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F I N A N C I N G S M A L L B U S I N E S S E S

A Study of the Sources of Initial,
Continuing and Growth Financing
for 452 Small Businesses in the
Massey University Region

by

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A B S T R A C T

In recent years there has been a widespread interest in the importance of small businesses. There is much evidence to indicate that small businesses are important to the New Zealand economy. A large segment of the population is directly affected by the prosperity of small businesses.

In New Zealand, there has been a dearth of studies on the financing of small businesses. There are few official government statistics or studies on the subject in New Zealand. This research was therefore undertaken to fill part of this information gap, and to serve as a basis for further inquiry into and support for small business activity.

The primary objective of the study was to identify the sources and types of finance that small businesses in the Massey University region used at three crucial stages of their development, namely:

- (1) When starting the business (Initial Financing)
- (2) For current operations (Financing Going Concern)
- (3) For future growth (Development and Growth Financing)

Corollaries to the primary objective were the areas in which the small businesses have the greatest financial need, the problems encountered by the small businesses when raising finance, and the criteria some lenders use when assessing the financial needs of the small businesses.

A survey of books and periodicals dealing with the financing practices of the small businesses was made to obtain any information relevant to the study. A postal questionnaire was used to obtain data from small businesses.

The major findings were:

- (1) The major sources of funds utilised in starting a business were from the owner's and their family's savings. Some short-term finance was available from trading banks and to a lesser extent through credit facilities provided by the suppliers.
- (2) Owner's investment and family sources continued to play a major role in the provision of continuing capital to small businesses. However, bank credit assumed a somewhat greater relative importance. Other sources (such as credit from suppliers, hire purchase financing and loans from finance companies) still played a minor role in the provision of current capital requirements for small businesses.

A significant group indicated that the existing sources did not provide sufficient funds for their current level of operations. More than half of the borrowing was to finance working capital needs.

- (3) The majority of the respondents indicated plans for growing slowly and remaining independent. A very small number had any active plans to expand rapidly. Therefore the funds they indicated using were mostly of a short term nature with trading bank again overshadowing all other sources.
- (4) A small number of the respondents indicated having serious difficulties in obtaining finance, mainly for working capital requirements.

- (5) Interviews with some lenders revealed no evidence of any policy amongst them restricting loans to the businesses because of their small size. In normal times, frequently the main cause of refusal was the borrowers' inability to provide adequate and safe security and their inability to service the loan.

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CHAPTER 1

INTRODUCTION

1.1 A BACKGROUND AND JUSTIFICATION FOR THE STUDY

In recent years there has been widespread interest in the importance of small businesses. The New Zealand Government has set up a Productivity Centre to promote improved productivity in manufacturing and service industries, and industry liaison officers attached to the Centre are available to help small businesses make better use of their resources by using productivity techniques.¹ In 1972, the Government established the Business Development Centre at the University of Otago, to assist the development and expansion of small scale industries in the South Island. This Centre provides, usually on a fee paying basis, and particularly for smaller businesses, a comprehensive and multi-disciplinary consulting service. Basic management and organisational problems are investigated and identified, and professional advice and assistance provided for their resolution.

The Massey University Faculty of Business has been very active in developing and conducting courses on small business management since 1973. Recently, the Massey University Council, recognising the need for assistance to businesses, has established the Management Education and Development Centre. At present numerous continuing management education programmes are being conducted. The small business management series occupies a prominent place in its programme.

1. Department of Trade and Industry, Directory of Advisory Services, Wellington, Productivity Centre, 1974, p.4.

In November 1976, the Minister of Trade and Industry announced a proposal to set up a small business agency on a national basis to aid small businesses. The agency would introduce new services and aids especially in the field of management and financial skills and where appropriate provide direct finance or loan guarantees.²

Small businesses have a major role to play in the New Zealand economy. A large segment of the population in New Zealand is directly affected by the prosperity of small businesses. This is evidenced by an analysis of the information recently published by the Department of Statistics.

Table 1-1 indicates that the largest group of workers, 218,110 (25.1 percent) were employed in the manufacturing division. The second largest group was in the service industry, representing 216,527 persons (19.4 percent) of the total labour force. The wholesale and retail trade was the third largest group employing 198,315 persons (17.7 percent) of the total labour force. It is therefore clear that 62 percent of the total labour force in New Zealand are employed in these three major industrial divisions.

Of the 7,668 Manufacturers in New Zealand in 1972, 5,430 (71 percent) employed fewer than 20 persons. There were 957 manufacturing establishments in the survey area³ employing an average of 30 persons per establishment. Statistics, available on a national basis only, reveal that retailers employed an average

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2. Otago Daily Times, November 11, 1976, p.11. A small Business Agency has since been established within the Development Finance Corporation.
 3. Statistics of New Zealand Industrial Production, 1972-73, Wellington, Department of Statistics, 1975, p.35.

TABLE 1-1

DISTRIBUTION OF TOTAL LABOUR FORCE BY INDUSTRIAL DIVISIONS

Major Industrial Division	Total Labour Force Actively Engaged	Percentage of Actively Engaged Population	Percentage of Total Population
Agriculture, hunting, forestry and fishing	128,894	11.5	4.5
Mining and quarrying	5,265	0.5	0.2
Manufacturing	281,110	25.1	9.8
Electricity, gas and water	13,273	1.2	0.5
Construction	93,688	8.4	3.3
Wholesale and retail trade and restaurants and hotels	198,315	17.7	6.9
Transport, storage, and communications	103,181	9.2	3.6
Financing, insurance, real estate and business services	64,774	5.8	2.3
Community, social and personal services	216,527	19.4	7.6
Activities not adequately defined	13,808	1.2	0.5
TOTALS	1,118,835	100.0	39.1

Source: New Zealand Census of Population. Industries and Occupations, 1971, Wellington, Department of Statistics, 1974, p.8.

of 6.1 persons per store, wholesalers employed an average of 13.3 persons per store and the service industry employed an average of 5.6 persons per establishment.⁴

The economic importance of the small businesses is of course not adequately measured by statistics. In a relatively free economic society one of the freedoms enjoyed is that, with certain exceptions, one may engage in such legal business activity as one thinks promising. Many individuals tire of working for someone else and long to enter business on their own account. Small businesses afford this opportunity. Many of the individuals have limited resources and thus must enter business on a smaller scale.

The importance of small business to the economy is further indicated by their contribution towards:

- "(a) More efficient provision of goods and many services.
- (b) A base for innovation, invention and testing of new ideas.
- (c) A base from which medium to large sized businesses can develop.
- (d) An important "opportunity" role for talented entrepreneurs.
- (e) A role in the maintenance of dynamic competition as well as the system of free enterprise."⁵

From the foregoing discussion it may be concluded that small businesses are important to the New Zealand economy. It is also clear that the small business

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4. New Zealand Official Year Book 1976, Wellington, Department of Statistics, October 1976, pp.554-558, 565-567, 569-570. See also New Zealand Census of Distribution, 1973.
 5. New Zealand Institute of Management. Small Business Management Advisory Committee, 2nd National Conference on Management Education, May 1975, p.4...2.

sector has, relative to its size, extremely important social and developmental roles to play in the New Zealand economy.⁶

Solvency is crucial to small business survival. While solvency is primarily concerned with having enough cash to meet current needs, this cannot be achieved without attention being given to overall financial management. A leading author, Ezra Solomon, explains the central issue of financial management as:

"... the wise use of funds, and the central process involved as a rational matching of the advantages of the potential uses against the cost of alternative sources so as to achieve the broad financial goals which an enterprise sets for itself."⁷

Solomon described the modern approach to managing finance as the attempt to provide answers to the following questions:

- "(a) What specific assets should an enterprise acquire?
- (b) What total volume of funds should an enterprise commit?
- (c) How should the funds required be financed?"⁸

This study is concerned with question (c), the financing decision, and seeks to identify the sources and types of debt and equity capital utilised by some small businesses at various stages of their development.

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- 6. Hunn, J.K., Small Business Agency as a Division of Development Finance Corporation, South Island Productivity Conference, May 1977.
 - 7. Solomon, E., The Theory of Financial Management, New York, Columbia University Press, 1963, pp.2-3.
 - 8. Ibid., p.8.

The research on financing small businesses came about as a result of extensive discussions with the owners and managers of small businesses, from which it became apparent that there was a definite lack of information on the financing of small businesses in New Zealand. The discussions took place at a series of seminars the author conducted at Massey University, and a number of addresses the author gave in the Massey University region. Approximately 300 businessmen attended these meetings and seminars. A majority of these businessmen had experienced some difficulty in financing some aspects of their businesses, and strongly encouraged the author to conduct the study so that some systematic information on financing small businesses would be made available.

Any examination of the problems of small businesses must necessarily presuppose an acceptable definition of what constitutes a "small business". The definition of what constitutes a "small business" is a subject of considerable debate, and no satisfactory definition is yet available which has been universally adopted. However, various governments and writers in attempting to define a "small business" have used either statistical (number of persons employed or the annual sales volume in dollars), or non statistical (the unique position of the owner/manager in the total and personalised control of his business) criteria.⁹

The dollar sales criteria has been eliminated from the definition adopted for the purpose of this study.

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9. United Kingdom Committee of Inquiry on Small Firms. Report of the Committee of Inquiry on Small Firms, London, Her Majesty's Stationery Office, 1971, p.3., and New Zealand Institute of Management. Small Business Management Advisory Committee, 2nd National Conference on Management Education, May 1975, p.4...2.

Overseas studies reveal that generally there was a poor response when businesses were asked to disclose actual business figures. Comments of Bruce, Burchardt and Gibb are worth noting:

"... three-fifths of the firms were willing to co-operate up to a point, but less than half the firms gave us adequate details of their balance sheet, and trading accounts. ... one in five refusal was due to the fact that one of the directors was prepared to co-operate fully, but could not obtain the agreements of others. Divided opinion within the firm about the desirability of revealing financial information almost invariably leads to a final refusal."¹⁰

An extensive search of material in libraries, trade associations, professional societies and government sources revealed that there was little factual information available as to the methods of financing small businesses in New Zealand. The search, however, revealed two studies¹¹ relating to the New Zealand scene. One was a Master's thesis (in progress then) concerned with the needs and problems of small firms in New Zealand. That study dealt at length with the general management problems, but gave sparse attention to the financing problems of small businesses. The

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10. Bruce, C., Burchardt, F.A., and Gibb, E.B., "Small Manufacturing Business: A Preliminary Report on a Pilot Survey", The Oxford Institute of Statistics, 1955, 17, pp.250-251.
 11. Devlin, M.H., The Needs and Problems of Small Firms in New Zealand. Thesis, M.Com., The University of Otago, 1976. 279p. and Australia and New Zealand Bank Limited, "Financing Small Businesses in New Zealand", ANZ Bank Quarterly Survey, 17, 1, October, 1967, pp.1-8.

other study was the ANZ Bank Survey, which dealt mainly with the role of bank credit in facilitating spending by small companies. The survey was confined to urban businesses employing a maximum of thirty persons. It concluded that bank credit provided a comparatively small proportion of funds to small businesses. These studies are reviewed fully in Chapter 2. The Devlin and ANZ Bank studies do not provide information on the financing of small businesses at various stages of their development.

In this research a small business is defined as one which employs a maximum of thirty persons, and is independently owned and managed. Independently owned and managed means either the owners themselves actively participate in all aspects of the management of the business, or they may have supervisors or foremen to interpret their decisions, and transmit them to employees. The definition excludes a public company, a subsidiary of a public company, and overseas owned and controlled companies which have formal management structure.

The definition follows closely the criteria adopted by the Committee of Inquiry on Small Firms in the United Kingdom,¹² and is based on the most widely used definition in the United States.¹³ While it is recognised that this definition may not be appropriate for all purposes, it has been adopted because it does emphasise those characteristics which make small businesses different from larger businesses.

12. Report of the Committee of Inquiry on Small Firms. op.cit., pp.1-4.

13. For example (1) Small Business as defined by the Act of United States Congress in 1953; (2) Paris, A.W., The Small Business Administration, Washington, Praeger Library of United States Government and Agencies, 1968, pp.27-35. Kaplan, A.D.H., Small Business: Its Place and Problems. New York, McGraw-Hill Book Co., 1948, pp.10-21.

Further, no official statistics on financing small businesses are published in New Zealand. The Reserve Bank financial statistics deals with the public companies and therefore are outside the scope of this study. Also unlike other countries, no official government studies on the state of small businesses and their financing problems have been carried out in New Zealand.

The inadequacy of information on financing small businesses in New Zealand is in itself a sufficient justification for this study. However, it is hoped that this study will ultimately prove of benefit to:

- (a) Owners and managers of small businesses who, from the conclusions drawn from the comparative studies, will get a greater appreciation of the appropriate sources and types of finance available and the criteria in determining their suitability.
- (b) Educational institutions in designing courses and programmes directed to the needs of small businesses.
- (c) Government in formulating programmes and policies relating to small business financing in New Zealand.
- (d) Consultants and others providing management services to small businesses.
- (e) Lenders (bankers etc.) in assessing the financial needs of small businesses.

1.2 ORGANISATION OF THE STUDY

Chapter 2 consists of a review of literature pertinent to this study. The materials are presented under the following general headings:

- (a) the sources of available funds, and
- (b) a discussion on financing small businesses with particular reference to the United States and the United Kingdom studies and financing small business in New Zealand.

Chapter 3 contains a description of the methods used to obtain and analyse the data for the study.

Chapter 4 reports the result of the survey. It includes a discussion of the demographic characteristics of the respondent businesses, the sources of their initial and continuing finance, its adequacy, the sources of finance for current operations, sources to be exploited for the financing of growth and the problems faced by the businesses when seeking finance.

The results of the interviews with the trading banks and a finance company are covered in Chapter 5. They bring out information on the criteria used when assessing the financial requirements of the small businesses.

Chapter 6 presents a summary and conclusions of the study.

CHAPTER 2

REVIEW OF THE LITERATURE

2.1 INTRODUCTION

While there has been a dearth of studies on the financing of small businesses in New Zealand, the topic has attracted research interest elsewhere, especially in the United Kingdom and the United States. Numerous articles, books, and research studies dealing with small businesses have been published by government appointed committees, professional and educational bodies, and individual writers. While it was impossible to review all studies, an attempt has been made to use those that have relevance for the present study.

This Chapter reviews some relevant literature on the financing of small businesses. It begins with an outline of the alternative sources of financing for small businesses in general, then proceeds to review some major studies on financing small businesses in the United States and the United Kingdom, and the financing of small businesses in New Zealand. The aim is to provide a background to the investigation of the specific research questions raised in Chapter 3 and for the analysis of the results that follow in Chapters 4, 5 and 6.

2.2 FINANCING SMALL BUSINESSES

2.2.1 Available Sources and Types of Funds

It is now proposed to outline the general characteristics of the major sources and types of finance available and to comment briefly on their essential qualities. In general a business firm whether large or small has two main sources of funds:

- (a) Internal Funds - derived mainly from retained earnings and sale of surplus assets.
- (b) External Funds - long term funds in the form of loan and share capital, and short term funds in the form of bank credit, credit from suppliers, hire purchase, leasing, and other similar short term obligations.

The risk elements (small size, less diversification, lack of experienced management) inherent in small businesses are greater than in larger businesses.¹ For this reason small businesses tend to have little appeal to lenders.² Small business does not have access to all the sources in the capital market.

