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Journal of Small Business Finance

Provided in Cooperation with:
The Academy of Entrepreneurial Finance (AEF), Los Angeles, CA, USA

Suggested Citation: Ang, James S. (1992) : On the Theory of Finance for Privately Held Firms, Journal of Small Business Finance, ISSN 1057-2287, JAI Press, Greenwich, CT, Vol. 1, Iss. 3, pp. 185-203

This Version is available at:
https://hdl.handle.net/10419/114636

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On the Theory of Finance for Privately Held Firms

James S. Ang

This paper is a first attempt at differentiating the problems of finance of the privately held small businesses from their larger counterparts. Small businesses, though not concerned with the problems and opportunities associated with publicly traded firms, have different types of complexities, such as shorter expected life, presence of estate tax, intergenerational transfer problems, and prevalence of implicit contracts. Some standard problems like agency and asymmetric information are also more complex. The relatively high transaction costs faced by small businesses in all types of financial decisions also preclude a sizable subset of available choices.

I. INTRODUCTION

Think small.

We, as financial researchers when confronted with potential research topics, have a fixation with resorting to the securities market for answers. Although it is a convenient and sometimes powerful approach, relying on the securities market will not get us very far in understanding small business finance. The requirement of analyzing only publicly traded firms whose share price data are continuously reported in easy to access sources virtually eliminate most truly small firms. To remedy this oversight I suggest that the simplest definition of a small firm is that it is privately held.[1] Even under this restrictive definition, there are millions of firms that may be considered as small businesses, from "mom and pop" operations to high technology firms on the verge of a public offering. I can assure you that at this point there is no single theory of finance that can adequately explain the behaviors of various types of small firms.

Even though I cannot promise you a unifying theory of small business finance, I will do the second or third best thing. I will attempt to give a sketch of what a finance theory for small business ought to be like, i.e., what are its unique determinants? How does it differ from the more familiar financial theory, which is modeled after large traded firms. Since small business

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The Journal of Small Business Finance, 1(3): 185-203
ISSN: 1057-2287
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finance research is a relatively new field, it would be more fruitful to speculate from the broadest set of factors and scenarios than working with a more formalized model with very narrow restrictions.

The paper is organized as follows. First, I discuss the features peculiar to privately held small businesses (Section II). These features, when in combination with standard financial issues such as agency, information, transaction costs, and taxes help determine how small businesses make financial decisions. The determinants of important financial decisions like capital structure, investments, dividends and liquidity management are then analyzed (Section III). Because the relative importance of different factors varies among types of small business, Section IV applies the broad financial model sketched in the previous sections to specific examples of small business types. Section V concludes the paper.

II. THE PRIVATELY HELD SMALL FIRMS

There are small businesses and there are small businesses. A complete taxonomy of privately held small businesses would classify a business based on whether it is a new or established business, how it is organized (proprietorship, partnership, corporation, cooperatives), who controls the voting and decision rights (family members versus outsiders), is it a high or low growth firm, and so on. Obviously, there is no such thing as a typical small business. Nevertheless, most small businesses do share some common features that are not as prominent in larger traded firms. These are as follows.

Integrating Personal and Business Accounts

Owners/managers in small businesses often have to make business and financial decisions on how they would ultimately affect their own personal wealth. For instance, optimal tax planning may suggest the type of organizational form as well as where and when gains or losses are to be realized and the type and mix of managerial compensations at both the business and personal levels. Due to unlimited liabilities (proprietorship and partnership) and incomplete limited liabilities (in the corporation form where lenders require personal guarantee or assets as collateral), business risk is no longer separable from personal risk. Business bankruptcy could cause personal bankruptcy.[2] The amount of the owner's nonbusiness personal assets matters. In case of multiple owners, the severity of agency problems and the potential shift in control are also a function of the relative as well as the absolute wealth of the various owners.

Shorter Expected Life

Compared to large publicly traded firms, small businesses may cease operations for many more reasons. Small businesses can terminate due to the departure or demise of a single individual or the dissolution of a partnership. These problems are further exacerbated by the lack of management depth, absence of a succession plan, and noisy control contest. Thus, there needs to be a greater emphasis on the termination phase in modelling small businesses.

