TRADITIONAL AND BOOTSTRAP FINANCING OF SMALL FIRMS

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Abstract

Problems related to financing are dominant in the small firm. Finance the operations of their enterprise is one of the most important decisions of small businesses.

The success of small firms depends on their ability to identify and access sufficient and levels of capital. Small businesses differ from larger firms in terms of capital structure decisions. Their reliance on private markets limits the types of financing they can receive.

Small firms are faced with unique issues related to access to capital markets, availability of capital, and knowledge of financing alternatives. Besides traditional sources of financing, managers of small business can also use financial bootstrapping methods, which are referring to methods used to the need for resources without relying on long-term external finance.

Keywords: small firms, traditional financing, bootstrap financing.

INTRODUCTION

In recent years, interest in small and medium enterprises has increased significantly. Small businesses have received much attention from policy makers and researchers, in that these businesses are considered important for economic growth and job creation. Much of the attention of the smaller firm has focused on capital structure decisions, because problems related to financing are dominant in the small and young firm. Empirical studies describing inadequate financial resources as a primary cause of small and medium enterprise failure (Gregory, Rutherford, Oswald, Gardiner, 2005).

One of the most important decisions that entrepreneurs make is financing the operations of their enterprise. Financing decisions are among the most important and challenging issues faced by small firms. Financing for a business usually comes in two forms: debt and equity. Debt is obtained from borrowing and must be repaid from cash flow. Equity is contributed by owner or outside investors and involves no direct obligation to repay any funds, but does involve selling a partial interest in your company.

For small business, the largest source of financing is the owner. Sources of capital appear difficult to obtain for small business without significant personal wealth, either for direct investment or as a commitment to secure financing. Without capital, small firms could not operate regardless of the region of the world in which they operate. When outside funding appears to be limited, bootstrap financing as the use of methods to meet the needs for resources without relying on long-term external finance, is an alternative way. Bootstrap financing methods are probably the most common financing link between firms throughout the world (Carter, Auken, 2005)

CHARACTERISTIC OF SMALL FIRM FINANCING

Osteryoung and Newman described the historical development of the definitions of small business from the nineteenth century to the present. They emphasize that the definition of small business has changed over time. Common variables used to define what is a small business include criteria based on number of employees, annual sales, amount of assets, management structure or industry dominance. They defined a small business as a firm (1) that does not have existing publicly traded common stock and (2) in which planned financing must be personally guaranteed by the owners (Van Auken, Neeley, 1996).

Small businesses are assumed to face major problems in securing long-term external finance, which is regarded as restraining their development and growth. Several studies have referred to the financial gap facing small businesses, in terms of problems in attracting long-term finance from market actors such as banks and venture capital companies (Winborg, Landstrom, 2000).

The financial gap for small businesses can be explained by the information asymmetry between external financiers and small business managers. Small business managers most often possess superior information about the potential of their own business. Furthermore, in some situations, such as in young innovative businesses, it can be difficult for the business managers to articulate and to give as detailed information about the business as the financiers want. Additionally, some small business managers may be restrictive when it comes to providing external financiers with detailed information about the core of the business, since trade secrets, in one way or another, may leak through to competitors. This implies that financiers face problems in finding the information they need, and as a consequence they experience great uncertainty. On the other hand, financiers may possess superior information on the aggregate level about the potential of the whole industry as such. The problems of information asymmetry are, in other words, not one-sided. The information asymmetry between the external financier and the small business manager in turn increases the costs of handling the financial transaction. High transaction costs arise because of the need to organize, carry out and monitor the exchange in such a way that the information asymmetry can be reduced (Winborg, Landstrom, 2000).

Small firms are faced with unique issues related to access to capital markets, availability of capital, and knowledge of financing alternatives. Capital structure decisions may be affected by small business owners' lack of information about capital alternatives and access to capital markets. Lack of business skills also may create a negative image of the firm among providers of capital and, thus, may affect an owner's ability to raise capital. Factors such as stage of product development, risk, availability of capital, firm type, ownership structure, and sales history affect the availability of sources and amounts of external capital. The entrepreneur's ability to raise capital is affected also by the investment preferences of the providers of capital. Equity investors, for example, are interested in return on equity, while debt investors are interested in the borrower's ability to repay the loan (Van Auken, 2005).

As noted before, several studies have noted smaller firms' lack of access to the capital markets. The difficulties associated with smaller firms' acquisition of capital can result in illiquidity and cash flow problems. The financial distress caused by the constraints and obstacles of capital acquisition results in many smaller firms being unable to respond to market demand. The inaccessibility of the financial markets has resulted in some small firms carrying high levels of debt and stretching accounts payable. The characteristics of small firm have an important impact on their ability to raise capital. Factors such as stage of product development, risk, availability of capital, firm type, ownership structure, and amounts of capital that are the most appropriate to pursue. Managerial preferences, risk tolerance, and firm characteristics are important factors affecting the firm's acquisition of capital (Akyuz, Akyuz, Serin, Cindik, 2004).