The available sources of funds are now identified and commented upon. The discussion follows the classification commonly encountered in the literature.

2.2.1.1 Short and Medium Term Sources of Finance

(a) Trading Banks

Trading banks are the main institutional sources of finance for both large and small businesses in New Zealand.³ The banks usually grant credit by way of overdraft facilities to customers, mainly to finance their working capital requirements. A

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1. Robinson, R.I., Financing the Dynamic Small Firm, Belmont, California, Wordsworth Publishing Company, 1966, pp.20-22.
 2. Ibid.
 3. Poole, W.A., Business Finance: Sources of Finance, Requirements of Lenders, Legislation and Regulations Controlling the Capacity of Lenders to Meet the Requirements. Wellington, New Zealand Society of Accountants, 1974, p.1.

bank overdraft being of short term nature, is the most suitable source of finance for inventory, payroll and other day to day operating costs. It is the most flexible source of external finance. The banks also grant some medium term loans, mainly as a bridging finance. This is dependent on the circumstances of the borrower and the bank's own liquidity position at branch and national level.

(b) Finance Companies

Finance companies are in operation to lend funds to businesses, both large and small. They offer a wide range of financial services, not all of which are available to small businesses. Their services to businesses are in the following areas:

i. Factoring

Although not strictly a form of borrowing, the factoring of book debts is an alternative source of working capital available to large and small businesses. Factoring is an arrangement whereby the finance company undertakes to pay cash immediately against invoices after allowing for bad debts, interest and administration charges. A factoring arrangement could be on a continuing basis, in which case the factoring company may provide a number of services to the business such as credit control and maintenance of debtors accounting. Although factoring is an expensive method of raising finance, savings in administration could make it very attractive for small businesses.

ii. Hire Purchase

Hire purchase is a form of credit which has

come into increasing use in businesses in recent years, particularly by the smaller rapidly growing firms which cannot obtain all their requirements elsewhere. The finance company will purchase or provide the finance for the purchase of plant, machinery or motor vehicles.⁴ This is essentially short term finance, as the terms of such loans are limited both by Government regulation and by caution on the part of the finance company.

iii. Equipment Leasing

Leasing is a form of medium term finance suitable for businesses seeking capital equipment and can be used for a variety of types of equipment. Immediate use of the asset is obtained. No deposit is required except in the case of motor vehicles.

For small business, leasing has definite advantage. It is possible to obtain the exact amount of finance needed without deposit (except in the case of motor vehicles). Thus capital is available for other uses and the bank overdraft and other short term sources are left for normal operating needs.⁵

(c) Trade Creditors

Credit extended by businesses to customers in the normal course of business has always been one of

4. Bates, J., Financing Small Business. London, Sweet and Maxwell, 1971, p.136.

5. Robinson, R.I., Financing the Dynamic Small Firm. Belmont, California, Wordsworth Publishing Company, 1966, p.89.

the most important sources of funds in the economy.⁶ Most creditors allow at least one months credit for purchases, hence the purchaser is receiving loans equivalent to the value of goods for at least thirty days. A small business can often make special arrangements for an extension of credit on favourable terms from major suppliers.

(d) Deposits From Customers

In some cases it is possible for a small business to obtain deposits or advance payments from customers by offering discounts.

(e) Regional Development Loans

A small business can seek grants from Government under the regional development scheme. The funds could initially be provided as a support to help the business establish itself and thereby show a return sufficient to attract finance from normal commercial sources. An outright grant may be obtained in some cases on the grounds of social desirability.

(f) Development Finance Corporation

A small business could obtain assistance from the Development Finance Corporation if it is export orientated or is in a region where the need for additional development is recognised.

2.2.1.2 Long Term Sources of Finance

Long term financing involves a provision of funds for the acquisition of fixed assets, such as building, plant, equipment and machinery for use in a business for a number of years.

6. Bates, J., op.cit., p.122.

(a) Internal Sources

Additional finance required by small businesses may be provided from profits retained in the business. Retained earnings represent an amount set aside as such from realised profits by forgoing dividend payments. The use of retained earnings does not affect the existing control of the business as it does not involve the business in issuing additional shares. Because small businesses are unable to generate sufficient funds to plough back into the business, the sole use of this source may retard their rate of expansion. Broom and Longenecker comment:

"In using retained earnings, it is apparent that the rate of expansion is limited by the amount of profits generated in the business. Funds are often insufficient to meet heavy capital needs."⁷

Nevertheless, retained earnings constitute a major source of funds for small businesses, and are important because of the limitation on the ability of the small businesses to borrow and to obtain additional share capital.⁸ It must be recognised however, that appropriation of profits as retained earnings does not increase the total cash flow, but merely represents an indication of the owner's decision to maintain the financial resources of his business.

(b) External Sources

A decision to procure some or all the long term funds required from external sources means that a

7. Broom, N.H., and Longenecker, J.G., Small Business Management. Cincinnati, South Western Publishing Company, 1975, p.32.

8. Sources of Finance for Smaller Business, Wellington, Productivity Centre, 1975, p.8.

business will seek funds in the capital market. Because loans are cheaper to service, and interest costs are deductible for taxation purposes, a small business will find it desirable to seek loan finance for long term needs. However, in order to attract outside investors, a business must maintain its borrowing potential, that is, a reasonable proportion of equity capital must be maintained. The following three sources and types of long term external funds are available to businesses:

i. Mortgage Finance

This source of finance is almost exclusively used for obtaining land and buildings. For small businesses, the best sources of mortgage finance are life insurance companies and building societies.

ii. Sale and Leaseback of Property

If a small business possesses valuable freehold property, it is possible to enter into a sale and leaseback arrangement with an institutional investor, usually an insurance company. The institutional investors buy the property from the business and lease it back for a long period of time with a right of renewal.⁹ Frequently the borrower is able to obtain the full value of the property by leaseback, whereas this is not usually possible with debt financing. The rental payments are deductible for tax purposes. A leaseback arrangement is a convenient and relatively simple method of increasing the liquidity of the business.

9. Soldofsky, R.M., Intermediate Sources of Funds. In F.J. Corrigan and H.A. Ward (Eds) Financial Management. Boston, Houghton Mifflin Company, 1963, p.227.

This source of finance is generally restricted to large companies because the finance source normally looks for secure long term investment so as to balance its long term liabilities. Therefore, unless the small business has a sound operation, its chances of obtaining funds from this source are severely limited.

iii. Issue of Shares

In the absence of retained earnings, and if loan capital is unavailable, or if available sources have been exhausted, a small business may need to raise long term capital by the issue of new shares. Shares may be issued to existing shareholders, or the issue of shares to outsiders may be considered, in which case existing owners may be forced to consider giving up some of the control in the business to those outsiders. Most businessmen are reluctant to do this.¹⁰ In any case the issue of shares to outsiders is difficult because small businesses are relatively unknown to the investors, and their shares are neither easily marketable or transferable. Thus the market for the issue of shares for small businesses is virtually nonexistent. Frank P. Morrissey comments:

"Because the operations of a small business are not easily publicised, it is difficult to get specific information about their products, methods of operation and markets ... Small businesses are more vulnerable

10. Broom, N.H., and Longenecker, J.G., op.cit., p.329

to unforeseen circumstances than are larger firms. They have fewer financial reserves and are easily hurt more by business recession. The result is greater risk to investors, especially equity investors."¹¹

However, additional share capital may be obtained by negotiating terms with certain interested parties, such as employees, acquaintances of the owners, customers, suppliers, or lawyers and accountants with wealthy clients or family estates. In this way loss of control may be avoided. It may also be possible to interest some institutional investors, who may be prepared to subscribe funds without taking an active part in the management of the business. Nevertheless, when new shareholders are brought in, or additional shares are issued, there may be some parting or sharing of control.

2.2.1.3 Summary

In this section the following sources of business capital for businesses were identified and discussed:

Short and Medium Term Sources

Trading bank

Finance Companies - factoring
 - hire purchase
 - leasing

Trade credit

Deposits from customers

Regional development loans

11. Morrissey, F.P., Financing the Independent Business. In Preston, L.E. (Ed.) Managing the Independent Business. New Jersey, Prentice-Hall, 1962, p.10.

Long Term Sources

Retained earnings

Mortgage finance

Sale and Leaseback of property

Issue of new shares

It is apparent that there are a wide variety of sources of funds which a businessman may tap. The literature indicates that the most widely used sources of short term funds are bank overdraft and credit from suppliers.¹² If a small business requires finance for inventory and accounts receivables, a trading bank overdraft is usually the most satisfactory source. Most suppliers make trade credit available to their financially responsible customers and to many small businesses this is an important source of finance. It may be possible for small businesses to finance their machinery and equipment requirements either through hire purchase or through leasing.

For the majority of small businesses, retained earnings represent a major source of funds for growth and expansion. However, unless the business is in a position to generate sufficient funds reliance on this method of financing could severely limits its rate of expansion. Other sources of finance are also available, for example a sole trader could take in a partner or another shareholder. A private company, limited by shares, can issue convertible notes to existing shareholders.

In limited cases a growing smaller business may take the advantage of private placement of shares with institutional investors through merchant banks, finance houses, business consultants or sharebrokers. In addition, small businesses often obtain funds directly from individuals who

12. For example, Bates, J., op.cit. p.122 and Robinson, R. I., op.cit. p.27.

may be associated with the business as friends or relatives of the owners or managers.

2.2.2 Financing Small Businesses - United States

In this section a review of some relevant literature is undertaken to trace the financing practices and the problems of small businesses in the United States, and the events leading to Congressional actions to assist small businesses in meeting their financial needs.

Table 2-1 gives an indication of the importance of small business in the United States.

TABLE 2-1
DISTRIBUTION OF FIRMS AND PAID EMPLOYMENT BY SIZE OF
FIRM 1967

Size Class (Number of Employees)	Percent of Firms in Operation	Percent of Paid Employment	Cummulative Percent of Paid EmPLY
1-19	94.7	21.7	21.7
20-99	4.5	18.2	39.9
100-499	0.7	13.2	53.1
500 or more	0.1	46.8	100.0

Source: Broom, H.N., and Longenecker, J.G., Small Business Management, Cincinnati, South Western Publishing Company, 1975, p.4.

From the table it is clear that over 99 percent of all businesses in the United States are classified as small. They provide jobs for about 40 percent of the total paid work force. Despite this, small business has been the subject for much controversy centred primarily on the role small businesses should play in the American way of life and the part the government should take in determining that role. One of the major questions posed by this controversy concerns the

financing of small businesses.¹³ Some of the major research relevant to this study are now reviewed.

One of the earliest studies was carried out by Kaplan (1948) for the Committee of Economic Development. The purpose of the study was to determine, "(1) the role of small businesses in the American economy, and (2) how small businesses can be helped to contribute their full share to post war employment and prosperity."¹⁴ It is not clear how the study was conducted, but references to sample interviews and National Opinion Research Centre's sample study conducted for the Committee of Economic Development, suggest that some field investigations was made to obtain the information. Further, tables and charts included in the study indicate that a systematic search for information was made, and the ramifications discussed. The study although dated, is significant in that Kaplan's conclusions on financing small businesses are still relevant, and also it serves as a reference source for statistical information on various government conducted and sponsored studies in the period 1935-45 on small business in the United States.

In appraising the financial requirements and the facilities available to small businesses, the study identified the following types of financing.

- "(a) Short Term Credit - funds required to purchase materials for processing or merchandise for resale, payroll and other operating expenses.
- (b) Term Loan - funds required to introduce new product line or modify an existing one, improvements to plant, machinery and equipment, and increased working capital for expanding operation.

13. Grafer, H.R., "Small Business Financing Gap", The Arthur Andersen Chronical, 1972, 33, p.18.

13. Kaplan, A.D.H., Small Business: Its Place and Problems. New York, McGraw-Hill Book Company, 1948, p.1.

- (c) Equity Capital - funds for the original investment in the firm and permanent additions to the investment for expansion of business."¹⁵

Kaplan sought answers to two major questions:

- "(a) What were the weaknesses in the structure of financial resources available to small businesses, and
- (b) What additional facilities, if any, were needed to satisfy the legitimate requirements of small businesses in the years ahead?"¹⁶

The main findings of the study so far as it concerns the financing of small businesses are summarised below:

- (a) For short term needs, small businesses sought ordinary credit from suppliers, commercial banks and finance companies.
- (b) The small businesses had the least difficulty in obtaining ordinary business credit (usually for periods 30 to 90 days) from suppliers.
- (c) Short term commercial bank credit was available, and small businesses appeared well supplied with working capital for the immediate future. Kaplan's review of the census distribution revealed that of the 6,158 businesses having 20-125 employees, 71 percent were regular borrowers from the banks. Ninety percent of the firms depended upon bank credit for working capital. Of the 4,387 firms which borrowed, 45 percent reported difficulties in obtaining credit.

15. Ibid., pp.139-140.

16. Ibid., p.135.

- (d) Where businesses had difficulty in obtaining short term credit, it was due to lack of accurate information on their economic position and their inability to state the case for credit.
- (e) Small firms with limited access to regular bank credit resorted to finance companies. Out of an aggregate of \$2.6 billion loans made against accounts receivable in 1941, 60 percent were estimated to be with finance companies.
- (f) The supply of long term capital was not adequately met. Commercial banks occasionally assisted small businesses by extending credit to provide capital for development by taking a mortgage on existing assets. Kaplan's review of census information revealed that 20 percent of the 6,158 businesses depended upon their banks for long term capital and 25 percent obtained long term funds through mortgage loans and sale of stocks and bonds. However, 40 percent of the firms which reported no difficulty in obtaining working capital, and 48 percent of those reporting difficulty in obtaining credit, had no available sources of long term credit.
- (g) Typically, the capital for new small enterprise was furnished by owners themselves, occasionally from friends and relatives.
- (h) Funds from civic development corporations were available, but only to intermediate rather than small enterprises.¹⁷

17. Ibid., pp.140-144, 173, 176.

Kaplan concluded with comments on the financial facilities to small firms as follows:

- "(a) New facilities for capital financing are needed to offset the decline in the traditional sources of personal financial backing for small enterprises.
- (b) For the development of new capital facility we should look to the banking system. There is a logical place for a network of capital banks under the Federal Reserve supervision to which commercial banks can refer small businessmen for permanent capital.
- (c) The alternative to private financing is government lending and investment. This holds dangers of financing under political pressure."¹⁸

The general inadequacy of long term sources of finance for small businesses was recognised by the Truman Administration and as a consequence a bill was introduced in the Senate in 1950 to provide for the establishment of national investment companies.¹⁹ These companies were to furnish long term credit and equity capital to small businesses. The bill failed to pass. The argument therefore raged for a number of years, and in 1953 the Small Business Administration (SBA) was established by the Congress to bridge the small business financing gap.²⁰ However, the SBA in giving preference to short term loanable funds was concerned with only one important feature of the many sided phenomenon. It had left to one side, yet to be resolved, the equally important question of long term

18. Ibid., pp.176-177.

19. Donaham, P., and Fitzgerald, C.L., "More Reasons in Small Business Financing", Harvard Business Review, 1959, 38, p.93.

20. Paris, A.W., The Small Business Administration. Washington, Praeger Library of United States Government Department and Agencies, 1968, p.3.

financing.²¹ So the debate continued.