Estate Tax

Heirs to small businesses have to pay estate tax. Although astute tax planning, e.g., early transfer of ownership, and use of ESOP, could minimize the tax bite. Nevertheless, estate tax stands out as a significant item for small businesses, on a par with corporate and personal taxes.[3,4] The incidence of estate tax will not only reduce the value of the business, it may also cause a liquidation of the firm to satisfy tax obligations.

Both estate tax and shorter life span in small businesses tend to increase the number of involuntary liquidation states. This fact will not pass unnoticed by other groups of stakeholders—lenders, suppliers, customers, and employees.

Divergence Between Market and Personal Interest Rates

At least in theory, publicly traded firms are guided by market determined interest rates or required rates of return. Although small businesses can observe the market rates for comparable firms, and on occasion, have to pay market rates for financing, they may not use the market rates for making financial decisions. For instance, an entrepreneur is more likely to take risk than heirs who are more interested in preserving wealth. Thus when faced with the same risky prospect, these two groups of owners may not make the same decision to invest. Other reasons not to rely on the market rate may include over-optimistic perception of opportunities, lack of external funding, and limited outside alternatives to invest excess funds.

The Importance of Informal Relationships

If a large firm is a nexus of contracts among its various stakeholders, then the small business is a nexus of informal relationships among its stakeholders. Owners of small businesses depend on the F-connections (family and friends) for the first source of outside financing. In comparison

to borrowing from strangers, traditional bonds, customs, loyalty, and repeated interpersonal transactions from these familiar sources all contribute to a reduction in agency costs. Small business owners and their stakeholders (local bankers, suppliers, customers and employees) also have more intimate knowledge of each other. This knowledge, which transcends formal financial reports, allows greater flexibility in adjusting the terms of the informal relationships.

Reputation capital has great value. It pays for both parties to sacrifice short term gains or to forego opportunistic behavior. A strong reputation enables a small business owner to acquire short term credit from suppliers and longer term financing from banks, or to secure favorable contracts from suppliers and customers. My conjecture is that the value of reputation to the small business owner is greater when (1) the owner has limited geographical mobility, or specialized nontransferable business skill; (2) there is high frequency of repeated transactions, where the dollar value per transaction tends to be small or moderate; (3) the flow of information among the stakeholders is efficient, e.g., a grapevine in a small community; and (4) there is a strong desire to pass on the business to heirs. Items (1) and (2) insure that gain in a single incident of breach of trust is small and not worthwhile. Item (3) precludes the low reputation type from obtaining alternate sources of funds and item (4) lengthens the relevant horizon of the firm and thus increases the present value of reputation.

Intergenerational Issue

A topic unique to a family-owned business is the intergenerational transfer issue. It refers not only to astute tax planning and ownership transfer, but also to the transfer of goodwill and reputation from one generation of owner to the next. Grooming an heir apparent in training usually preserves and transfers a larger percentage of the intangibles, while lack of an orderly succession plan may lead to the destruction of these intangibles, and a corresponding reduction in the value of the firm. To some extent, retaining the existing management of an acquired privately held small firm allows some of the firm's intangibles to be transferred.

The Role of Two-Party Transactions

Small business owners deal with their stakeholders on a one to one basis, or two-party transactions. The owner's financial strength, gaming, negotiating and bargaining skills could determine the outcomes of the observed financial decisions. The optimal relationships with the stakeholders may vary from cooperation to confrontation. As an extreme example of

cooperation, a small business, when dealing with a stakeholder that values its own reputation capital highly, could voluntarily bond itself via policies that reduce its bargaining alternatives, for example, reduce the number of suppliers it deals with to increase its dependence on them. Elements of gaming may be involved when a cash rich small business under-reports its profitability to reduce the threat of wage increases. On the other hand, window dressing and favoring short term quick results may also be observed to strengthen one's bargaining position. In sum, because small businesses deal with fewer opposite parties vis-a-vis the large publicly traded firms, concerns for gaming and negotiations could play a large role in explaining their behavior, some of which may appear to be counterintuitive at first glance.

Larger Potential for Making Mistakes

Most new small business owners have neither business experience nor training. In fact, most business ideas are pretty mundane; they are neither new nor profitable. Even for established firms, many are not equipped to changes in the business environment. Thus, there is a difference between what they ought to do, what they are capable of doing, what they want to do, and what they actually end up doing. Small businesses magnify a dilemma in financial research: mostly normative theoretical models are being used to explain positive empirical observations. To describe observed practices among small businesses, a researcher has to be willing to accept that small businesses are prone to make mistakes, either due to overconfidence or simply ignorance. For example, an observation of high debt in a firm may not indicate high debt capacity, which is what the theory will say, but rather, it could represent a deteriorating financial condition where a shrinking equity is combined with a debt level that could not be payoff.

