesses as defined as being those enterprises, which are involved in all or most of the business functions and decisions concerning production, marketing, financing, and management and which do not exceed a size which, concerning the nature of the business, permits personalized management by one or a few executives.²³ This definition included 95% of the businesses in 1967.

The 1970's

In the 1970's, definitions continued the trend towards flexibility and added other variables that had not been previously mentioned on a regular basis. A research project conducted from 1969 to 1971 of British small business used a two part definition: small businesses have less than 500 employees and are private companies, with a private company comprising fewer than 50 shareholders. A private company does not invite the general public to buy shares and is therefore removed from the general capital market.²⁴ In the late 1970's David L. Birch and his MIT associates looked at small businesses using information from Dunn & Bradstreet. Using a sample of 5.6 million firms they concluded that companies with less than 100 employees created 80% of the net new jobs in the United States' economy during the 1970's. These numbers also held true in the early 1980's.²⁵ Another study in the late 1970's chose to define small business based on ownership. In his essay "Lilliputians In Brobdingnag: Small Business In Late Nineteenth-Century America" Harold Livesay defined a small business as any enterprise in which three or fewer individuals hold controlling ownership and small enough to be operated with no more than one layer of supervision between owners and workers.²⁶ Another definition considered the impact of geographical regions. In "Law and Small Business In The United States: 100 Years of Struggle and Accommodation," Lawrence Friedman defines a small business as being unincorporated, not doing business across state lines, and under the control of a single family of a group of associates who are in personal contact day by day.²⁷

The 1980's

In 1980 the Small Business Administration defined a small business as having less than 250 employees²⁸, while the White House Conference on Small Business considered a small business to have less than 500 employees.²⁹ By 1980 the SBA had adopted size requirements based in addition to its basic definition of being independently owned and non-dominant in its field. These size requirements were given in ranges for various industries: retail—\$2 to \$7.5 million annual sales, services—\$2 to \$8 million annual receipts, wholesaling—\$9.5 to \$22 million yearly sales, agriculture—less than \$1 million annual receipts, general construction—average annual receipts not greater than \$9.5 million for the three most recently completed fiscal years, special trade construction—\$1 to \$2 million average annual receipts for the three most recently completed fiscal years, and manufacturing—number of employees from 250 to 1,500.³⁰ The Committee for Economic Development's Standards (CED) created four qualitative definitions of which two must be

Table 2

<i>Basis of Definition</i>	Percentages
Annual Revenue	32.0%
Number of Employees	23.0%
Business Characteristics	14.0%
Industry Characteristics	12.0%
Annual Revenue + No. of Employees	10.0%
Geographic Area Served	2.0%
Company Assets	0.5%
Miscellaneous measures	6.5%

met before a business could be considered small: (1) management is independent; (2) capital is supplied and ownership is held by an individual of a small group; (3) the area of operation is mainly local, owners and workers are in one home community (but markets are not limited to local markets); and (4) the business must be small when compared to the biggest unit in the given field.³¹ Storey(1982) categorized a small business as having a small share of the market, being managed by the owners rather than by employees on behalf of the shareholders, and having owners who are legally independent in taking their decisions.³²

Up to this point in time, most of the definitions were provided by groups; very few definitions came from the actual small businessperson. However, research undertaken in 1977 and finished in 1981 did look to small business people for answers. Of course to get the survey form to these people the writers had to create their own definition of small business, and for this purpose the writers initially defined a small business as being independently owned, having a single decision-making center, and being operated by an owner/manager who is the primary person who deal with government regulations. This definition was impractical for the purpose of data analysis, so forms were sent to business with less than 50 employees.³³ Most of the questions asked about the interaction between the small business and the government. Some questions asked specifically about various definitions, and the survey ended with an open ended question, "How would you define a small business in your industry?." Answers to this question were grouped together by type of definition, and the results are given in Table 2. Definitions based on business characteristics include factors such as type of legal organization, number of establishments, number of managerial personnel, and degree of affiliation with a larger corporation. Industry characteristics usually involve number of units produced, serviced or maintained or variations of other industry related statistics. Miscellaneous definitions ranged from relationship with governmental programs to access to various areas of expertise.³⁴

Current Definitions

The 1990 definition of a small business as given by the Small Business Administration is linked to the Standard Industrial Codes (SIC). By this definition a small business does not dominate the industry, has less than \$10 million annual sales, and has less than 1000 employees.³⁵

Overview Of Definitions

After reviewing the available information on definitions on small business, some trends have prevailed as to variables most often used to delineate between small and large business. These variables include:

- Number of employees
- Annual sales
- Amount of assets
- Management organization structure
- Dominance in its operating industry

The number of employees is the most often used definition of a small business, with numbers ranging from less than 50 employees being considered small to less than 1000 employees being considered small.