In 1957, the Congressional Committees again began to investigate the need for long term and equity capital for small businesses. Numerous individuals testified before the House and Senate Committees as to the need for funds and the sources of available funds, and in 1957, William McChesney Martin Jr, Chairman of the Board of Governors of the Federal Reserve System, agreed that the Board would undertake a study of the financing needs of small businesses to ascertain the facts.²² In April 1958, the Federal Reserve System presented its report on small business financing. Based on this study and its own hearings the House Small Business Committee reported to Congress that:

- (a) the gap caused small business concerns serious difficulties in obtaining the volume of long term and equity capital required for adequate growth and development.
- (b) Where such capital was available to small businesses, they were at a disadvantage in that a higher interest rate was charged.
- (c) Government must sponsor the establishment of the new facilities to counteract the two problems cited immediately above.²³

Senator Sparkman (Democrat, Alabama) spear-headed a new investment company bill in 1957 which attracted the support of prominent

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- 21. Kennedy, R.D., "The SBIC: A New Concept in Finance", The South Western Social Science Quarterly, 1961, 42, p.240.
 - 22. United States Senate, Subcommittee of the Committee on Banking and Currency. Credit Needs of Small Business. 85th Congress, 1st Session, 1957.
 - 23. United State Senate, Subcommittee on Banking and Currency. Financing Small Business. 85th Congress, 2nd Session, 1958.

citizens in the field of finance and the whole debate reached a terminal point in 1958, when the Congress moved ahead with a positive programme to supply capital for small businesses. The conclusion of the Federal Reserve inquiry that there was a credit gap for smaller businesses in the areas of long term loans and equity capital was used to support the programme.²⁴ Early in 1958, the Small Business Investment Act was passed by the United States Congress making possible a new institutional arrangement under which long term debt and equity capital may be secured by small businesses from the newly chartered, Federally licensed Small Business Investment Companies (SBIC's).

Since 1958, numerous additional studies have been undertaken, many under the Small Business Administration sponsorship. Three further studies which are relevant to this research are now reviewed.

Pugh (1960)²⁵ carried out a study of the sources, availability and the terms of financing small businesses in South Carolina during 1958-59 under a grant from the Small Business Administration. The sample consisted of 1,248 firms conforming to the size standards of small businesses as defined by the Small Business Administration. The study was conducted on the basis of personal interviews with management of the small business units. Eighty-nine interview schedules were used in the analysis.

24. Pugh, O.S., "Small Business Investment Companies", Business Topic, 1963, 11, p.65.

25. Pugh, O.S., Financing 689 Small Business Firms in South Carolina, 1958-1959. Columbia, Bureau of Business and Economic Research, University of South Carolina, 1960, pp.2-5.

The major findings of the study were:

- (a) More than two-thirds (67.4 percent) of the reporting business firms indicated that personal investment and sale of securities supplied 85 percent of their initial funds.

Another 16 percent of the sample reported that nearly 50 percent of their funds came from these sources.

- (b) Mortgage financing provided more than 50 percent of the original funds for 5 percent of the sample.
- (c) Suppliers provided more than one half of the initial capital in 5.5 percent of the cases.
- (d) A small proportion (7.6 percent) received more than 50 percent of the original funds from friends and relatives.
- (e) About 9.9 percent of the firms reported they regularly 'floor financed' some part of their inventory and approximately 12 percent indicated they discounted, sold or assigned commercial paper as a means of acquiring working capital.
- (f) Small firms which were newly organised or firms attempting to expand were the ones confronted with the most serious problems of credit availability.
- (g) Approximately 70 percent reported an increase in the investment of their firms during the most recent business year, almost all from personal savings and retained earnings.
- (h) Fewer than one-third of the firms indicated any active plans to expand.

- (i) More than one-third of the reporting firms did not negotiate a regular business loan during the years immediately prior to the survey.
- (j) The small business firms reported about half of their loan requirements were for short term working capital and about a third were for long term requirements.²⁶

Another study, also sponsored by the Small Business Administration was conducted by Stevenson (1962) and concerned with various private and government sources of equity and long term finance available for small manufacturing firms in Minnesota.²⁷ The information was obtained through personal interviews and through a questionnaire survey. The total response was 45 percent of the questionnaires mailed and by groups representing 55 percent of those sent to banks, 100 percent to Small Business Investment Companies, 75 percent to community development and 31 percent of those to the manufacturing firms.

The findings of the study were:

- (a) Small manufacturing firms' requiring finance for new equipment, plant, or working capital could where appropriate rely upon lease financing, bank or insurance company term loans or public offering of securities.
- (b) Leasing was of considerable importance in equipment and plant financing.

26. Ibid., pp.121-130.

27. Stevenson, H.W., Equity and Long Term Financing for Small Manufacturing Firms in Minnesota. Minneapolis, The University of Minnesota, 1962, p.9.

- (c) Bank loans were available with maturities of 5 to 7 years.
- (d) Insurance companies' funds were available on mortgage loans, or other term loan commitments.
- (e) Manufacturing firms in Minnesota generally appeared to have potential sources of funds open to them, but were not actively seeking funds.²⁸

Generally the conclusion that emerges from these studies are:

- (a) There has been an increase in the availability of funds for small business since 1958, primarily as a result of the SBIC programme.
- (b) Access to this increased availability of funds has been restricted to those small businesses with growth prospects. Consequently, a financing gap still exists for small businesses, especially with less than high growth prospects.

So the debate continued, and in September 1969 yet another study was commissioned. The President of the United States announced the appointment of a Task Force on Improving the Prospects of Small Business. The mission of the task force was to:

"... appraise the effectiveness of the programmes and policies related to small businesses in force then, suggest how such programmes and policies may be improved, and to determine what actions might be taken to ensure expanded role for the small businesses in the American economy."²⁹

28. Ibid., pp.53-55.

29. United States President's Task Force. Improving the Prospects of Small Business. Washington, United States Government Printing Office, 1970, p.ix.

The task force engaged Dun and Bradstreet to conduct a survey and obtain information on the problems of small businessmen. The following is a summary of the findings:

- (a) Financing was mentioned by 49.2 percent of the sample as the most serious problem.
- (b) Sixty-three percent replied that their greatest financing problem was high rate of interest, and another 37 percent mentioned unavailability of loan money.
- (c) Only 40 percent of the respondents were seeking more finance.
- (d) Of those seeking more finance, 58 percent were negotiating with banks, and the remainder spread amongst the finance companies, Small Business Administration, partners, insurance companies or public financing.
- (e) Sixty-nine percent of the businessmen replied they had been able to obtain all needed financing for the year. Thirty-one percent indicated they had not been successful in obtaining finance.
- (f) Those who had not been able to obtain finance, experienced serious difficulties in expanding into new products, or to commence new plant construction or to replace obsolete equipment.³⁰

On the basis of these findings, the Task Force concluded that while financial assistance was not unavailable to small businesses that needed it, small businesses, and

30. Ibid., p.15.

particularly new venture small businesses appeared to be handicapped when compared with well established large corporations. However, the Task Force Committee felt that a further study was necessary to determine the extent of such disadvantage, and resolved against direct lending by the government on the ground that it was the least effective and efficient method of providing financial assistance. The Task Force Committee believed that Government participation should be based on the guarantee concept rather than on direct loan programmes. The Committee therefore recommended that:

"... careful consideration be given to the methods that will effectively motivate private sources to take the risks of lending to small business."³¹

The Committee did not specify how this was to be achieved, except that a further study was considered necessary. So the debate continued.

Dun and Bradstreet's statistics on commercial and industrial failures, which essentially cover small businesses, in 1974 reached a three year high in numbers (9,915) and a record high in total dollar liabilities.

"New business incorporation slumped to 319,419 in 1974 from a record of 329,358 in 1973. Early in 1975 the number dropped to the lowest level in four years."³²

31. Ibid., p.7 and p.10.

32. Small Business: The Maddening Struggle to Survive. Business Week, 30 June 1975, pp.96-100.

2.2.3 Financing Small Businesses - United Kingdom

There was no systematic official study of the small business sector in the United Kingdom until the Committee of Inquiry on Small Firms was set up in 1969. There were however, several small scale research studies and Committees of Inquiry, whose findings provide some background information on the needs of the small businesses in the United Kingdom.

One of the earliest inquiries was reported by the Committee on Industry and Finance in 1931. In its report the Committee pointed to the existence of what is known as the Macmillan Gap:

"It has been represented to us that great difficulty is experienced by the smaller and medium sized businesses in raising the capital which they from time to time require, even when the security offered is perfectly sound."³³

On the general question of finance and industry, and in particular the provision of long term capital, the committee recommended that a private investment company be formed, devoted primarily to the capital needs of the smaller companies.

The Oxford Survey

In 1955, the Oxford Institute of Statistics carried out a pilot survey to collect systematic information on the workings of small and medium sized businesses. The study was concerned with collecting the firms' financial statements to present the framework for measuring the size and composition of assets, net worth and various liquidity and financial ratios and to fill the background against which the financial

33. Committee on Finance and Industry. Report of the Committee on Finance and Industry, London, Her Majesty's Stationery Office, 1931, p.173.

statements must be seen, i.e. to get a picture of the economic environment in which the sample firms were working - market structure, ownership structure, and factors influencing growth.

The sample consisted of 148 firms employing between 10 and 200 persons. The information was obtained from interviews carried out by interviewers employed specially for the project. The main findings of the study were:

- "(a) Almost all the firms responding to the enquiry were private companies.
- (b) Eighty-two firms gave details of their finance over the period 1947-53.
- (c) All of them ploughed back profits at some time over the period, while 24 of them relied on profits alone, and used no other source.
- (d) Fifty-eight firms used external sources of finance.
- (e) Only two sources, directors' loans and overdrafts were used by a higher proportion of firms.
- (f) Two of the seven firms issuing shares raised the money entirely from new shareholders.
- (g) Much of the external finance was raised entirely from persons or firms already connected with the business (i.e. new capital provided by existing owners, or from directors and partners loans)."³⁴

Sufficiently encouraged by the results of the pilot survey the Oxford Institute of Statistics undertook the full enquiry early in 1956. The interviews were completed in two stages with the owner and senior partner or managing director of each firm. In the first stage the interviewer asked questions about the general behaviour of the firm; in the second stage an attempt was made to get details of the financial acti-

34. Bruce, C., Burchardt, F.A., and Gibb, E.B., "Small Manufacturing Company: A Preliminary Report on Pilot Survey", The Oxford Institute of Statistics, 1955, 17, p.7.

vities of the firm. The survey was confined to ten major industrial areas. Of the 1,077 firms which gave interviews and whose answers were used in the analysis, 335 gave access to their balance sheets and profit and loss statements, a further 182 answered questions designed to discover the structure of their financial statements, and a total of 991 firms answered questions about their financial experience during the period 1950-56.

The results of the survey have been reported in a series of articles, notably by Bates. The main conclusions are summarised below:

- (a) As a proportion of income, retained profit was much higher in the firms surveyed than in large quoted public companies.
- (b) Typically private companies retained about 55 percent of their total net profit, compared with about one-third of total profit being retained in quoted public companies. This does not necessarily mean that small companies were more thrifty than large: they were retaining a larger share of proportionately smaller incomes.
- (c) Relating it to the extent to which large and small firms were self financing - the typical ratio of savings to investment in private companies was between 55 percent and 65 percent with fairly wide fluctuations from year to year.
- (d) In the large public companies the ratio of savings to investment was 136 percent. There were slight differences between two groups in the ratio of savings to expenditure. Large companies financed more than half of their expenditure on operating assets from their own savings. Private

companies financed between 40 and 60 percent in this way in the three years to which the information was available.³⁵

The tentative conclusion reached was that the very largest and the smallest companies tend to finance from their own savings. Other public companies and quoted public companies possibly financed rather smaller proportions in this way.

In conclusion the report states:

- "(a) Retained profits, expressed as a proportion of income after the payment of directors fees are rather higher in survey firms than in the company sector as a whole; but as a proportion of total sales, retained profits in the two groups are similar.
- (b) This simply means that small firms tend to retain a larger share of proportionately smaller income than do large firms. Small firms tend to finance a large part of their expenditure from their own savings, but this does not necessarily mean that they are in a position of relative financial ease. Their difficulties in raising the outside capital may simply mean that small firms are forced to trim their capital expenditure close to the availability of internal funds."³⁶

The Committee of Inquiry on Small Firms

In July 1969, the President of the Board of Trade announced the appointment of an independent Committee of Inquiry under the Chairmanship of Mr John Bolton, to consider the role of small firms in the national

35. Bates, J., "The Finance for Small Business", The Oxford Institute of Statistics, 1958, 20, p.154, and Bates, J., The Profits of Small Manufacturing Firms. In P.E. Hart, Studies in Profits, Business Savings and Investment in the United Kingdom 1920-1962. Vol. 1, London, George Allen & Unwin Ltd, 1965, p.208.

36. Ibid., p.154.

economy and the problems confronting them.³⁷ The Committee received written and oral evidence and commissioned extensive research studies involving postal questionnaires to gather information on the small firm sector. The Committee presented its report in November 1971. In the area of finance, the Committee considered whether the needs of the small firm sector for external finance were being adequately met by the financial institutions.

Representations received by the Committee suggested that the small firms had limited access to the external finance, by comparison with larger companies, and that the terms on which they could obtain such finance, as was available, were unduly onerous. On the basis of the representations received, the Committee concluded that there was a considerable body of opinion in favour of some or all of the following propositions:

- (a) That the operation of credit restrictions and particularly of the ceiling on bank lending had particularly severe and damaging effects on small firms.
- (b) That small firms had great difficulty in raising medium term finance in relatively small amounts - that is, between £5,000 to £50,000 - and that to the extent the "Macmillan Gap", referred to earlier still existed.
- (c) That the inability of most small firms to raise capital on the Stock Exchange was a very serious disadvantage, necessitating the creation of a "secondary market" to give them improved access to equity capital. On the use of external finance by the small firms, the Committee states:

37. United Kingdom Committee of Inquiry on Small Firms. The Report of the Committee of Inquiry on Small Firms. London, Her Majesty's Stationery Office, 1971, p.150.

"External finance of all kinds comprises a very small proportion of the total capital employed by the small firm sector. Long term loans together with bank overdrafts accounted for 14 percent of the total assets of the firms in our sampling survey, compared with 19 percent for quoted companies. Joint stock banks are the most common source of funds, yet about half the respondents to our postal inquiry had no overdraft facilities."³⁸

As regards other institutional sources, the Committee reports:

"In the manufacturing industry no less than 92 percent of the respondents had not been concerned in any attempt to obtain finance from institutions other than the commercial bank."³⁹

While the Committee acknowledged that in part this was so, because in some cases firms did not seek finance because they did not need it, and in other cases firms would not seek finance through ignorance and prejudice or moral scruples. But the Committee had no doubt that many firms had not obtained and could not obtain institutional finance simply because they were not sufficiently creditworthy.