Before I leave this section on modelling the peculiarities of small businesses, I would like to mention that standard issues in finance such as agency, information, failure costs, taxes, and transaction costs are no less important for small businesses. Take agency problems among equityholders. It ranges from none in the case of a proprietorship to potentially very serious in a partnership organization without limited liability. Costs of bonding and monitoring vary among different types of small businesses as well. Some lenders have intimate personal knowledge of the small businesses, and others have to depend on more costly on-site auditing. The seriousness of asymmetric information varies quite a bit too. It ranges from the very low, such as among those small businesses whose fortune depends largely on the local economic conditions in which the local banks would have superior

knowledge, to very high information asymmetry, such as in the case of a research-oriented high tech startup where the owners are among the few experts in their narrow field.

It has also been documented that small businesses face higher failure costs, due to the presence of scale economics in bankruptcy expenses, etc. They also face higher transaction costs, for example, in complying with regulations or acquiring or transmitting information. Finally, step jumps in the progressive tax schedules for both business and personal incomes could also cause financial decisions around the jumps to be noncontinuous too.

III. FINANCIAL DECISIONS

In this section, I attempt to give my educated speculations to the following question: What are the determinants to the key financial decisions of small businesses? The purpose of this paper is to initiate the process of thinking about the finance problems of the privately held firms, hoping that more rigorous theorizing and empirical testing may follow.[5] To give a semblance of theoretical modelling, I start out thinking about the objective function of privately held small businesses. Will it be similar to those of the large publicly traded firms where their objective function may be stated as consisting of maximizing three components: (a) current market price, to avoid unwanted mergers and to obtain outside financing in the securities market; (b) long term or intrinsic value, if the two values shall diverge; and (c) nonowner manager's own pecuniary and nonpecuniary incomes from having control rights. Should the absence of marketable securities mean that small firms need not be concerned with current performance and can concentrate on long term value?

My thought on this subject is that, depending on the organizational types and circumstances, there are several admissible forms of objective function for small businesses. The simplest is the profitable small businesses where outside funding is not a major concern. These firms can afford to simply maximize long term value. On the other hand, most small businesses do need outside financing (e.g., banks and suppliers), and are being monitored in some fashion (e.g., Dun and Bradstreet). Current performance, albeit a rather noisy measure, may no longer be unimportant. Thus, a good number of small businesses would have a weighted average objective function consisting of both current profit and long term value. Weight for current profit is expected to be higher for small businesses approaching loan renegotiation, initial public offering, potential sale to an acquirer, signing long term contracts with supplier or customers and possible dissolution of a partnership. On the other hand, its weight will be smaller when the business

is due to pay estate taxes, renegotiate employee contract, discourage a nonmanaging family member from selling their shares, and avoid tax on excess accumulation.[6] Furthermore, since many owners of small firms integrate both business and personal accounts in terms of taxes, compensations, risk exposure and diversification, the complete formulation of the small businesses objective could be quite involved—incorporating schedules of personal and business taxes, forms of compensation and overall portfolio risk. A third, albeit behavior, goal is the "career independence" or the urge to create or build on the part of many entrepreneurs. With these concerns in mind, I discuss how small businesses would make the following financial decisions.

The Investment Decision

Two questions of theoretical interests are: (1) Would privately held small businesses invest too much or too little? In other words, are the marginal projects undertaken by the small businesses more likely to have negative or positive net present value? (2) If they invest, will they favor projects with quick short term or more steady long term cash flows?[7]

The question of over or underinvestment has received more attention in recent literature,[8] where the results are mostly driven by the conflict of interests between the shareholders and the lenders. Although agency conflict of this type could also arise in privately held small firms, over or underinvestment may occur for other reasons as well. To facilitate the presentation I have come up with two listings of factors, one offers the reasons for underinvestment and the other the reasons for overinvestment.