Criteria for a Definition

It is clear that the definition of small business has changed over time. One reason for the changing definition is its arbitrary dimensions (e.g., a business with 250 employees is large and a firm with 249 employees is a small business). If researchers and government officials are to find ways to study small business and to target policy instruments effectively, they must know the specifications of the entity they are to measure.

A definition of a small business must have three criteria. First, it must be measurable and observable. For example, a definition predicated on the type of management structure would be unacceptable as this attribute is very difficult to measure.

The second criterion is that any definition of a small business must be congruent with the perceptions of the market system. For example, the financial markets could not delineate any significant difference between a firm that revenue of \$2,000,000 and a firm that has revenue of \$1,999,999; whereas, the market system can clearly delineate between firms that have publicly traded stock and those that are private.

The third criterion is that any definition of a small business must be meaningful. For example, defining a small business in terms of share of market is not meaningful, as the definition is contingent on the size of the market. A firm might have a commanding share of the market (e.g., 50%), but the total annual volume of the market is \$500.

A Small Business Definition

Given the three criterion that are specified, there are two measures that appear to specify a small business. A *small business* is defined as:

1. A business in which there is no public negotiability of common stock, *and*
2. A business in which the owners must personally guarantee any existing of any planned financing.

The first element of the definition specifies the marketability of the firms equity. When a firm has public stock, then there is a significant degree of sophistication required over a private firm. A publicly held company must have audited financial statements and, also, be subject to rigorous reporting requirements from the listing market and the government. Disclosure of the firms profits, sales, and officers are typical requirements of regulatory authorities. Additionally, the valuation of publicly held stock is quite easy (i.e., reading the financial section of a newspaper) to ascertain, while the valuation of privately held firm is very difficult.

The second element in this definition of a small business recognizes the owner's personal guarantee on any debt obligation. The reason for personal guarantees are to ensure that the funds are repaid. With small businesses, the threat of bankruptcy risk and the inability of the lender to control internal operations of the firm, mandate the need of personal guarantees.

Personal guarantees create a risk differential between small and large firms. Investors in publicly traded company can only lose their investment. The investor/owner, however, in a small business has unlimited risk (subject to the financial net worth of the owner) because of the personal guarantees. Figures 1 and 2 demonstrate the risk differences of both the small businesses and large public firms.

Figure 1 shows the risk of a small business owner as being much higher than an equivalent investment in a large corporation (Figure 2). The maximum investment loss of an equity investor in a large corporation is the market value of the initial investment; whereas, there is a relatively unlimited loss for an equity investor (limited to the entrepreneur's net worth)

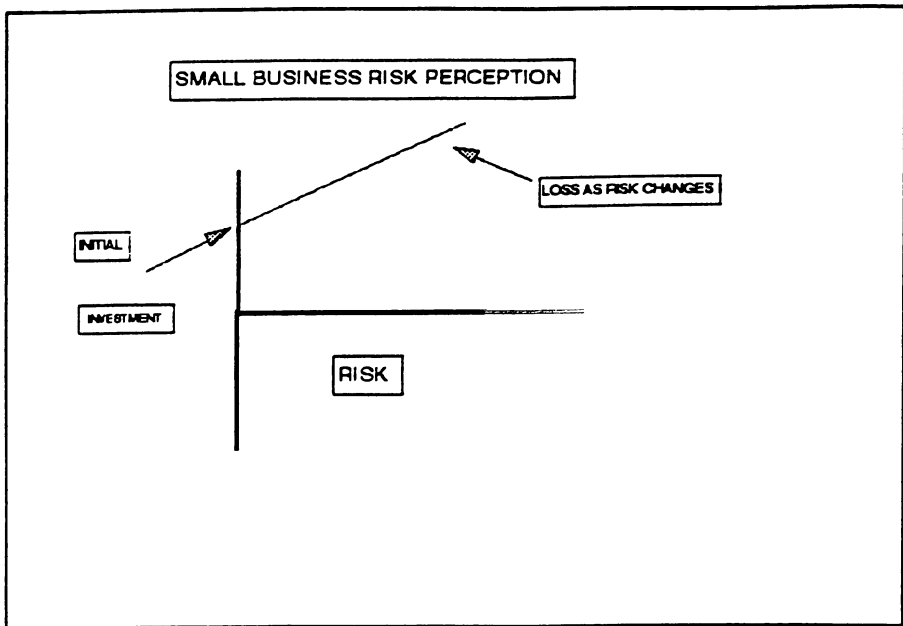


Figure 1

in a small business with personal guarantees. This unlimited loss potential will affect the performance of the small business.