The Committee therefore concluded:

"We must assume that self financing will remain a dominant financial characteristic of the small firm sector, for it is the essence of small business as we know it, that the owner should be risking his own capital on the strength of his energy, experience and talents and that he should be free from outside control in making his decision."⁴⁰

38. Ibid., p.150.

39. Ibid., p.151.

40. Ibid., p.152.

"The continued health of the sector, therefore, requires, first the availability in private hands of capital with which businesses may be founded or acquired, and second, an adequate level of profit after tax for reinvestment."⁴¹

While recognizing the limited role of financial institutions in providing capital requirements of the small firm sector, the Committee nevertheless acknowledges the contribution of the financial institution as of critical importance particularly in supplementing the initial investment of the founders. "The dynamism of the sector is thus intimately related to the adequacy of the provision made for it by the institution."⁴² However, the Committee investigations revealed a very widespread belief that the institutions were failing to meet the legitimate capital requirements of the small firm sector. The report concludes:

"We have found that small firms have suffered and still suffer a number of genuine disabilities by comparison with large firms, in seeking finance from external sources. First, they must have suffered differentially, from the official ceilings on bank lending. Second, some institutional facilities available to large firms are not available to small ones. Third, for those facilities that are available small borrowers must generally pay rather more than large ones. Fourth, many small firms are prevented due to lack of information and by prejudice against borrowing, from making use of the full range of facilities available to them."⁴³

41. Ibid., p.153.

42. Ibid., p.155.

43. Ibid., p.192.

2.2.4 Financing Small Businesses in New Zealand

As mentioned in Section 1.1, pages 7-8, there were two studies relating to New Zealand scene which are of particular significance to the present study. These studies are briefly reviewed below.

- (1) The Australia and New Zealand Bank in co-operation with the New Zealand Society of Accountants carried out a survey of Financing Small Business in 1967. The purpose of that study was firstly to provide factual accounting data in a form which could be used by accountants, bankers, and other financial advisers and, secondly to measure the relative importance and cost of bank credit and other finance used by small businesses.⁴⁴ The survey was confined to urban businesses employing a maximum of thirty persons. Two thousand two hundred questionnaires were sent to public accountants requesting them to select one business within the definition and, for that business, to provide a series of balance sheet items, a complete breakdown of source and use of funds, information on borrowing costs and an indication of reliance, if any, on hire purchase finance and equity capital provided by suppliers and/or major customers.

Two hundred and sixty-two questionnaires were returned and 198 were used in the analysis. Some of the findings of the survey were:

- (a) Approximately 50 percent of the funds have been self-generated and derived from retained profits.

44. Australia and New Zealand Bank Limited. "Financing Small Business in New Zealand", ANZ Bank Quarterly, 1967, 17, p.3.

- (b) Less than 3 percent of funds came from increases in equity capital. The small businesses lack of reliance on (or inability to obtain) capital was partly offset by the large volume of funds obtained by way of loans from directors and shareholders. The manufacturing group obtained 5 percent, while the non-manufacturing group obtained 12 percent of their funds in this manner.
- (c) Bank credit represented only 14 percent of the total credit.
- (d) Use of hire purchase finance was marked in the case of capital intensive industries - (e.g. transport group). The value of hire purchase agreements equalled nearly 10 percent of total fixed assets covered by the survey.
- (e) In fifteen cases suppliers were extending long term credit (6 months and over) to businesses.

The survey concluded that:

- (a) Bank credit provides comparatively small proportions of credit and a very small proportion of total funds used.
- (b) Hire purchase and direct borrowings were very important sources of funds.
- (c) Use of direct borrowing reflects restrictive controls on lending institutions and could mean a deterioration in the quality of credit.

- (d) Small businesses utilize a wide variety of institutional sources and are unlikely to be affected by economic policies which rely on the control of bank credit.⁴⁵
- (2) Devlin's study (1976) is the first major research designed to identify and measure empirically the problems peculiar to the small businesses in New Zealand. Although Devlin's research is not specifically related to financing, it is of value to anyone looking at the small business scene in New Zealand. A lengthy questionnaire was sent to 1,073 firms in the Otago Statistical District. Of the total return of 296 responses, 240 were used in the analysis.

The Devlin study provides a lengthy treatise on the problems of small businesses particularly in the areas of advisory services, education and training, research, and direct aid. Commenting on the ease or difficulty in obtaining working capital, Devlin states:

- "(a) About 56.2 percent of the sample always experienced some difficulty in obtaining working capital.
- (b) For 12.8 percent of the sample, obtaining working capital was a continuous problem.
- (c) Only 7.8 percent of the sample could obtain finance for working capital with ease."⁴⁶

On the problem of financing small businesses, the study concludes:

45. Ibid., pp.4-6.

46. Devlin, M.H., The Needs and Problems of Small Firms in New Zealand. Thesis, M.Com., The University of Otago, 1976, p.143.

"... in most cases funds are very difficult to come by, and many unsuccessful firms are so because of the need to use internal capital to fund their everyday needs."⁴⁷

2.2.5 Summary

The aim of this section was to review previous research on financing small businesses. Some of the major United States and the United Kingdom studies have been identified and discussed. Generally the conclusion that emerge are summarized below.

United States

In the United States the availability of finance for small businesses has been the focal point of research surveys, Congressional hearings and numerous writings by individuals. Three major studies dealing with small business financing have been identified and reviewed. A comparative summary of the conclusions of these studies are provided in Table 2-2.

Small businesses in the United States have a reasonable access to short term working capital finance and use most of the traditional sources such as credit from suppliers, commercial banks and finance companies. In the area of long term finance, the small businesses appear to have access to only a few sources. Long term finance is largely provided by the owners themselves, and only a small proportion is obtained from mortgages and loans from finance companies.

The literature revealed that the United States Select Committees of Congress have for many years been collecting information, examining policy and publishing reports on small businesses. This led

47. Ibid.

TABLE 2-2
COMPARATIVE SUMMARY OF UNITED STATES STUDIES

<u>TYPES OF FUNDS</u>	<u>STUDIES (AUTHORS)</u> <u>KAPLAN</u> <u>STEVENSON</u>		<u>PUGH</u>
1. <u>Short Term Working Capital</u>	1. <u>Suppliers</u> Readily available 2. <u>Commercial Banks</u> 70 percent borrowed regularly 90 percent depended wholly on banks 3. <u>Finance Companies</u> 60 percent of their lending	1. <u>Commercial Banks</u> Term loans of 5-7 years maturity	1. <u>Suppliers</u> 5.5 percent borrowed from this source 2. <u>Floor Financing of Inventory</u> 9 percent financed from this source
2. <u>Long Term Capital</u> (including capital for starting a business and for expansion)	Not Adequately Available 20 percent depended on Commercial Banks 25 percent on mortgage and sale of securities 40 percent had no available source All capital for expansion were provided by owners and friends and relatives	Lease financing - equipment Financing plant from Insurance Company loans Mortgage finance	<u>Owner's Personal Investment & Sale of Security</u> 2/3 financed 85 percent from this source <u>Relatives & Friends</u> 1/6 financed 50 percent <u>Mortgage</u> 5.5 percent financed 50 percent <u>Retained Earnings</u> 70 percent financed expansion from this source

to the establishment of an independent department of the state - Small Business Administration in 1953, to foster the interest of small firms. In 1958 the Congress passed the Small Business Investment Companies Act, designed to assist small businesses, particularly in the provision of long term and equity capital. However, as the President's Task Force on small business indicated, the institutional arrangements had not filled the gap in the supply of long term capital for small business, and therefore the problems of financing small businesses in the United States remained unresolved.

United Kingdom

In the United Kingdom the problems of financing small business was first spotlighted by the Committee of Inquiry on Industry and Finance in 1931. A gap in the financing of small business was recognised. As in the United States, the United Kingdom Government commissioned studies to obtain some empirical information on small businesses, notably the Committee of Inquiry on Small Firms. Several major studies have been reviewed and the conclusions that emerge are:

- Private Companies retained over 55 percent of their net profit and over 55 percent of the small firms were self financing.
- The small firms trimmed their capital expenditures to meet the available internal funds.
- The small firms have great difficulties in raising medium term finance and external finance of all types comprise a small proportion of total capital employed by the small firms.
- The small firms were not seeking loan finance from sources other than the commercial banks.

The findings lend support to the general conclusion that self financing remains dominant in the financial structure of the small firms. The institutions were not meeting the legitimate needs of the small firm sector. Also small firms were generally unaware of the various facilities available in the financial market to them.

New Zealand

The extensive search for material in New Zealand revealed that there was little local information on financing small businesses. Two studies were located and reviewed. The Devlin study while important in general management area, does not specifically deal with the financing aspect of small businesses. There are no official government statistics or studies on the subject in New Zealand.

2.3 SUMMARY

The search of the literature showed the various sources of financing small businesses. It indicated that the financial requirements of small businesses can be considered at three stages of their development as follows:

- (a) Finance required to promote an undertaking (Initial Financing).
- (b) After a business has started, finance required for continuing financing of inventories and for conducting day to day operations (Financing Continuing Operations).
- (c) The supplementary finance required to expand activities of the existing unit and to modernise or renovate plant and equipment (Development and Growth Financing).

It was therefore decided to empirically investigate the financing of small businesses using these three stages of development as a framework.

It was recognised that the small business sector in each of the countries discussed above has a different upper-limit definition and therefore it would be inappropriate to include in this report extensive or detailed comparisons between previous overseas studies and this research.

CHAPTER 3

METHOD OF RESEARCH

3.1 RESEARCH OBJECTIVES

Statement of Problem

The primary objective of this study was to identify the sources and types of finance that small businesses in the Massey University region used at various stages of their development. In order to achieve this objective the study specifically considered the following questions with respect to small businesses in the Massey University region:

- (a) What sources and types of finance did the small businesses use when starting the business (Initial Financing)?
- (b) What sources and types of finance were being used for current operations - working capital and other essential assets (Financing Going Concern)?
- (c) What sources and types of finance were being used for development and or were expected to be used for future growth (Development and Growth Financing)?

The study also investigated the following sub-questions:

- (a) In which areas do small businesses have the greatest financial need?
- (b) What problems were encountered by small businesses when raising finance?
- (c) What criteria do some lenders use when assessing the financial needs of the small businesses?

3.2 DEFINITION OF TERMS

This section gives essential definition of the concepts important to the study.

Small Business

For the purpose of this study a small business was defined as one employing up to 30 people (including working proprietors) and which was independently owned and managed, excluding however public companies, subsidiaries of public companies, overseas-owned or controlled companies. For a fuller discussion of the definition see Chapter 1, pages 6-9. This definition was adopted for the following reasons:

- (a) To provide a meaningful comparison of the results of this research study with the findings of the ANZ Bank survey. The ANZ Bank survey also used 30 persons as a cut off point.
- (b) There were approximately 1,000 manufacturing firms in the region that would qualify as small business under the definition.¹ Further, most retailers were not public companies and on an average employed approximately 6 persons per store.²

Working Capital

Funds essential for inventory (for resale or for processing), payroll and credit to customers.

Other Assets

Items purchased or used in business which are of a long term nature (machinery, plant, land, building, motor vehicles) etc.

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- 1. Statistics of New Zealand Industrial Production 1972-73, Wellington, Department of Statistics, 1975, p.35.
 - 2. New Zealand Official Year Book 1976, Wellington, Department of Statistics, October 1976, pp.554-558.

Financing Initial Operation

Initial operation refers to the situation when the business first began. If the business was first purchased by the present owner, the date of purchase is regarded as the date when the business first began. If the business was started by the present owner, the date of incorporation is regarded as the date when the business first began.

3.3 DESCRIPTION OF RESEARCH METHOD

A survey of books and periodicals dealing with the financing practices of small businesses was undertaken to obtain any information relevant to the study. Research conducted overseas provided some information pertaining to the financing and the financial problems of small businesses. Two New Zealand studies which contain some relevant information on the New Zealand scene were located. Both overseas and New Zealand studies provided some background information for the study. However, as previously indicated there is very little information available as to the methods of financing small businesses in New Zealand. This survey was therefore undertaken to fill part of this information gap, and to serve as a basis for further inquiry into and support for small business activity.

To enable the compilation of significant results, the group of small businesses selected had to be sufficiently large. No outside financial assistance was available. It was therefore decided that a postal questionnaire would be the best means of communicating with potential respondents.

The study was based in the Massey University region and the sample was confined to postal region of Hawkes Bay, Manawatu, Taranaki, Wanganui, and Wairarapa (Pahiatua only).

The names of the businesses surveyed were taken from a list supplied by the Labour Department, New Zealand Manufacturers directory, New Zealand Who's Who in business and the number was brought up to 1,700 firms by adding approximately 50³ firms from the region's telephone directories. A number of firms had previously responded to a survey on Education and Training needs conducted by the Massey University School of Business and the Department of University Extension in 1971. These businesses fall in the category of small business as defined in this study and therefore included in the survey.

The questionnaire form was prepared after the pilot study which consisted of a comparison of several mail surveys. Several sets of draft questionnaires were tested with the small business owners before the final questionnaire was adopted. In line with the objectives of the study, the questionnaire sought information in four areas:

- (a) Section A sought some basic information such as the type, location, size and the industry group to determine the composition of the group of respondents.
- (b) Section B was concerned with obtaining the respondents initial source(s) of capital, particularly:
 - how the business was first financed.
 - how the business was financed at the time of the survey.
 - whether the sources of financing used at the time of survey provided adequate funds for the business.
- (c) Section C was concerned with data on (1) how the businesses were currently financing the working capital and other assets, (2) whether they have found it necessary to borrow money during the last

3 These firms had previously attended a number of small business seminars at Massey University. They met the criteria for small business adopted in this research.

five years, and if so (3) from what sources they have obtained funds, and the purposes for which the money was borrowed. The section also sought information on the businesses most pressing current financial need, if any?

- (d) Section D was aimed at obtaining information on development and growth financing and was in three parts: (1) whether the business had any plans for expansion, (2) if so, to what external source they would look for finance. The third part sought information on the problems the respondents faced when seeking finance and the conditions (favourable and unfavourable) imposed by lenders.

In order to obtain all the information needed, the questionnaire had to be a lengthy one. A number of questions were difficult to answer because they required reference to the records dating back a number of years - in some cases to ten or more years. Also because a large number of small businessmen are working proprietors, it is conceivable that many did not have time to fill the questionnaire. Further, while every effort was made to keep the questionnaire simple, some businessmen may have found it difficult to complete. These factors could have reduced the number of responses.

On 1 July 1975, 1,700 questionnaires with a covering letter and a reply paid envelope were mailed (see Appendix 1). Although 609 (35.8 percent) questionnaires were returned, only 452 (27.6 percent) were suitable and used in the analysis. The remaining 157 were not suitable for the analysis for the following reasons:

52 returned as - "gone no address".

30 returned with a note - "not prepared to fill".

75 returns were from businesses falling outside the definition of the small business adopted for the purpose of this study.

This response compares favourably with Devlin's 22.4 percent, and the United Kingdom Committee of Inquiry on Small Firms of 22 percent on non-financial questionnaires, and only 13 percent on financial questionnaires.

The processing of the information received was completed on the Burroughs B6700 electronic computer at Massey University, using Statistical Packages for Social Sciences (SPSS). The information derived from the survey data is contained in the tables included in this study.

Following the analysis of the questionnaire, interviews with the managers of the trading banks and a finance company followed which covered inter alia the criteria they used in granting loans to small businesses. The objective of these interviews were to obtain indepth information beyond that derived from the questionnaire. It was hoped that such information would give further insight on the financial facilities available to small businesses.