Reasons for Overinvestment

- to avoid taxes on excess accumulation of profit. It may still be rational to accept negative NPV project if the small business could save enough taxes from undistributed profits.
- an entrenched managing partner. An entrenched managing partner invests internal funds to avoid distribution to nonmanaging partners especially when he/she realizes the control benefit which may be a function of the firm's size.
- overconfidence and miscalculations. Small businesses often lack the complete set of requisite skills (such as production technology or marketing channels) to realize the full NPV of a not-so-simple project. Unfortunately, they often underestimate potential difficulties and overestimate their ability to tackle these problems, i.e., they assume that they are in the shoes of a much larger firm with more experience, depth and breadth in various skills.

- low cost of funds. Some business owners manage to obtain funds from family members and friends at below market, if not subsidized, interest rates (at equilibrium, implicit interest costs based on a long term relationship should be just as high as premiums on market rates). This artificially low interest rate could distort the investment decision to invest too much.

Reasons for Underinvestment

- no or partial limited liability. Small business owners could face personal bankruptcy in the case of proprietorship or general partnership, and in the corporate form when personal assets are pledged to secure loans. Depending on the size of personal worth, its covariability with the project, and the owner's willingness to take risk, a small business owner may underinvest in low to moderately risky projects, but overinvest in very risky projects. This is because for low to moderately risky projects, personal worth is at risk. Since small businesses are often a one project firm, the risk of lack of diversification could be substantial. But for the very risky and very profitable project, potential loss far exceeds personal worth, and a valuable limited liability is again restored regardless of its organizational form.
- attempting to solve agency problems in partnership. The partnership form has probably the most serious agency problems. Just imagine the harm a managing partner can impose on the unlimited liability silent partners via reckless risky investments. Thus, to protect their personal wealth from the managing partner, the nonmanaging partners would put restrictions on the former's ability to invest. The restrictions may screen out bad projects as well as good projects, i.e., some positive NPV projects may not be undertaken.
- high cost of external funds. Small businesses face a large discrete jump in the cost of funds when moving from the first sources of own savings and borrowing from family members and friends, to venture capital and out of town financial institutions. The presence of high transaction costs, asymmetric information between the owners and the outside capital suppliers, such as in the case of a new technologically sophisticated product, could cause a large wedge between the cost of funds perceived by the owners and by the capital suppliers.
- unwilling to dilute control. Small business owners do derive pecuniary as well as nonpecuniary benefits from maintaining control. Furthermore, there is also the desire to be able to pass on the business to their heirs. Thus, when faced with highly profitable but very large investment projects requiring outside financing that could result in

the dilution of their control, some owners may forego the projects. And if the idea for a project cannot be sold, licensed, or subcontracted, then it is lost.

- lack of resources. A problem of being small is that these businesses do not have the full range of managerial expertise for more involved projects, the breadth to diversify into unfamiliar areas, or simply the management depth to take on a large scale expansion. Thus, there is a gap in the NPV for the same project calculated for a well-staffed large firm and a small firm with an incomplete management team. Some positive NPV projects for the large firm will appear to be negative for smaller firms and they will not be undertaken.[9]

The second issue of interest concerning the investment behavior of small businesses has to do with the question of whether they will favor short term but high payback (myopic) or high NPV but longer term projects. The answer depends on the objective function of the small businesses as discussed earlier, the need for outside financing, and imperfections in the financing market. On one hand, a cash rich small business can afford to invest in a long term value maximizing project. On the other hand, new firms that need to create an impression of being profitable, firms on the verge of initial public offering or debt renegotiations, firms that need cash to fund future more profitable projects where available financing may be uncertain, would all favor projects that give quick short term returns.

The Financing Decision

Small businesses use different sources for financing. In addition to the owner's own savings and, family and friends, they also obtain financing from suppliers and advances from customers. Leverage ratio calculated from traditional financial reports is biased for several reasons. First, the role of quasi-equity is not recognized. Quasi-equity are debts held by individuals or institutions that have an implicit understanding with the small business owners (1) not to exercise the right to force bankruptcy when interest payments are delinquent, and (2) to share some residual claims when the firm is returned to profitability. Thus, equity (liabilities) is understated (overstated). Second, owners' true equity contributions due to subsidized or reduced salary, low cost or free labor from family members, owners' loan to the business, owners' assets (used by the business or for loan guarantee but not recorded in the business financial statement), and owner's intellectual property, are also underestimated. This effect is probably more important for firms in the early stages of their life cycle. Third, some asset and liability items are often not reported. The most important item in this category are