The administration or bank practices in requiring personal guarantees may or may not be consistent between similar firms. Consistency, however, is not important with this definition of small business. Personal guarantees are important because they change behavior and risk perception. If a certain bank should not be consistent with its application of personal guarantees, then those firms without the guarantees (*ceteris paribus*) would have a different risk perception of those firms which did have the guarantees.

Financial markets (i.e., lenders) impose personal guarantees on the owner's of small businesses (regardless of the form of organization—proprietorship, partnership, or corporation) because they cannot delineate the business from the owner(s). It is this intertwining (business and the owner) expressed in a financial market concept that clearly separates small businesses from large businesses.

There are many firms according to the above definition which are neither small nor large. These firms can be identified as those that have no public common stock and the financial markets do not require personal guarantees for current financing or planned financing. These firms are defined as **Medium Size Firms**. With medium size firms, the financial markets have enough confidence (e.g. years in business, history of profitability, etc.) not to require personal guarantees.

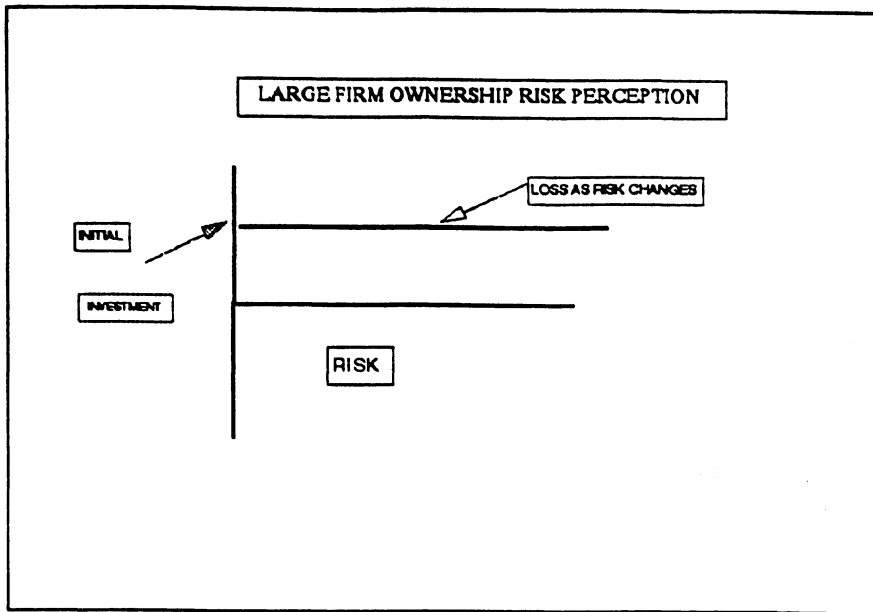


Figure 2

FUTURE RESEARCH

This paper is meant to be a stepping stone for encouraging empirical work on delineating and defining small businesses. A thorough study needs to be undertaken that will use a technique like multiple discriminant analysis to delineate different sizes of firms according to their operating and financial characteristics.

Additionally, there needs to be research undertaken that measures the magnitude of the change in risk that is perceived by a small business owner with personal guarantees.

SUMMARY AND CONCLUSIONS

The first part of this paper reviewed the historical evolution of the definitions of small business. The definitions adapted over time and were arbitrary in the specification of the parameters that identified small businesses.

The second part of the paper suggested three criteria for the effective definition of a small business: such a definition has to be measurable, congruent with the perception of the financial markets, and meaningful.

A small business was then defined as a business that does not have any publicly negotiable equity and whose owners have to personally guarantee any existing or planned debt. This definition necessitated the creation of a

third category of firms: these firms had no publicly traded stock and no personal guarantees required. These firms were classified as medium sized firms.

By having a definition of a small business that is measurable, congruent with the financial markets, and meaningful, the prospect of understanding the operations of small business should be enhanced and should result in a more effective research and more effective government policy in dealing with small business.

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