The findings and the conclusions of the study are presented in Chapters 4, 5 and 6 that follows.

CHAPTER 4
PRESENTATION AND ANALYSIS OF FINDINGS

4.1 INTRODUCTION

This Chapter begins with a discussion covering such aspects as the form of legal ownership, location, number of employees, and industry group. Sections 4.2 to 4.5 will cover the findings of the survey as follows:

- (a) The sources of the respondents' initial and continuing finance and its adequacy,
- (b) financing current operations - working capital and other essential assets,
- (c) whether borrowing was necessary and the sources from which funds were borrowed,
- (d) the businesses most pressing current financial needs,
- (e) the sources to be explored when seeking finance for growth and development, and
- (f) the problems faced by the business when seeking finance.

As indicated in Chapter 3, 452 firms are represented in the survey and the data collected through the questionnaires are the bases for major portions of this Chapter.

The information obtained from the survey is presented in three ways:

- (1) the results are arranged in tabular form,
- (2) highlights of the findings are presented in written form,
- (3) a general conclusion is drawn after each major part.

This course of action has been taken to give readers a better perspective on the financing of small businesses at various stages of their growth.

4.2 CHARACTERISTICS OF RESPONDENT FIRMS

The purpose of this section is to provide some general background information about the firms who responded to the survey. Tables 4-1, 4-2 and 4-3 provide information according to the form of legal ownership, location, industry group and employee numbers.

Replies came from small businesses in all the districts forming part of the region. The largest number of the responses was from the Manawatu district. Eighty per-cent of the respondents were private limited companies. All major industry groups are represented. As shown in Table 4-3, 73 percent of the responding firms employed less than eight employees. There were 957 manufacturing establishments in the survey area employing an average of 30 persons per establishment.¹ About 10 per-cent of these completed the survey questionnaire. It was not possible to obtain similar data for other groups.

4.3 SOURCES OF INITIAL AND CONTINUING FINANCE

The purpose of this section is to review the sources of initial and continuing finance employed by responding firms. In Section B of the questionnaire, respondents were asked to indicate what sources of finance were used to start the business by the present owners, what sources were used at the time of the survey, and whether or not the sources provided sufficient funds for their businesses. A summary of the replies are presented in Table 4-4, 4-5, and 4-6, and form the basis for analysis and discussion.

1. Statistics of New Zealand Industrial Production, 1972-73, Wellington, Department of Statistics, 1975, pp.19-26.

TABLE 4-1

LOCATION OF RESPONDENT FIRMS BY FORM OF LEGAL OWNERSHIP

<u>LOCATION</u>	<u>PRIVATE LIMITED COMPANY</u>		<u>PARTNERSHIP</u>		<u>SOLE TRADER</u>		<u>TOTAL</u>	
	<u>Number</u>	<u>Percent</u>	<u>Number</u>	<u>Percent</u>	<u>Number</u>	<u>Percent</u>	<u>Number</u>	<u>Percent</u>
Hawkes Bay	65	18	8	18	6	14	79	18
Manawatu	259	71	32	73	32	73	323	71
Taranaki	11	3	2	5	1	2	14	3
Wanganui	20	6	2	4	5	11	27	6
Wairarapa	9	2	-	-	-	-	9	2
TOTAL	364	100	44	100	44	100	452	100

TABLE 4-2
DISTRIBUTION OF RESPONDENT FIRMS BY INDUSTRY CLASSIFICATION

<u>INDUSTRY GROUP</u>	<u>PRIVATE LIMITED COMPANY</u>		<u>PARTNERSHIP</u>		<u>SOLE TRADER</u>		<u>TOTAL</u>	
	<u>Number</u>	<u>Percent</u>	<u>Number</u>	<u>Percent</u>	<u>Number</u>	<u>Percent</u>	<u>Number</u>	<u>Percent</u>
Manufacturers	86	24	11	25	7	16	104	23
Wholesalers	19	5	6	14	1	2	26	6
Retailers	122	33	14	32	12	27	148	33
Service	137	38	13	29	24	55	174	38
TOTAL	364	100	44	100	44	100	452	100

TABLE 4-3
DISTRIBUTION OF RESPONDENT FIRMS BY NUMBER OF EMPLOYEES
BY INDUSTRY GROUP

<u>NUMBER OF EMPLOYEES</u>	<u>MANUFACTURING</u>		<u>WHOLESALEING</u>		<u>RETAILING</u>		<u>SERVICE</u>		<u>TOTAL</u>	
	<u>Number</u>	<u>Percent</u>	<u>Number</u>	<u>Percent</u>	<u>Number</u>	<u>Percent</u>	<u>Number</u>	<u>Percent</u>	<u>Number</u>	<u>Percent</u>
Under 2	11		7		43		47		108	24
3-4	17		7		57		61		142	31
5-8	23		3		30		27		83	18
9-12	15		3		5		16		39	9
13-16	14		-		5		7		26	6
17-25	13		5		8		12		38	8
26-30	11		1		-		4		16	4
TOTAL	104	(23)	26	(6)	148	(33)	174	(38)	452	100 (100)

Table 4-4 presents a percentage distribution of the sources of initial finance used by the respondents. It indicates that owner's savings played a prominent part in starting the respondent business. Of the 402 firms which used this source, 36 percent financed all their initial capital requirements in this way. Fifty-four percent financed more than 20 percent of their initial capital requirements from owner's savings.

The trading bank loan was the next most utilised source. Of the 167 firms which indicated using this source, 53 percent were able to finance more than 20 percent of their requirements from this source. Other sources provided some funds, the most notable of which were family's savings, and the credit facilities from suppliers.

When this result is compared with other research findings discussed in Chapter 2, sections 2.2.2 to 2.2.4, it appears that a smaller proportion of the respondents to this research survey were using the owner's savings to finance their initial capital requirements. Kaplan's² findings indicate that finance for new enterprises was almost wholly furnished by the owners. Pugh³ found that personal investment provided 85 percent of the initial funds for two-thirds of the businesses. Similar situation existed in the United Kingdom where the Committee of Inquiry into Small Firms⁴ reported that self financing was dominant in the capital structure of the small firm.

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2. Kaplan, A.D.H., Small Business: Its Place and Problems, New York, McGraw-Hill Book Company, 1948, p.140.
 3. Pugh, O.S., Financing 689 Small Business Firms in South Carolina, 1958-59, Columbia, Bureau of Business and Economic Research, University of South Carolina, 1960, p.122.
 4. The Committee of Inquiry on Small Firms, London, Her Majesty's Stationery Office, 1971, p.152.

TABLE 4-4
SOURCES OF INITIAL FINANCE

Proportion (Percent)	Owner's Savings	Family's Savings	Loans from Friends	Trading Bank	Insurance Company	Other Financial Institution	Deposit from Customers	Credit from Suppliers	Others
0	50	386	400	285	431	411	451	393	407
1-10	20	5	11	37	3	4	-	20	4
11-20	20	12	3	42	3	5	-	15	5
21-30	18	12	7	27	4	4	-	7	2
31-40	22	7	3	20	6	7	1	5	8
41-50	65	9	14	23	1	9	-	6	5
51-60	28	1	3	13	2	5	-	2	17
61-70	19	5	2	-	2	2	-	1	3
71-80	47	3	6	5	-	5	-	3	1
81-90	16	2	3	-	-	-	-	-	-
91-99	1	-	-	-	-	-	-	-	-
100	146	10	-	-	-	-	-	-	-
TOTAL	452	452	452	452	452	452	452	452	452

The findings of the ANZ Bank Survey⁵ do not lend themselves to any meaningful comparisons, because it did not consider the financing of small businesses at the three crucial stages as adopted in this research study. However, it is significant to note that approximately 50 percent of the funds used by the respondents in the ANZ Bank Survey were self generated and less than 3 percent came from capital issues.

When other sources of finance used are considered, a different picture also emerges. For example, Pugh⁶ found that 6 percent of the businesses surveyed financed more than 50 percent of their requirements from suppliers. The result of this survey indicates that 13 percent of the respondents used credit from suppliers with only 1 percent financing more than 50 percent of their requirements in this way. A significantly large proportion (60 percent) of those who indicated using this source financed less than 20 percent of their requirements from credit facilities provided by the suppliers.

After the business has started the owner's savings continue to play a major role in the provision of finance for the firm. Of the 421 firms indicating using this source, 34 percent obtained all their requirements in this way, 55 percent financed more than 51 percent from this source and only 6 percent financed less than 20 percent of their needs from this source.

The number of firms using trading bank loans totalled 238, with 26 percent obtaining more than 20 percent of their finance from this source. A significant proportion (73 percent) used this source for up to 20 percent

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5. ANZ Bank Limited, "Financing Small Business in New Zealand", ANZ Bank Quarterly, 1967, 17, p.2.
 6. Pugh, op.cit., p.123.

of their present financing need. Credit from suppliers, loans from finance companies, and hire purchase were other sources mentioned by respondents as providing some current financing. The above information is amplified in Table 4-5.

Question 7 asked respondents to indicate whether the current sources provided adequate funds for their businesses. Table 4-6 shows that 61 percent indicated that the present sources of finance provided adequate funds. Thirty three percent indicated that the sources did not provide adequate funds. Analysis by industry grouping revealed that slightly - higher proportion of manufacturers (39 percent) had inadequate funds.

Thirty five respondents included comments with their answers to Question 7. They indicated having inadequate funds to finance increased accounts receivable, inventory, machinery and equipment, building extensions, product development, and new business ventures. When the data is compared with other research findings, it appears that a similar proportion of the respondents to this survey were in the same predicament, insofar as the adequacy of the present sources to provide needed funds are concerned, as their overseas counterparts. Kaplan⁷ found that 40 percent had no available sources of credit. The findings of the Oxford Survey⁸ indicate that one-third of the responding firms relied on profit alone and used no other source. The United States President's Task Force⁹ on Improving the Prospects of Small Businesses reported that 31 percent of the respondents were unable to obtain needed finance.

7. Kaplan, op.cit., pp.141-142.

8. Bruce, C., Burchardt, F.A., and Gibb, E.B., "Small Manufacturing Business: A Preliminary Report on a Pilot Survey", The Oxford Institute of Statistics, 1955, 17,p.7.

9. United States President's Task Force. Improving the Prospects of Small Business, Washington, United States Government Printing Office, 1970, p.15.

TABLE 4-5
SOURCES OF CONTINUING FINANCE

Proportion (Percent)	Owners	Family	Trading Bank	Insurance Company	Hire Purchase Fin.	Leasing	Factor- ing	Short Term Money Market	Credit from Sup.	Loans from Fin. Co.	Others
0	31	383	214	429	412	440	450	439	353	424	404
1-10	4	32	112	9	32	7	1	7	36	10	17
11-20	2	17	63	2	6	3	-	-	26	11	6
21-30	16	3	25	5	2	2	1	5	14	3	8
31-40	22	6	11	3	-	-	-	-	8	2	7
41-50	42	5	13	-	-	-	-	-	8	2	5
51-60	24	2	5	2	-	-	-	-	4	-	3
61-70	28	-	5	2	-	-	-	1	3	-	2
71-80	59	1	4	-	-	-	-	-	-	-	-
81-90	60	-	-	-	-	-	-	-	-	-	-
91-99	20	-	-	-	-	-	-	-	-	-	-
100	144	3	-	-	-	-	-	-	-	-	-
TOTAL	452	452	452	452	452	452	452	452	452	452	452

TABLE 4-6

ADEQUACY OF CURRENT SOURCES OF FINANCE

	<u>Number</u>	<u>Percent</u>
Adequate Funds	276	61
Inadequate Funds	147	33
No Reply	29	6
TOTAL	<u>452</u>	<u>100</u>

BREAKDOWN BY INDUSTRY GROUP

	<u>Adequate Funds</u>		<u>Inadequate Funds</u>	
	<u>Number</u>	<u>Percent</u>	<u>Number</u>	<u>Percent</u>
Manufacturers	57	55	41	39
Wholesalers	17	65	9	35
Retailers	93	63	47	32
Service	109	63	50	29
TOTAL	<u>276</u>	<u>61</u>	<u>147</u>	<u>33</u>

Summary and General Observation

This section has reported the findings of the study on the sources of finance respondents used when starting up a business, sources of finance used at the time of the survey, and their adequacy. The result indicates that the main source of initial finance was from the owner's personal savings. More than one-third of those using this source indicated financing all of their requirements from this source. A majority financed more than half of their requirements in this way. Some funds were provided from other sources, such as trading banks and credit facilities from the suppliers. There was little use made of insurance companies and other financial institutions in the provision of initial capital by the respondent firms.

The owner's investments continue to play a major role in the provision of finance for current operations. However, bank credit assumed a somewhat greater relative importance with almost one-third using this source for up to 20 percent of their continuing capital requirements. Credit from suppliers, hire purchase, and loans from finance companies provided some funds.

On the question of the adequacy of these sources to provide needed funds, a significant proportion (33 percent of those responding) indicated that the sources did not provide adequate funds for their business.

When compared with other research surveys quoted earlier, it appears that a smaller proportion of the respondents to this research survey were using owner's investment and credit from suppliers to finance their initial capital requirements. In overseas surveys it was found that a greater proportion of finance came from owner's investment and credit from suppliers. However, a similar proportion were in the same situation as the respondents in the other surveys in so far

as the adequacy of the present sources to provide needed funds were concerned.

The findings would appear to support the prevailing view that promoters of small businesses would normally be unable to obtain any significant help from outside investors. Few investors are interested because the risks (small size, inexperienced management etc.) inherent in small businesses are greater than those of large businesses.¹⁰ Therefore small businesses have to depend almost entirely on their own resources. As revealed by the survey results, some help may be available from relatives and friends. Some short term funds may also be available from institutional lenders such as the trading banks, if small businesses were able to meet the lending criteria.

Although the majority of respondents appeared to have sufficient funds for the current level of operations, it should not be assumed that they have an abundant supply of funds. During the course of the survey the author had an opportunity to have extensive discussions with a number of owners and managers of small businesses. It became apparent that many businessmen found it necessary to remain on the same level of operation year after year despite increased demand for their products or services. They were either unaware of the potential sources of finance, or unable to meet the stringent conditions imposed by the lenders, particularly the trading banks. It is important to note that in the case of small businesses, banks require not only a floating charge over all the businesses' assets, but shareholder/owner guarantee, supported by personal securities. Guarantees from third

10. Robinson, R.I., Financing the Dynamic Small Firm, Belmont, California, Wordsworth Publishing Company, 1966, p.21.

parties are also required. It is obvious that bank lending has been very restrictive, forcing small businesses either to abandon the idea, or to higher cost sources. Most small businessmen were unable to service the higher cost loans and thus forced to remain on the same level of operation.

4.4 FINANCING CURRENT OPERATIONS

In Section C of the questionnaire, respondents were asked to indicate the sources of financing their current working capital, and other essential assets. Tables 4-7 and 4-8 summarise the responses received.

Of the 680 mentions, 45 percent indicated bank credit as the source of financing their working capital requirements. Advances from shareholders and partners ranked second with 19 percent mentions. Other sources used include credit from suppliers, building societies, finance companies, and other financial intermediaries, as well as advances from owners. The number of retailers and service firms mentioning advances from owners/shareholders, bank credit and credit from suppliers was a significantly higher proportion than for the other industry groups. Table 4-7 contains this information.