leased assets. In addition to the lessor's economies in purchasing and disposing of assets, small business owners find the leasing (renting) cancellation option to be attractive. The cancellation option provides small businesses with the ability to terminate two commitments—asset ownership and financing—that are not normally present in a borrow and purchase alternative. It is advantageous for a small business because they often make mistakes, and leasing is the least costly way to undo a mistake. It also provides limited liability even where it is usually not possible in organizational form, such as proprietorship or partnership.[10] Furthermore, the possibility of mispricing by leasing companies, for example, charging the same rate for all types of businesses, may make leases attractive to small firms that otherwise would find alternative sources of financing too expensive. Fourth, equity may be overestimated due to failure to account for the potential liabilities such as estate tax. Thus, the usefulness of the simple debt to equity ratio for small firms as a tool for analysis is much reduced. Having these effects on the definition of the small businesses leverage ratio in mind, I list below the factors that may explain debt to equity ratios among small businesses.[11]

Reasons for Higher Leverage

- value of reputation and informal relationship. Agency costs are reduced for lenders and other capital suppliers who are personally familiar with the owners. Monitoring as well as information acquisition are lower in this case too. For instance, business transaction related debt such as accounts payable, prepaid receipts, etc., could cost less than other external sources of funds.
- no or partial limited liability. Interestingly, lack of perfect protection from liability makes the lender more willing to provide financing because small business owners would have to put up personal assets, implicitly or explicitly, as collateral. It serves as a good bonding mechanism within limits. The limitations are: (i) when compared to assets in the firm as collateral, lenders cannot monitor the use and disposal of personal assets. Thus, the value lenders can claim is also less certain; (ii) when lender's loss exceeds claimable personal wealth, limited liability is again restored to the borrower/small business.
- fewer lenders. Small businesses tend to have fewer lenders. The fewer the number of lenders, the less is the conflict among lenders in case of default. Disagreements among the lenders are often a major source of bankruptcy costs, in terms of higher administrative bankruptcy costs and dissipation of firm value due to delayed resolution. In the case of one lender, the lender would simply take over the firm at no bankruptcy

expense. The reduction of bankruptcy costs induces more debt from the lenders.

- quasi equity and unreported equity. Quasi equity, or financing provided by family and friends, and unreported equity, owners various contributions, are expected to give the firm more capacity to acquire outside debt.[12]
- risk taking and overoptimistic entrepreneurs. By virtue of self selection, entrepreneurs who are willing to start a new business and sacrifice stable employment and leisure are more prone to take risks, and possibly, more optimistic too. Although there is no assurance that they will obtain the funds they want, they will most surely take as much as they can get.

2. Reasons for Lower Leverage

- tax disadvantage. The combined business and personal incomes of many small business owners are at the low end of the progressive personal and corporate tax schedules. Since they borrow from institutions or wealthier individuals in a higher income tax bracket, the tax deduction they receive from borrowing will not be adequate to offset the gross up-in-interest expense to compensate the lenders' personal taxes on interest incomes, i.e., the net tax shield is negative. Thus, in contrast to larger firms, taxes actually favor less not more debt for small business.
- desire to maintain control. As discussed earlier, small businesses that want to keep control in the family may forego large scale expansion that requires outside financing. Consequently, leverage would be low for these firms.
- minimize agency costs. Since unlimited liability in a partnership is potentially costly to the nonmanaging partner when the partnership uses debt, a way to neutralize this source of risk is no or low debt.
- owners' risk aversion. The combination of lack of diversification on their personal portfolio (the possibility of unlimited liability and high personal bankruptcy costs) make some owners hesitant to acquire large amount of debt. However, if the extent of the entrepreneur's risk aversion is known to the lender, the amount of debt the firm is willing to carry could be a credible signal of the entrepreneur's expectation.
- high cost of bonding and monitoring. Beyond the sources of financing that are personally familiar with the owners, most lenders find monitoring a large number of small business a rather expensive proposition. Some owners of new small businesses simply do not have much to offer as a way of bonding. Thus, higher monitoring and bonding costs translates into higher cost of fund and less debt.