TRADITIONAL AND BOOTSTRAP FINANCING

Financing a business is a simple enough concept. A firm must have adequate funds to enable your business to begin operation, expand operations, or even to continue operations. Funds are needed for a variety of purposes and they must come from somewhere. Basically funds for financing business operation come in some variation of equity and debt. Equity is funds permanently invested in the business, and debt is funds which are borrowed for business purposes.

Small firm capital acquisition commonly begins with investment from personal equity such as personal savings, cash value of life insurance, home equity, sale of personal assets, and heritance; and loans such as loans from financial institutions or loans from friends and relatives (Van Auken, 2004).

Traditional theories of capital acquisition assume that companies will raise capital in a manner consistent with finance theory. The relative costs of debt and equity will affect owners' decisions regarding financing strategies. Access to capital markets is an assumption underlying the ability of owners to raise capital (Carter, Van Auken, 2005). Traditional financial theory assumes that firms should build a capital structure that maximizes shareholders wealth. Wealth maximization is an over-simplification of the goals of the owners of small firms and that the acquisition of capital is jointly determined by internal and external factors (Van Auken, 2004).

Funds for financing business operation come in some variation of equity and debt. Equity denotes funds which are permanently invested in the business and provided by the firm's owners, and debt denotes funds which are borrowed for business purposes.

Some sources of funds are traditionally used for each different purpose. Small businesses need various types of financing for different purposes. Small businesses can divide their lending into three categories: short term, intermediate term, and long term. The loan can be either backed up by collateral, or just is backed up by the bank's faith in their credit and capability of repaying the loan. In this case, as once the debt is repaid the lender has no further claim on their business. It means debt financing has advantage that it allows the business owners to retain control of their company.

In the case of equity financing that involves no direct obligation to repay any funds, it means that business owners do not have to repay the money invested on a regular basis. The equity investors themselves have an interest in the success of the business and it impacts their involvement on how to make improvement in business.

The role of traditional financing on small businesses operation as described above means that traditional sources of capital include funds from personal savings and borrowing from financial institutions. Entrepreneurs who are unable to raise adequate amounts of capital from traditional sources may attempt to raise additional capital from alternative sources. Commonly referred to as bootstrap financing, these alternative sources of capital are often important to the launch of the new firm and to support growth strategies. With bootstrap financing, capital acquired from sources other than traditional providers of capital (Van Auken, Neeley,1996).

Alternative sources of capital become important to the financial strategies of small firms when financial resources appear to be limited. If small firms face a problem in obtaining external finance, they should rely more on their internal funds in financing their fixed investment, for example they have a tighter liquidity constraint than large firms (Chow, Fung, 2000). Bootstrap financing provides financing alternatives to small firms that are confronted with the lack of access to traditional sources of capital. Bootstrap financing commonly refers to financing methods other than the traditional debt from financial institution and personal equity (Carter, Van Auken, 2005).

Most small business managers handle the need for resources using means other than external finance by applying different kinds of financial bootstrapping methods. Financial bootstrapping refers to the use of methods for meeting the need for resources without relying on long-term external finance from debt holders and/or new owners (Winborg, Landstrom, 2000). Freear, Sohl, and Wetzel defined bootstrap financing as "highly creative ways of acquiring the use of resources without borrowing money or rising equity financing from traditional sources" (Van Auken, Neeley,1996). As Bhide (1992) stated that the use of bootstrap financing can force firms to solve problems that otherwise would remain hidden and unresolved.

A large number of firms use such financing schemes that are different from traditional methods. Bootstrap financing sources include all sources of capital used after personal savings and loans from financial institutions are either exhausted or are not available, such as loans from friends and relatives, credit cards, home equity loans, life insurance, supplier credit, leases, and customer financing. These methods are often important in providing the required capital base to support companies' operations and growth. Some methods may be highly creative (such as specialized leasing arrangements) while others are less creative (such as credit cards). A large number of firms use such financing schemes that are different from traditional methods. These methods are often important in providing the required capital base to support companies' operations and growth (Van Auken, Neeley, 1996).

Bootstrap financing can either supplement or substitute for traditional sources of capital. Some forms of bootstrap financing must be planned, while other forms arise from the normal operations of the business, such as accounts payable, while other sources must be planned, such as sharing equipment. Owners of small firms can develop comprehensive primary and contingent financial strategies if they have better and more complete information about all sources of capital.