TABLE 4-7
FINANCING CURRENT OPERATION - WORKING CAPITAL

	<u>Number</u>	<u>Percent</u>
Advances - Owners	67	10
Advances - Partners/Shareholders	130	19
Credit from Suppliers	124	18
Credit from Trading Bank	302	45
Others	57	8
TOTAL	<u>680</u>	<u>100</u>

	<u>Manufac-</u> <u>turers</u>	<u>Whole-</u> <u>salers</u>	<u>Retailers</u>	<u>Service</u>
Advances - Owners	10	2	23	32
Advances - Partners/ Shareholders	25	8	47	50
Credit from Suppliers	29	3	48	44
Credit from Trading Bank	81	17	92	112
Others	17	3	15	22
TOTAL	<u>162</u>	<u>33</u>	<u>225</u>	<u>260</u>

Note: The total number is greater than 452 because many respondents indicated more than one source.

The ANZ Bank Survey¹¹ concluded that about 10 percent of the finance was obtained by way of credit from suppliers. The results of this research survey reveals that 18 percent of the respondents obtained finance in the same way. Although exact comparison is not possible, it could be inferred that the respondents to this research survey were financing a similar proportion of their working capital requirements from suppliers as the respondents in the ANZ Bank Survey.

Table 4-8 provides information on the sources used to obtain other essential assets. Of the 1,328 mentions, 85 percent purchased their assets either for cash or credit, rather than obtain the asset by other financing methods.

Summary and General Observation

This section has reported the findings of the study with respect to sources of finance utilised by respondents in financing their working capital (inventory, wages, credit to customers), and other essential assets (plant, machinery, motor vehicles, buildings). Almost half of the respondents indicated using trading bank credit to finance their working capital requirements and a very high proportion (85 percent) mentioned purchasing their other assets for use in business.

The results shows clearly that the most important source of working capital finance for small businesses in this survey was bank credit. This is consistent with the existing practice in New Zealand.¹² After a small business has started and has been in operation for a reasonable

11. ANZ Bank Limited, op.cit., p.4.

12. Interviews with the Managers of the trading banks reported in Chapter 5, Section 5.2.

TABLE 4-8
FINANCING CURRENT OPERATION - OTHER ASSETS

	<u>Number</u>	<u>Percent</u>
<u>LEASING</u>		
Plant	7	
Machinery	10	
Motor Vehicles	23	
Buildings	46	
	<hr/> 86	<hr/> 7
<u>RENTING</u>		
Plant	-	
Machinery	12	
Motor Vehicles	7	
Buildings	60	
	<hr/> 79	<hr/> 6
<u>HIRING</u>		
Plant	6	
Machinery	8	
Motor Vehicles	9	
Buildings	6	
	<hr/> 29	<hr/> 2
<u>PURCHASING</u>		
Plant	340	
Machinery	287	
Motor Vehicles	337	
Buildings	170	
	<hr/> 1,134	<hr/> 85
<u>TOTAL</u>		
Plant	353	27
Machinery	317	24
Motor Vehicles	376	28
Buildings	282	21
	<hr/> 1,328	<hr/> 100

Note: The total number is greater than 452 because many respondents indicated more than one service.

period of time, it is in a position to establish a good commercial relationship with its banker. Since a large part of bank lending to businesses is restricted to short term working capital, small businesses who have good banking connections and are able to meet the lending criteria, generally obtain finance from trading banks.

4.5 BORROWING

Table 4-9 shows that 63 percent of respondents borrowed money during the past five years for use in their business, and 37 percent did not borrow any money for use in the business.

<u>TABLE 4-9</u>		
<u>BORROWING IN THE PAST FIVE YEARS</u>		
	<u>Number</u>	<u>Percent</u>
Borrowed	283	63
Did Not Borrow	169	37
TOTAL	<u>452</u>	<u>100</u>

In question 11 the respondents were asked to indicate the sources from which they had obtained money.

Table 4-10 shows that of the 583 mentions, 40 percent obtained money from trading banks, 13 percent from partners and shareholders, 12 percent from hire purchase and leasing, 10 percent from creditors, 9 percent from private individuals, and the remainder from insurance and finance companies, and other sources such as solicitors and building societies.

The ANZ Bank Survey¹³ indicated that 12 percent of funds were obtained by the respondents from directors and shareholders. The Oxford Survey¹⁴ found that only two sources - directors loans and bank overdraft were used by a higher proportion of the firms. The inference is that the respondents to this research survey were using a relatively higher proportion of bank loans and approximately similar proportion of loans from partners and shareholders than the two just mentioned.

<u>TABLE 4-10</u>		
<u>SOURCES OF BORROWING (MENTIONS)</u>		
	<u>Number</u>	<u>Percent</u>
Trading Bank	234	40
Insurance Companies	21	4
Hire Purchase & Leasing	69	12
Other Finance Companies	40	7
Trade Creditors	57	10
Private Individuals	55	9
Partners/Shareholders	78	13
Others	29	5
TOTAL	583	100

Note: The total number is greater than 452 because many respondents indicated more than one source.

The respondents were also asked to indicate the purpose for which the money was borrowed. Table 4-11 presents the information received for the three years

13. ANZ Bank Limited, op.cit., p.4.

14. Bruce, Burchardt & Gibb, op.cit., p.7.

TABLE 4-11
PURPOSE FOR WHICH THIS MONEY WAS BORROWED

	<u>1973</u>		<u>1974</u>		<u>1975</u>	
	<u>No.</u>	<u>%</u>	<u>No.</u>	<u>%</u>	<u>No.</u>	<u>%</u>
<u>TO FINANCE WORKING CAPITAL</u>						
Stock (for resale)	88	36	90	31	92	34
Raw Materials	26	11	29	10	26	10
Payroll	14	6	17	6	21	8
Others	13	5	19	6	19	7
	<u>141</u>	<u>58</u>	<u>155</u>	<u>53</u>	<u>158</u>	<u>59</u>
<u>TO PURCHASE OTHER ASSETS</u>						
Machinery	24	10	23	8	23	8
Plant	21	9	25	8	24	9
Land	11	4	15	5	14	5
Building	24	10	27	9	15	6
Motor Vehicles	16	7	43	15	26	10
Patent Franchise	2	1	2	1	2	1
Others	2	1	3	1	4	2
	<u>100</u>	<u>42</u>	<u>138</u>	<u>47</u>	<u>108</u>	<u>41</u>
 TOTAL	 <u>241</u>	 <u>100</u>	 <u>293</u>	 <u>100</u>	 <u>266</u>	 <u>100</u>

(1973, 1974 and 1975). Responses for the two previous years (1971 and 1972) were in many cases incomplete and therefore excluded from the analysis. For 1973, 58 percent mentioned borrowing money to finance working capital. In 1974 the figure decreased to 53 percent, and in 1975 the figure was comparable to the 1973 level at 59 percent. It is significant to note that the money was borrowed largely to finance inventory for resale and raw materials for processing, the average for the years 1973-75 being 60 percent (inventory for resale), and 18 percent (raw materials for processing) of the total borrowing to finance working capital.

The respondents were also asked to indicate their most pressing financial needs. Table 4-12 shows that 27 percent lacked money for the day to day operation of their business, 17 percent indicated that lack of money had deferred the purchase of assets such as plant, equipment, motor vehicles, and buildings. Fifty-two percent indicated that they had sufficient funds to finance their present level of operation.

TABLE 4-12		
BUSINESSES MOST PRESSING FINANCIAL NEEDS		
	Number	Percent
Adequate Funds	236	52
Lack of Money for Day to Day Operations	120	27
Lack of money for Assets	79	17
Lack of Money for Both Day to Day Operations & Assets	17	4
TOTAL	452	100

Devlin¹⁵ found that 56 percent of the respondents always experienced some difficulty in obtaining working capital and for 13 percent, obtaining working capital was a continuous problem. The result of this research survey indicates that a smaller proportion of the respondents were experiencing difficulty in financing their day to day operations. However, for reasons already discussed (in Section 4.2, page 66) it must not be assumed that these businesses have access to unlimited funds.

Summary and General Observation

This section has reported the findings of the study on whether respondents borrowed money during the last five years, and if so, from which sources the money was borrowed, the purpose for which the borrowing was necessary, and the businesses most pressing financial needs. It was discovered that 63 percent of respondents borrowed money for use in their business. Bank credit again featured prominently, with 40 percent mentioning using this source. The next important source was shareholders and partners, providing funds for 13 percent of respondents. The respondents to this research were using a relatively higher proportion of bank loan and approximately similar proportion of loans from partners/shareholders when compared with other research surveys.

The financing of working capital accounts for more than half of borrowing during the last three years. About one quarter of the respondents mentioned borrowing to purchase machinery, plant and motor vehicles.

15. Devlin, M.H., The Needs and Problems of Small Firms in New Zealand, Thesis, M.Com., The University of Otago, 1976, p.143.

On the question of the businesses most pressing financial needs, 27 percent indicated lack of funds to meet their day to day operations, 17 percent deferred purchase of essential assets due to lack of funds, and a small proportion had insufficient funds for both the day to day operations of their business and for the purchase of necessary assets. When compared with other research surveys, a smaller proportion of the respondents to this survey were experiencing difficulties in financing their working capital. Although 52 percent indicated having adequate funds, the implication is that there is not an abundant supply of funds to these businesses (see also Section 4.2, pp.62, 64 and 66).

4.6. FINANCING GROWTH

Section D of the questionnaire sought information on growth and development, and the sources of outside finance respondents would seek to finance them. Tables 4-13 and 4-14 provide the detail.

Table 4-13 shows that 276 firms (61 percent) indicated that they desire to grow slowly and stay independent. Eleven percent indicated staying at about the same level of operation, and six percent indicated growing rapidly and staying independent. The remainder indicated either having no future plans or going public, winding up or selling as a going concern.

Table 4-14 summarises the responses on the sources of finance respondents indicated they would seek in order to finance their expansion programme. Of the 235 respondents, 55 percent mentioned trading banks, and 7 percent listed finance companies as a source. Next on the list included building societies, insurance companies, mortgage and credit from suppliers, about 6 percent each. The remainder mentioned such sources as the Development Finance Corporation, hire-purchase,

loans from friends and families, shareholders and partners, and solicitors.

TABLE 4-13 GROWTH AND DEVELOPMENT		
	<u>Number</u>	<u>Percent</u>
Stay Same	51	11
Grow Slowly	276	61
Grow Rapidly	28	6
Become Public Co.	2	1
Sell as Going Concern	41	9
Wind Up	7	2
Other Plan	47	10
TOTAL	<u>452</u>	<u>100</u>

When compared with Pugh,¹⁶ it appears that a much smaller proportion of the respondents to this survey were actively seeking finance for growth and expansion. The majority seemed satisfied with slow growth and thereby safeguarding their independent ownership and control. Research indicates that although small businessmen are able and anxious to have access to borrowed funds most are reluctant to share ownership and control of their businesses.¹⁷ As a consequence most would seek debt finance only.

The result of the survey to some extent confirms this in that the majority of the responding firms specified growing slowly and remaining independent. Also the

16. Pugh, op.cit., p.125.

17. Ibid., see also Robinson, op.cit., p.80.

TABLE 4-14
FINANCING GROWTH

	<u>Manufac-</u> <u>turers</u>		<u>Whole-</u> <u>salers</u>		<u>Retailers</u>		<u>Service</u>		<u>Total</u>	
	<u>No.</u>	<u>%</u>	<u>No.</u>	<u>%</u>	<u>No.</u>	<u>%</u>	<u>No.</u>	<u>%</u>	<u>No.</u>	<u>%</u>
Building Society	5				2		7		14	6
Development Finance Corporation	7				1				8	3
Finance Company	7				5		4		16	7
Hire Purchase	5						3		8	3
Insurance Company	5		3		3		2		13	6
Loans from Friends and Family	5				2		3		10	4
Mortgage	1				4		8		13	6
Shareholders/Partners	4				2		4		10	4
Solicitors	1				2		2		5	2
Suppliers	1				4		4		9	4
Trading Banks	34	45	12	80	37	60	46	55	129	55
TOTAL	<u>75</u>	<u>100</u>	<u>15</u>	<u>100</u>	<u>62</u>	<u>100</u>	<u>83</u>	<u>100</u>	<u>235</u>	<u>100</u>

sources of funds they indicated using were mostly of a short term nature with trading banks again overshadowing all other sources. The other sources comprised some intermediate finance from sources such as insurance companies, building societies and Development Finance Corporation. Therefore intermediate and domestic sources provide significant amounts of growth and expansion finance which trading banks cannot cope with.

Summary and General Observation

This section has reported the findings of the study with respect to the respondents' planned growth and the sources of finance they would seek in achieving them. A large proportion (61 percent) of the respondents, specified growing slowly and remaining independent. Only 6 percent had any active planning to expand rapidly on the basis of additional funds. The majority of the responding firms indicated that they would seek finance from the trading bank for growth and expansion. Other sources were mentioned, but the proportions were too small to justify any discussion of them.

When compared with other research surveys, it was found that a much smaller proportion of the respondents to this survey were actively seeking growth on the basis of additional funds. For expansion, small businesses require capital to finance additional fixed assets (plant, machinery, buildings etc.) and extra circulating assets (inventory, accounts receivables etc.). Although the choice of sources is virtually the same as in the case of initial financing, small businesses are able to obtain a greater proportion of growth and expansion funds from external sources. This is so because most businesses seeking such funds have been in operation for a reasonable period of time to become settled and recognised in the business community.¹⁸

18. Robinson, R.I., op.cit., pp.36, 81-82.

They also have some record of earnings behind them. Therefore, lenders are more willing and interested in investing in the businesses because they can more objectively assess the risk.

4.7 GENERAL SUMMARY

The characteristics of respondent small businesses were analysed according to the form of legal ownership, location, industry group and number of employees. The largest number of responses was from the Manawatu district. Eighty percent of the respondents were private limited companies. Twenty-three percent were in manufacturing industry, 38 percent in service industry, 33 percent in retailing, and the wholesalers represent six percent. Seventy-three percent of the responding firms employed less than eight employees.

It was discovered that almost all initial financing was provided from owner's savings and their family sources. Respondents reported that some debt financing was obtained, largely from trading banks and credit facilities from suppliers. A similar pattern existed when an analysis of the present capital financing was made. However, trading banks assumed a greater relative importance with about one-third of respondents financing up to 20 percent of their requirements from this source. The other categories of debt sources consisted of hire purchase, leasing, finance companies, and credit facilities from suppliers, which provided some funds. A significant proportion (33 percent) indicated that the sources did not provide sufficient funds for the maintenance of the current level of operation.

On the question of financing working capital and other essential assets, a high proportion (45 percent) indicated trading banks as the main source. Owners were the second largest source of working capital finance. A much higher proportion (85 percent) indicated purchasing their other essential assets, such as plant, motor vehicles and buildings for cash or credit rather than obtain use of the asset by other financing methods.

Sixty-three percent of responding firms borrowed money for use in their businesses during the last five years. Trading banks again feature prominently with 40 percent of the respondents using this source. The next most important sources of borrowings were shareholders and partners (providing finance in 10 percent of the cases), and the hire purchase and lease financing (representing 9 percent). The money was borrowed largely to finance working capital, plant, and motor vehicles.