- minimize estate tax. Estimating the values of small businesses involves a wide range of uncertainties. Small business owners and their heirs have the incentive to report a lower estimate of their businesses worth as the basis for estate tax. In addition to trading off short term for long term earnings, a small business may effectively use less debt to bias the estimate. The underlying idea is as follows: If the value of the small business could take on a wide range, say, from a high value (u) to a low value (l), only the owner knows its true value. And if the owner of a high value small business acquires debt, d_u, close to its high value, it appears to the court as a high value firm since the amount of debt establishes a floor to the value of the firm. In other words, if the firm is not worth u, the lender would not have lent d_u. Thus, the lender unwittingly provides the court a free valuation. Therefore, to mislead the court, a high value firm would use low or no debt and be priced at no worse than the average value, ($[u + l]/2$).[13]

Finally, standard factors affecting leverage such as higher bankruptcy costs, greater asymmetric information and the corresponding lesser ability to signal could all cause small businesses to acquire less debt.

The Dividends Decision

In analyzing small businesses, it is more fruitful to expand the topic of dividends decision to one of total cash flows to and from the owners. Thus, it includes the owner's contributions, various forms of compensations including company-provided perks, loan to or from the officers, as well as remittances from profit earned. An attempt to minimize overall taxes, for example, may dictate that the owner uses the business account for personal expenses rather than to consume out of dividend, like driving a car registered under the company's name. The owner's subsequent equity contributions may be viewed as negative dividends, which may serve a signaling purpose to outside fund suppliers. Better still, owners may also label their contributions as loans to the firm.[14] They can take a deduction at the corporate tax rate on interest paid, which is not possible for dividends. Furthermore, there could be an arbitrage gain if the owner's business tax rate exceeds his personal tax rate.

To facilitate comparison with the large publicly traded firms, I list below the determinants of dividends for small businesses.

Reasons for More Dividends

- as a solution to agency problems. In small businesses with many owners, managing partners can substitute perks for dividends while

nonmanaging partners get nothing. Thus, in spite of a possible tax penalty on distributed dividends, nonmanaging partners would demand dividends. After all, after-tax dividends is better than nothing. Therefore, it is not unusual to find a full payout or a specific dividend policy written on corporate charter or partnership agreement.

- tax. Shareholders of a subchapter "S" corporation being taxed as individuals, have to pay tax on undistributed profit. A 100% payout is indeed expected.[15]
- for consumption by heirs. Lack of a ready market and unwillingness to lose their proportional influence in the family business cause heirs to prefer dividends. Receiving taxable dividends for consumption may not appear to be irrational if (1) dividends distributed from profit reduce the power of the dominant family member in the business and (2) maintaining proportion shares is strategically important in the game of control, e.g., obtaining a proportional shares of merger premium offered by an outside bidder.

Reasons for Less Dividends

- tax minimization. As shown in the discussion above, owners of some small businesses, e.g., "C" or regular corporations, could reduce overall taxes via other forms of distributions, such as interest payments, and substitution of business for personal expenses as tax deductible perks. This flexibility is not possible with a large firm with many shareholders.
- to provide internal financing. Asymmetric information, transaction costs, and lack of access to the securities market make some small businesses with growth prospects rely more on internally generated funds. The result is less dividends in the current period.

The Liquidity Decision

The question of interest here is whether small businesses keep more or less liquid assets, i.e., slacks.

Reasons Favoring More Slacks

- to guard against uncertain termination. Small businesses face uncertain termination in more states of nature than larger firms. Slacks or more liquid assets are often needed to avoid liquidating fixed assets in the following contingent events: unscheduled dissolution of partnership, payment of estate tax, or buyout of departing partners.

The situation is made more serious due to small businesses high earnings variability and lack of market valuation—the high cost of being illiquid.

- to reduce risk of premature liquidation. When asymmetric information is severe, a temporary shortfall of cash from operations, below the level required to satisfy debt obligations, may induce the lenders to initiate the bankruptcy proceeding in some cases. Reserve of excess liquidity that can be called upon to make up the shortfall would avoid premature liquidation. Thus, riskier but ultimately profitable firms are expected to hold excess liquidity. Here, liquidity rises with the amount of debt and the potential for difference in expectations between the lenders and the firms.
- to strengthen bargaining position. Small businesses could strengthen their bargaining position against adverse stakeholders in several ways:

  (i) slacks enable the firm to pay off banks, suppliers and other creditors and thus avoids closer monitoring or restrictions on its ability to make business and financial decisions.

  (ii) the presence of slack also allows the firm to flex its muscle, or show it has the resources to outlast the other party in the negotiation (e.g., labor) or to shop for an alternative source of supplies or funds.