Since the majority of the responding firms specified growing slowly and remaining independent, the sources of funds they indicated using were mostly of short term nature with trading banks again overshadowing all other sources. The other category of growth finance comprised some intermediate finance from sources such as finance companies, building societies, insurance companies, and credit facilities from suppliers.

When this result is compared with previous surveys, it is apparent that a small proportion of the respondents to this research survey were using owner's savings and credit from suppliers to finance their working capital requirements. In overseas studies it was found that a greater proportion of finance came from these sources. Available evidence does not permit a reliable assessment of the reasons for the differences. However, in New Zealand the banks do satisfy most borrowers demand for short term loans.¹⁹ A similar proportion of the respondents to this survey as in the overseas studies, were experiencing difficulties in obtaining sufficient funds for their business.

The comparative data indicate that a similar proportion of the respondents to this survey used suppliers and

19. Interviews with the Managers of the trading banks.

bank credit as sources of financing their working capital. However, a somewhat smaller proportion as their overseas counterparts, were experiencing difficulties in obtaining working capital finance. When compared with overseas surveys, a much lower proportion of the respondents in this survey were actively seeking finance for growth and development.

CHAPTER 5
ANALYSIS OF FINANCIAL FACILITIES
FOR SMALL BUSINESSES

This Chapter reports the findings of the study on the availability of finance, the problems encountered by small businesses when seeking finance, and the criteria used by some lenders when assessing the financial needs of the small businesses.

5.1 AVAILABILITY OF FINANCE, AND FINANCING PROBLEM

Question 17 asked respondents to comment on the availability of finance and the problems encountered by the businesses when seeking finance. Thirty-five firms gave replies to this question. Some illustrative comments were:

- "(a) Long term finance was sought, but, extremely difficult to obtain. Short term capital was as difficult to get, even if real property was offered as collateral.
- (b) The business has grown about four times during the last two years. However, taxation is crippling our cash position. Funds are hard to get even at 15-20 percent interest rate.
- (c) I have been fortunate in having a parent, who had finance available for lending at a reasonable rate of interest. Also I was lucky to strike two building society ballots enabling me to borrow money interest free. If these funds were not available, I would have been forced to wind up the business.
- (d) We had considerable difficulty in obtaining bank overdraft for normal trading, although we have been in business since 1879, and have a good asset backing per share. We hope to see a day when the banks are more than token lenders of finance.

- (e) Generally bank lending has been very conservative and restrictive. Their ratio between assets and the amount they lend appears to be ten to one.
- (f) Having been in business for twenty-five years, I am fortunate that suppliers have allowed me more credit than perhaps is usual. If this source ceased, I would be forced to close my business.
- (g) In early years of our operation, we experienced considerable difficulty in raising finance, and only succeeded in getting established by cutting to a very basic minimum our own drawings. It seems to us that the little rhyme is true - most banks would gladly grant a loan and in fact they often speed it. The only thing they require is a proof that you do not need it.
- (h) The burden of company taxation, and the need to maintain inventory at a constant level in times of inflation, means little working capital can be provided from profits. There is insufficient outside sources of short term funds available.
- (i) There is a distinct lack of interest shown by trading banks, forcing one to look to higher cost sources. Banks as lending institutions place too much emphasis on the need for financial security before making an advance.
- (j) The rising cost of stock replacement, and increases in wages and rent make it impossible to finance working capital requirements from our trading profits. We are therefore, increasingly looking to the trading banks for more and more everyday working capital, and this is becoming increasingly difficult to obtain.
- (k) Trading banks require disproportionate amount of security.
- (l) We feel that the overdraft limit imposed by the bank is totally inadequate for the volume of our turnover.

- (m) We normally use bank finance, and find it most unsatisfactory because of the conservative limits they place on borrowing - totally inadequate for the volume of our turnover, and the ever present likelihood of a demand being made to reduce the overdraft at short notice."

This section has presented the complaints and experiences of some small businesses on the question of the availability of finance, and the associated financial problems. It is significant to note that almost all comments are directed to bank lending, largely because most small businesses in need of outside financing usually consult their bankers first.

5.2 FINANCIAL FACILITIES FOR SMALL BUSINESSES

This section reports the result of interviews with trading banks, and a finance company on the criteria they used when assessing the financial needs of the small businesses, the facilities available, and the conditions which must be satisfied before a loan is granted.

Size of Firms and Loans

The trading banks assistance to business firms is generally restricted to the working capital needs. Some medium term finance (normally 3 years, 5-7 years in times of comfortable liquidity) is available for purchase of capital assets. Similar assistance is available from the finance company. There was no evidence of any policy restricting loans to businesses because of their size. The banks indicated having no fixed minimum/maximum amount of loan, whereas the finance company does impose a certain minimum, for example \$500 in the case of the company interviewed.

The main lending criterion is the ability of the borrower to pay the principal and the interest as they fall due. Normally banks require at least 40-50 percent owners equity in the firm. Also as a rule banks would grant overdraft facilities equivalent to one-tenth of the sales turnover on a fluctuating basis, that is, the current trading account should be in credit at regular intervals. A variation of this rule is possible depending on the purpose for which the loan is sought. For example, importers in receipt of shipments requiring finance until the goods are sold.

Credit Worthiness and Security

The banks normally rely on their own records, and the borrowers' financial statements for assessing credit worthiness. A strong reliance is placed on the borrowers' business knowledge, on their integrity, and their ability to control all facets of their business. The finance company relies on reports from credit bureaux or other organisations specialising in credit reporting. References from banks and other lenders with whom the borrower has had dealings in the past are also required.

The banks require adequate security to cover the total obligation of the borrower. In the case of private companies, the security comprises a floating charge on all assets, and shareholder/director guarantees, supported by personal securities. Sometimes partly secured, and unsecured loans are given, but these are an exception rather than the rule, and is dependent on the financial strength of the borrower, and the period for which the loan is required.

The main types of securities required by the banks are:

- (a) Life insurance policies
- (b) Equitable mortgage over marketable securities
- (c) Equitable mortgage over building society shares
- (d) Memorandum of mortgage (usually a first charge) over freehold land and buildings
- (e) Debenture over assets including uncalled and unpaid capital. The terms of debenture include the right to appoint a receiver - manager if the loan is not repaid when due or demanded, depending on the terms of issue.
- (f) Mortgage over interest in a Will
- (g) Guarantees from third parties who have appropriate securities to offer.

The finance company requires similar types of securities, for example, debenture, mortgage, lease or hire purchase agreements. There is no specified limit as to the amount of loan, and on occasions 100 percent finance on chattels may be given. Personal guarantees of directors are required for all advances to companies. Sometimes an unsecured loan may be given for an amount up to \$2,000.

Criteria

In addition to a record of continuous trading, the banks require a cash flow forecast on an annual basis. A schedule of current assets and liabilities is frequently sought during the year. The proprietorship ratio is also considered at more frequent intervals. The banks however, pay more attention to the forward projections including cash flow to be achieved in future years. Although not normally required, banks are generally

interested in any form of financial control system or methods of investment appraisal used by the borrowers to determine their specific cash requirements. This has the effect of strengthening the case for a loan.

The finance company requires the latest three year's balance sheets, and if possible forward cash flow forecasts. Like trading banks it is interested in the financial control systems and methods of investment appraisal used by the borrowers to determine their cash requirements.

Costs

The main cost is the interest charge on the loan. In the case of trading banks, the rates of interest vary according to the type of loan, and interest is usually calculated on a daily balance. There are other costs to the borrower, such as an annual overdraft service fee, unused overdraft limit fee, and a loan application fee. The size of the loan and the credit rating has little to do with the rate of interest charged. However, a good credit rating and collateral may qualify for the banks prime lending rate.

The finance company's rate of interest varies from time to time, depending on the availability of funds. A flat rate of interest is charged on the total amount borrowed. Other charges include inspection and valuation fee, legal fee, and documentation costs, usually paid by the borrower.

Proportion of Small Business Loans to Total Lending

The bank estimated that about 10-15 percent (at times higher) of their total advances were going to small businesses as defined in this study. Although no record was kept, there was a feeling

amongst those interviewed, that advances to small businesses were decreasing as a percentage of total advances. The finance company estimated that approximately 10-20 percent of their total dollar lending was to small businesses, and that this figure had remained fairly constant for several years.

Reasons for Rejecting Requests for Loan

The following reasons were mentioned by both the trading banks and the finance company as having an important bearing when rejecting an application for finance:

- (a) Unsatisfactory trading results
- (b) Inability of the borrower to offer adequate and acceptable security
- (c) Inability of the borrower to service the loan
- (d) Insufficient cash contributed by the owners themselves in the business
- (e) Unsatisfactory financial structure (debt/equity ratio) of their businesses

There were a very small proportion of the borrowers who withdrew after the loan negotiation was completed, mainly because they themselves were uncertain of the future profitability.

Impact of Credit Restriction on Lending

The trading banks indicated that credit restrictions since 1974 imposed some limitations on their ability to lend. As a result requests for increases in normal borrowing arrangements, and new loans, were closely scrutinised. A good proportion of requests continue to be favourably received, where satisfactory security is provided and the lending criteria in terms of priorities

imposed by the monetary authorities are met. The curtailment in lending has been proportionately more severe for smaller firms than for larger firms, because larger firms were in a position to offer better security and investment prospects, and were able to service the loan. However, the banks' criteria have always been stringent to all borrowers irrespective of their size, and therefore do not specifically discriminate against a business because it happens to be small.

When restrictions were applied, all businesses (large and small) were equally affected. The banks indicate no falling off in the rate of application for loans despite the restrictions.

The finance company indicated that the credit restrictions placed severe limitations on its ability to lend, though lending is on an increase again. Concurrent with this, there has been a slight increase in applications from small businesses. However there was no stated practice or policy which favoured a large business as opposed to a smaller one.

Export Financing

In line with the Government policy to encourage exports wherever possible, the banks are involved in the provision of financial facilities to small businesses, mainly in pre-shipment working capital, credit references, discounting overseas bills, and extended credit term to enable overseas buyers of the local firms to market the goods before payment. As in other cases, the normal lending criteria must be met. Where everything is equal, export financing receives priority. The size of the business has no bearing on the loan granted. All requests are considered, providing the bor-

rowers' have adequate resources and reserves.

Similar considerations apply in the case of the finance company.

Assistance to Small Businesses

On the question of their ability to assist small firms, the banks indicated that there was an intense competition for funds in the financial market. Therefore, it was essential that bank lending be channelled in investments which offer a reasonable return and sound security. As a consequence it was likely that some small businesses, which would otherwise qualify for assistance from a bank, would be unable to receive credit from this source. They emphasise however, that their ability to lend is restricted by the Government policy (reserve ratio system) and their own ability to attract deposits in face of competition from other sources, such as finance companies and solicitors, who offer higher rates of interest to investors. They suggest an improvement in the economic climate as essential before any further assistance to small businesses may be forthcoming.

The banks also consider that in view of the risk inherent in any business, small firms should provide most of their own capital. Some finance is available from most lending institutions, providing the proposition is sound and borrowers have sufficient equity and are able to service the loan. Where a firm is expanding rapidly, there may be a case for the Government to provide short term loan, depending on the profitability, and where there is an obvious demand for the firm's product particularly in the export field. The finance company offered similar views.

On the question of improving financial facilities for small firms, the following comments are worthy of note:

- (a) "... many small firms enter business undercapitalised, and immediately run into difficulties with working capital ... they are forced to lean on creditors to an unhealthy degree. Lenders have no desire to become major shareholders. Small firms do not properly assess their requirements and frequently have not prepared detailed cash budget."
- (b) "... people who intend entering into business must be made aware of the many facilities already available. Frequently we find that businessmen lack knowledge of these facilities."
- (c) "Small firms especially, tend to come to us with only half the facts and very little concrete information about their past performance. Too few small firms liaise closely with their financial advisers."

5.3 Summary

This Chapter has reported the findings of the study on the availability of finance, and on the financial facilities available to small businesses. The majority of the businesses indicated serious difficulties in obtaining short term finance. They were critical of the criteria some lenders used, particularly the trading banks.

Section 5.2 reported the result of the interviews with trading banks and a finance company on the criteria they used when assessing the financial needs of the small businesses. It was discovered that these institutions, especially trading banks, assist businesses in financing their short term working capital requirements. There was no evidence of any policy restricting loans to businesses because of their size. The main criteria

was the ability of the borrowers to repay the principal and interest when due.

The trading banks normally make their own assessment of the customer's creditworthiness. The finance company in addition to its own assessment, resorted to reports from credit bureaux, and require references from other lenders with whom the borrowers have had previous dealings. All lenders required adequate security, but the requirements of the banks was more stringent. The main cost is the interest charge on the loan. However, other costs such as legal, loan application, and valuation fees are payable by the borrower.

Approximately 10-20 percent (at times higher) of the total dollar lending of the trading banks and the finance company was to small businesses as defined in this study. There was a feeling amongst the lenders of this figure decreasing due to the tight liquidity situation. Apart from the adverse economic condition however, other reasons for refusing loans were in the main, unsatisfactory trading results, inadequate security, and the inability of the borrowers to service the loan. Credit restrictions have placed a severe limitation on the ability of lenders to service all deserving requests for loans. Therefore, those requests which offer better and secure returns receive priority. As a consequence small businesses which frequently lack adequate security, and are unable to provide a better case, suffer.

In line with the Government policy, the lenders give priority assistance to those firms who have export trade or potential export trade. However, other lending criteria must also be met. The

lending institutions state that due to severe competition in the capital market, and the Government policy, their ability to offer assistance to all deserving businesses was severely curtailed. This situation was likely to continue until the present economic situation in New Zealand improved.

The lenders indicated that most small businesses would strengthen their case for loans, if they had adequate equity in their business and were able to provide information regarding their future profitability and cash surpluses to meet the repayments and interest.

CHAPTER 6

SUMMARY AND CONCLUSIONS

6.1 RESTATEMENT OF THE AIMS OF THE STUDY

This research survey was designed to study the financing of independently owned and managed small businesses in the Massey University region. The major purpose of the study was to identify and analyse the sources and types of funds these small businesses use for establishing the business, for continuing operation, and for development and growth.

A review of literature revealed that there was little empirical information available that could be related to small business financing in New Zealand. A research survey was therefore undertaken to gather data from small businesses in the Massey University region on the sources of initial, continuing, and growth capital they utilised at various stages of development.

6.2 SUMMARY OF FINDINGS

Statistics reveal that the great majority of New Zealand businesses are classified as small. In manufacturing alone, 90 percent of the firms may be classified as small, employing 25 percent of the total labour force in New Zealand. Small business also provides a base for innovation, invention, and testing of new ideas.¹

(a) Initial Finance

The major sources of funds utilised in starting a small business were from the owner's and their family's savings. Thirty-three percent of the respondents financed all their initial capital

1. New Zealand Institute of Management. 2nd National Conference of Management Education, May 1975, p.4...2.

capital requirements from these sources. Another 43 percent obtained over one half of their initial finance from these same sources.

Bank credit was the second major source of finance, providing up to 50 percent of the initial funds for 35 percent of the responding firms. A small number of small firms financed up to 30 percent of their initial requirements through credit facilities provided by the suppliers.