Reasons Favoring Less Slacks

- to use other least costly substitutes. Small business owners could, instead of keeping slacks in the business, store slacks in their own personal account. Although both excess liquidity at the personal and the business accounts could be called upon if needed, the personal account has the added advantage that additional contribution of its slack is voluntary (or it may be viewed as an option which the owners may decide not to exercise).
- to reduce agency costs. Small slack reduces the potential for agency costs in a partnership, i.e., managing partners would have fewer excess funds for perks. Unfortunately, assets that are too illiquid increase agency costs from the owners to the lenders. Illiquid assets that have low liquidation value from second best use 'lock in' the lenders, and could cause them to accept a partial loss on a bad loan in preference to outright liquidation.

Finally, before leaving this section, I would like to discuss the effect of not having marketable securities on the financial decisions made by small

firms. Without an objective market valuation, exit by partners or shareholders represents a major agency problem that can waste a large portion of the firm's assets in a dispute. A solution, albeit not optimal ex post, is for all the owners to pre-commit to a formula in calculating the exit price, for instance, five times the last three years average earnings. On the positive side, a privately held small firm need not be concerned with short term fluctuations in share prices, and sometimes, with financial performance. However, even if they may not have to use costly signals to resolve the asymmetric information with shareholders, they would still have to find other ways to signal to the stakeholders (creditors, customers, employees) such as via the amount of owner's contributions.

IV. A SUMMARY OF PREDICTIONS FOR VARIOUS TYPES OF SMALL BUSINESSES

There is no typical small business, consequently, there is no single prescription for financial decisions of such businesses. Attempts to explain observed behaviors of small businesses depend on the type of small businesses and their special set of circumstances. Following, I list several small business types and briefly discuss their main financial characteristics.

Entrepreneurs in High Tech Firms

Entrepreneurs in new markets or with new products such as high tech firms, are by selection risk takers and self-confident, otherwise they would not have given up a secured job with steady income. They are also resource-poor relative to the cash demands of the business. Those without a proven track record experience the most difficulty in securing financings, i.e., the probability of obtaining outside financing is low. Thus, in the short term, their overconfidence and overoptimism will cause them to overinvest (personal wealth, own time and energy, and business investment), and their concern with establishing a track record induces them to choose suboptimal projects with short term payoffs. As the values of these firms depend on their future growth opportunities, outsiders cannot easily distinguish the values of the truly high-growth from those of the mediocre or average firms. Furthermore, all entrepreneurs, good or bad, make the ultimate sacrifice, to quit their jobs and invest all their own monies as well as their F-connection monies, and good firms with limited ability to signal are bound to be undervalued, i.e., pay higher interest rate or receive lower price for securities. Their lack of financial resources will also bias downward the value of projects with multiple options in future periods as there could be future states of the

world where they would lack the requisite fund to exercise a profitable investment opportunity. Excess liquidity is desired but generally less available.

Founders in Established Firms

These firms have a good track record. If they are profitable, they would have the deep pocket to maximize long run value. They could also use the corporate form to minimize overall (corporate and personal) taxes, or maximize after-tax personal consumption. They would want to have a succession plan and groom a successor as early as possible to transfer the business's goodwill and reputation. Careful planning will also minimize estate tax. A less successful firm on the other hand will have a different set of problems. For instance, lack of attractive employment opportunities often means that small business owners with or without outside debt would delay termination or sale of their business beyond the optimal time. If the consequences of declaring business failure is large, i.e., the possibility of establishing a new business is nil, then, there is an inducement to invest in very risky opportunities. In the unlikely event of success, the business not only ensures survival, it also establishes a more favorable track record for future financing.

Family Controlled Firms

Small businesses whose family members control the majority of voting shares may or may not value control. If they value absolute control, they may underinvest to avoid outside financing. Excess liquidity, either in the form of slack or preferring more liquid assets, may also be observed. On the other hand, if relative control is important, family members would prefer to receive taxable dividends for consumption rather than dilute their relative share via sales to other members, to avoid a change in the balance of power in the family.

Partnership

Agency problems could be very serious in a partnership type of arrangement. The managing partner may not only consume excessive perks but could also take excessive risk at the expense of the silent (non-managing) partners' unlimited liabilities. One would expect the non-managing partner to either spend resources to monitor or put restrictions on the activities of the managing partner. Contractually specified restrictions include 100% dividend payout and zero slack to minimize opportunity for perks, and no

significant debt to reduce risk of unlimited liability. Thus, depending on the protection accorded the non-managing partners, the investment decision for a partnership could range from a very risky overinvestment to a very conservative underinvestment policy.

Small Businesses in Transition

Small businesses on the verge of approaching outside sources, e.g., venture capitalists, lenders, or other investors, may take on entirely different behavior. They would need to project as high a market value as possible, whether asymmetric information is or is not the reason for difference in valuation. They would conduct window dressing, e.g., reporting liquid assets, more favorable earnings, etc., or show a preference for short term projects with early cash flows.

Franchises

The franchise organizational form solves several financial problems. With the owner/franchisee's own money at stake, agency cost is minimized. To the lenders, the franchisee's use of borrowed funds is well-defined, thus reducing the risk of asset substitution. Moreover, part of the monitoring function is performed by the franchisor, which the lenders can free ride and pass on the savings on credit investigation and loan monitoring costs to the franchisee by reducing the cost of financing. Franchising is also a cost effective way to transfer the track record or reputation of the franchisor to the franchisees.

V. SUMMARY AND CONCLUSIONS

This paper represents a first attempt at differentiating the problems of finance of the privately held small businesses from their larger counterparts. Small businesses, though not concerned with the problems and opportunities associated with publicly traded firms, have different types of complexities, such as shorter expected life, presence of estate tax, intergenerational transfer problems, and prevalence of implicit contracts. Some standard problems like agency and asymmetric information are also more complex. The relatively high transaction costs faced by small businesses in all types of financial decisions also preclude a sizable subset of available choices.

The finance problem for small businesses is indeed very rich. There is no single prescription for the optimal financial decision for different types of small businesses—startups or new ventures versus established or matures

ones. Once this fact is recognized, the challenge for the finance researcher is to, on the one hand, provide a more detailed theoretical model and empirical testing for each type, and, on the other hand, to continuously synthesize the results of small businesses in general.

Acknowledgments: This paper was presented as the keynote address of the Third Annual Symposium on Small Business Finance. I appreciate Charles Ou, Jerry Osteryoung, and two anonymous referees for valuable comments.

NOTES

1. Admittedly, there are a few very large privately held firms. Still, they are not well-analyzed and since they do share several common features with small privately held firms, some of the results on the latter group may also be applicable to them as well.
2. In contrast, corporate level risk taking (business and financial) is separable from personal risk taking for large incorporated firms.
3. Charles Ou pointed out to me that only 10-25% of successful business owners "consider" transferring the business to their heirs. Most simply wanted to sell and thus incur capital gains.
4. Estate tax on small businesses differs from capital gain tax of publicly traded firms in both magnitude and timing. Estate tax, to be incurred at the demise of the owner, is often not reflected as a contingent item that reduces the equity account. Capital gain tax on the other hand is reflected in the pricing of shares. Even random sales of shares to pay for estate tax will not cause the publicly traded firm to liquidate.
5. See Yazdipour and Constand [8] for an extensive list of reference on small finance research.
6. Tax on excess accumulation of profit in theory is equally applicable to both large and small firms. But in reality, it applies almost exclusively to small firms.
7. I do not discuss here the profitability of small business investments. Except for a few truly superior opportunities where small businesses offer unique product or service with large potential demand, most investment decisions involve imitation of existing businesses where success is a function of the owner's familiarity of the local conditions and efforts.
8. See, for example, Myers [4] and Berovitch and Kim [3].
9. Of course, the unwieldy coordination and communication problems in large firms could cause them to forego many positive NPV projects as well.
10. There have been several noteworthy works on small business financing. See, for example, Bates [2], Ou [5] Stoll, Whaley and Day [6] and Walker [7].
11. In contrast, the rationale for cancellable lease to large firms involves the possibility of jumps in technological innovations in the same class of equipment.
12. Although the real effect is to increase the supply (dollar amount) of debt, not incorporating quasi equity debt to equity ratio would appear to be too high.
13. The low value firm has no choice but to follow suit in this situation of minimizing valuation for estate tax.
14. IRS imposes a limit, albeit a rather high one, on the allowable ratio of this type of debt to equity.

15. Nonetheless, an 'S' corporation could still use undistributed after-tax profit as a source of internal funds, a combination of dividend payout, pay tax on dividends, and reinvest proceeds.
16. In an earlier paper (Ang [1]), I pointed out some unique characteristics of small businesses in general, and urged the investigation of different approaches to model small businesses.

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