(b) Going Concern Finance

Owner's investment and family sources continue to play a major role in the provision of continuing capital to small businesses. About 34 percent of the respondents still provide all their continuing requirements from these sources. Bank credit assumed a somewhat greater relative importance with a significant number (175 firms) utilising this source for up to 20 percent of their continuing requirements. Credit from the suppliers, hire purchase financing, and loans from finance companies were increasingly used, but they still played a minor role in the provision of current capital requirements of small businesses.

A significant group (33 percent) indicated that existing sources did not provide sufficient funds for their current level of operations, mainly short term needs - financing accounts receivables and inventories. The major source of finance for working capital was provided by the trading banks. Forty-four percent indicated using this source. Owners and shareholders/partners were the second major source of finance for 19 percent of the responding firms. The third major source of working capital finance was credit facilities from the suppliers, with 15 percent using this source. Other sources

such as building societies and finance companies were also utilised, but to a minor degree.

A large number of firms (85 percent) reported obtaining use of other assets (machinery, plant, motor vehicles etc.) by outright purchase. A very small number (7 percent) leased or rented the required assets, mainly motor vehicles.

Approximately two-thirds of the respondents borrowed money during the past five years for use in their business. Forty percent mentioned borrowing from trading banks, 13 percent from partners and shareholders, and 12 percent used hire purchase finance. Other sources provided small amounts to an insignificant minority. More than half of the borrowing was to finance working capital needs. Only a third of the borrowing was for purchase of fixed assets, mainly plant, machinery and motor vehicles.

(c) Development and Growth Finance

About two-thirds of the respondents reported plans for growth and expansion on the basis of additional funds. Only 6 percent had any active plans to expand rapidly. A significant proportion (61 percent) specified growing slowly and remaining independent. The major source of development and growth finance indicated by the respondents was the trading bank. About 50 percent mentioned that they would seek finance from this source. About 6 percent mentioned finance companies as a source of their growth finance.

(d) Financial Facilities for Small Business

A small number (35 firms) commented on the availability of finance. These firms indicated having serious difficulties in obtaining finance, mainly

for working capital requirements. They were also critical of the stringent criteria some lenders used when appraising their requests for finance.

Approximately 10-20 percent of the total dollar lending of the institutions interviewed were channelled to small firms as defined in this study. There was no evidence of any policy amongst the lenders restricting loans to businesses because of their small size. In normal times, frequently the main cause of refusal to lend was the borrowers inability to provide adequate and safe security and their inability to service the loan. However, in periods of tight liquidity lenders were more selective, consequently larger firms who were able to offer safer investments, tended to be favoured.

The lenders pointed out that the small businessmen were themselves to blame, as frequently they start their business under-capitalised, and thereby rely heavily on the lenders and their creditors to provide risk capital without becoming shareholders. The lending institutions interviewed were unwilling and unable to provide such capital.

6.3 CONCLUSIONS

After reviewing the literature, a framework for the investigation of the financing practices in small businesses was developed. The research survey was conducted to obtain pertinent data that would allow an assessment of the sources and types of finance small businesses utilised when starting a business, for continuing operations, and for development and growth. The basic questions posed by the study have been answered.

Small businesses in the Massey University region finance most of their initial and continuing capital requirements from the owner's savings and their family sources. This conclusion is almost identical to that found in previous surveys, particularly the overseas ones, in which it was found that owner's investment was dominant in the capital structure of the small firms surveyed.²

In financing working capital, small businesses in the region rely heavily on trading bank credit and to a lesser degree credit from the suppliers. However, the ANZ Bank Survey found that bank credit represented a small proportion of total funds of the businesses surveyed. The majority of the respondents to this survey indicated plans for growing slowly and maintaining their independent ownership. A very small number had any active plans for growth on the basis of additional funds. In overseas surveys it was also found that few firms had any plans to expand and that a sizable number did not negotiate a regular business loan during the years immediately prior to the survey.³

There were numerous potential sources of finance available, but small businesses were actively seeking finance from few sources only. The implication is that small businesses were unaware of the various sources of credit available. The interviews with some lenders confirmed this in that few small businessmen sought professional advice or confided fully with the lenders on their business affairs.

2. Pugh, O.S., Financing 689 Small Business Firms in South Carolina, 1958-59, Columbia, Bureau of Business and Economic Research, University of South Carolina, 1960, p.121, and Kaplan, A.D.H., Small Business: Its Place and Problems, New York, McGraw-Hill Book Company, 1948, pp.140-144.

3. Pugh, op.cit., p.130.

Lenders did not favour larger companies over smaller ones as a matter of policy. They were interested in all borrowers willing and able to meet the normal lending criteria. Small businesses did not seem to be adversely affected by the recent credit restrictions. However, credit restrictions had placed some limitations on the lenders ability to meet all requests for finance. Therefore, those able to offer better security and investment prospects and were able to service the loan received priority.

Arising from the study is an opportunity to undertake further research to discover why small businesses are not utilising the various sources of finance available in the capital market. A real contribution would be a comprehensive study of the ways in which small businesses may be made aware of all forms of finance and the techniques for evaluating the financial implications of their development proposals and the presentation of them to lending institutions.

A Small Business Agency has been established within the Development Finance Corporation. The Agency is expected to "provide advisory services for small businesses and financial support in the form of guarantees".⁴ It is recommended that additional study should be undertaken to determine (1) the areas in which small businesses are in need of specialist advice, and (2) the role of government in the provision of direct finance to small businesses.

4. Evening Post, Wellington, 12 October 1977, p.11.

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APPENDIX 1

A copy of letter sent to participating
small businesses with sample of
questionnaire.



PALMERSTON NORTH, NEW ZEALAND

TELEPHONES 69-099, 69-089.

ML:LMJ

In reply please quote:
25 June 1975

Dear Sirs,

The School of Business at Massey University is conducting a survey of the Financing of Small Businesses in the University region.

Your assistance in completing the attached questionnaire is solicited and will be greatly appreciated by the University.

There is little factual information available as to the methods of financing small businesses in New Zealand. This survey is a first major study designed to provide some data on the subject and it is hoped that the results will prove of benefit to:

- (a) Owners and managers of small businesses who from the conclusion drawn from the comparative studies will get a greater appreciation of the sources and types of finance and criteria in determining their suitability.
- (b) Educational institutions in designing courses and programmes directed to the needs of the small businesses.
As you are aware, Massey University School of Business has been very active in designing and conducting courses on small business management since 1973. Recently the University Council, recognising the need, has approved the establishment of the Management Education and Development Programme. At present over fifty continuing management education programmes are being conducted. The Small Business Management Series occupies a prominent place in our programme.
- (c) Government in formulating programmes and policies relating to small business financing in New Zealand.
- (d) Consultants and others providing management services to small businesses.
- (e) Lenders (banks etc.) in assessing the requirements of the financial needs of the small businesses.

As indicated in the questionnaire, your anonymity is guaranteed and all information contained therein will be treated in strictest confidence. However, a survey report can only be sent to those firms who supply us with their addresses.

If you experience any difficulty in completing the questionnaire and would like clarification of any points, please contact Mr Mohan Lal, Senior Lecturer in Financial Management, School of Business, Massey University.

Would you please endeavour to return the questionnaire as soon as convenient, but to allow sufficient processing time, not later than 31 July 1975.

Your co-operation is greatly appreciated.

Yours sincerely,

George H. Hines,
Professor of Business Studies and
Director, Management Education and
Development Centre

SCHOOL OF BUSINESSQUESTIONNAIRE ON FINANCING SMALL BUSINESSES

Please complete the questionnaire during the next few days and forward it in the reply-paid envelope enclosed to Mr Mohan Lal, Senior Lecturer, School of Business, Massey University, Palmerston North.

There are no identification marks on this questionnaire, therefore your reply will remain anonymous.

Please endeavour to answer all questions - estimates are better than no answer.

Are you a public company, a subsidiary of a public company, overseas-owned or controlled company, farmer or finance company? (please tick one)

Yes ☐ No ☐

If your answer is YES, OR if your number of full time employees is 31 or more, do not proceed, but kindly return the questionnaire in the reply-paid envelope enclosed.

SECTION A - GENERAL

1. Is your firm:
(please tick one)

(a) Private limited company	<input type="checkbox"/>
(b) Partnership	<input type="checkbox"/>
(c) Sole trader	<input type="checkbox"/>

2. Location of your business:
(please tick as appropriate)

(a) Hawkes Bay	<input type="checkbox"/>
(b) Manawatu	<input type="checkbox"/>
(c) Taranaki	<input type="checkbox"/>
(d) Wanganui	<input type="checkbox"/>
(e) Wairarapa	<input type="checkbox"/>
(f) Other	<input type="checkbox"/>

(please specify) _____

3. Number of full time employees (including proprietors):
(please tick one)

1-2	3-4	5-8	9-12	13-16	17-25	26-30	31 or more
<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

4. Category(ies) of business:
(please tick as appropriate)

(a) MANUFACTURER	<input type="checkbox"/>
Type of product	
(b) WHOLESALE	<input type="checkbox"/>
Type of product	
(c) RETAILER	<input type="checkbox"/>
Type of product	
(d) SERVICE INDUSTRIES (e.g. carriers, electricians and contractors, etc.)	<input type="checkbox"/>
Type of service	
(e) OTHERS (please specify	<input type="checkbox"/>
.....	
.....	
(f) Has your firm any export trade?	
Yes <input type="checkbox"/>	No <input type="checkbox"/> Potential <input type="checkbox"/>

It is understood that, particularly where a business has been established for a number of years, some of the questions will be difficult to answer but any help you can give would be appreciated.

How was the business first financed by the present owners? (please tick as appropriate, more than one answer is possible)

		Approximate proportion per cent (%)
(a) Owner's personal savings	<input type="checkbox"/>	<input type="checkbox"/>
(b) Family's savings	<input type="checkbox"/>	<input type="checkbox"/>
(c) Loan from friends	<input type="checkbox"/>	<input type="checkbox"/>
(d) Trading bank loans	<input type="checkbox"/>	<input type="checkbox"/>
(e) Insurance company	<input type="checkbox"/>	<input type="checkbox"/>
(f) Loans from other financial institution	<input type="checkbox"/>	<input type="checkbox"/>
(g) Deposit from customers	<input type="checkbox"/>	<input type="checkbox"/>
(h) Credit from suppliers	<input type="checkbox"/>	<input type="checkbox"/>
(i) Others (please specify)	<input type="checkbox"/>	<input type="checkbox"/>
.....		100%

Which of the following sources of money are at present being used in your business? (please tick as appropriate, more than one answer is possible)

		Approximate proportion per cent (%)
(a) Owners	<input type="checkbox"/>	<input type="checkbox"/>
(b) Members of family	<input type="checkbox"/>	<input type="checkbox"/>
(c) Trading bank loans	<input type="checkbox"/>	<input type="checkbox"/>
(d) Loan from insurance company	<input type="checkbox"/>	<input type="checkbox"/>
(e) Hire purchase financing	<input type="checkbox"/>	<input type="checkbox"/>
(f) Leasing (motor vehicles, plant)	<input type="checkbox"/>	<input type="checkbox"/>
(g) Factoring (selling debtors)	<input type="checkbox"/>	<input type="checkbox"/>
(h) Short term money market	<input type="checkbox"/>	<input type="checkbox"/>
(i) Credit from suppliers	<input type="checkbox"/>	<input type="checkbox"/>
(j) Loans from finance company	<input type="checkbox"/>	<input type="checkbox"/>
(k) Others (please specify)	<input type="checkbox"/>	<input type="checkbox"/>
.....		100%

Do you consider these sources provide adequate funds for your business?

Yes ☐ No ☐

SECTION C - FINANCING

How do you finance working capital requirements - that is funds for essential stock levels, wages, credit to customers, etc.? (please tick as appropriate)

(a) Advances from owner	<input type="checkbox"/>
(b) Advances from partner(s)	<input type="checkbox"/>
(c) Advances from shareholder(s)	<input type="checkbox"/>
(d) Credit from suppliers	<input type="checkbox"/>
(e) Bank	<input type="checkbox"/>
(f) Others (please specify)	<input type="checkbox"/>
.....	

How did you obtain use of your other assets (such as plant, machinery, building (including extensions), motor vehicles, etc.)? (please tick as appropriate)

	<u>Plant</u>	<u>Machinery</u>	<u>Motor Vehicles</u>	<u>Bldg.incl. Extensions</u>
(a) Leasing	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(b) Renting	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(c) Hiring	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(d) Purchasing Cash/or Credit	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(e) Other (please specify)	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
.....				

Did you during the last five years, borrow money for use in your business?

Yes ☐ No ☐

11. If YES, please indicate:

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- (a) From what source (or sources) you have obtained money?
(please tick as appropriate, more than one answer is possible)

- (1) Trading bank
- (2) Insurance company
- (3) Hire purchase and leasing company
- (4) Other finance companies
- (5) Trade creditor (suppliers)
- (6) Private individuals
- (7) Partner(s)/shareholder(s)
- (8) Others (please specify

- (b) The amount and the purpose for which the money was borrowed. (It is understood that some of the questions will be difficult to answer but any help you can give would be appreciated.)

Purpose

Please state the total amount to the nearest
\$100 in appropriate column

- (1) To finance Working Capital

1971 1972 1973 1974 1975

- Stock (for resale)
- Raw materials (for process)
- Payroll
- Others (please specify)
-

\$	\$	\$	\$	\$
\$	\$	\$	\$	\$
\$	\$	\$	\$	\$
\$	\$	\$	\$	\$

- (2) To purchase other assets

- Machinery
- Plant
- Land
- Building (incl. extensions)
- Motor vehicles
- Patent/Franchise
- Others (please specify)
-

\$	\$	\$	\$	\$
\$	\$	\$	\$	\$
\$	\$	\$	\$	\$
\$	\$	\$	\$	\$
\$	\$	\$	\$	\$
\$	\$	\$	\$	\$
\$	\$	\$	\$	\$

12. If a written budget is normally used to forecast your cash position (i.e. cash receipts, payments, surplus or deficit), please indicate the period for which the cash budget is prepared. (please tick)

- (a) Monthly
- (b) Quarterly
- (c) Six monthly

- (d) Yearly
- (e) Budget not normally prepared

13. Please indicate who prepares the cash or other operating budget? (please tick one)

- (a) Accountant employed full time by the business
- (b) Accountant employed part time by the business
- (c) Chartered Accountant in practice
- (d) Others (please specify)
-

14. For your business, which is the most pressing current financial need? (please tick)

- (a) Lack of money for day to day operation
- (b) Lack of money has deferred the purchase of assets
(plant, equipment, motor vehicles, buildings, etc.)
- (c) Neither (business has adequate financial resources)

Which of the following do you plan for your business over the next ten years? (please tick) ¹¹¹

- (a) Stay about the same ☐
- (b) Grow slowly and stay independent ☐
- (c) Grow rapidly and stay independent ☐
- (d) Grow and become a public company ☐
- (e) Sell as a going concern ☐
- (f) Cease to exist (wind up) ☐
- (g) No future plans at this stage ☐
- (h) Other plan (please specify ☐
.....

What outside sources of finance (if applicable) would you look to, in order to fulfil your plan in (15) above?

Please comment further, if you wish to do so, on the availability of finance to meet your business needs. You may also indicate the problems you faced when seeking finance and the conditions (favourable and unfavourable) imposed by lenders.