Traditionally, it has been argued that is evidence of credit rationing; small firms are using trade credit and pay late because the supply of bank finance to them is restricted (Howorth, 2003). Stretching accounts payable is sometimes suggested as a reasonable strategy for a firm as long as it does not damage its credit rating. The firm can pay accounts payable as late as possible without damaging the firm's credit rating, and the same time consider to take advantage of any favorable cash discounts. This strategy is financially attractive, but the firm have to notice an important ethical issue, because it may cause the firm to violate the agreement it entered into with its supplier when it purchased merchandise.

Small firms can also utilize accruals as another common spontaneous source of short term financing for a business. Accruals are liabilities for services for which payment has yet to be made. For example, the firm can delay tax payment. By increasing accruals in this way the firm can save some amount of money.

Another bootstrap financing category is minimizing accounts receivable. It can be done by speeding up, or accelerating, the collection of accounts receivable as quickly as possible without losing future sales due to high-pressure collection techniques. If they are economically justifiable, cash discounts may be used to accomplish this objective. This is desirable because accounts receivable tie up money that could otherwise be invested in earning assets.

Short-term funds through traditional commercial bank loans or lines of credit are not always available to emerging businesses. They typically lack sufficient credit history or liquidity ratios to meet benchmarks required by large banks. A growing number of start-up enterprises are turning to receivables factoring at small community banks and non bank factoring institutions. Factoring is also another common financial technique that can be utilized. This technique frees up money that would otherwise be tied to receivables

Factoring accounts receivable has many advantages for small, growing firms. Factoring receivables allows a company to purchase more inventories to keep up with growing sales or perhaps take advantage of supplier discounts by reducing payables early. Factoring receivables also allows a company to increase its capital without taking on additional debt or contributing more equity. This can result in improved credit ratings resulting from prompt debt repayment. Factoring accounts receivable can result in internal cost savings by reducing the time and money committed to managing receivables by providing managers with more time to focus on growing the business. Finally, factoring accounts receivable allows a business to shift the risk of collecting its receivables to the factoring institution (Borgia, Burgess, Shank, 2003).

Small firms can also utilize another form of bootstrap capital like obtain loans from relatives or friends, use personal credit cards for business; or borrow equipment, share employees or equipment, and they might barter in buying or selling goods.

Several researches have focused on the use of bootstrapping method in small business financing. Van Auken and Neeley found that ownership structure and type of firm have a significant impact on the use of bootstrap financing (Akyuz, Akyuz, Serin, Cindik, 2004). Freear, Sohl, and Wetzel found that small software firms actively employ bootstrap financing as an important source of growth capital (Van Auken, Neeley, 1996).

On the basis of their research, Winborg and Landstrom (2000) identified six clusters of bootstrappers from the cluster analysis, differing from each other with respect to the bootstrapping methods used and the characteristics of the business. On the basis of this information the different clusters were labeled:
- delaying bootstrappers
- relationship-oriented bootstrappers
- subsidy-oriented bootstrappers
- minimizing bootstrappers
- private owner-financed bootstrappers

This research provides a pioneering study in examining the bootstrap financing techniques and identifies several groups from commonly used bootstrap financing techniques: delaying payments; minimizing accounts receivable; minimizing investment; owner-financing; resource sharing; and subsidy financing. These were further organized into three groups based on the apparent orientation toward a particular mode of financing. For example, those preferring to delay payments, minimize accounts receivable and investments, and use private owner-financing represent a more internal resource acquisition process.

Carter, Van Auken (2005) identified motivating factors in the use of bootstrap financing techniques. They developed three categories or factors of constraints and opportunities, as perceived by the owners, using factor analysis: Risk, Ability and Effort. These were then compared to the choices of bootstrap financing techniques to determine the driving factor. They also found that, while risk is the most pervasive motivating factor for bootstrap techniques in general, for owners who perceive themselves as having less ability Private owner financing techniques are the most popular. Alternatively, Delaying payment techniques are most likely to be used when risk levels appear to be highest, while Private owner financing is preferred for owners with lower levels of ability and, finally Minimizing accounts receivable is preferred in business environments with the most opportunity.

Beside the advantages in using the various methods of bootstrap financing in small business, there are also disadvantages associated with bootstrapping method. Bootstrap financing has the advantage of often being easy to obtain (credit cards), convenient (loans from life insurance), and with few requirements (home equity line of credit). In addition, bootstrap sources of financing commonly do not require a business plan or collateral (Van Auken, Neeley, 1996).

With this bootstrapping method, the business will be worth more because less money has been borrowed, and therefore, no equity positions had to be relinquished. The firms will not have to pay the high interest on borrowed money, and coming from a stronger position (with less debt on hand), the firms look more desirable to external lenders and investors when the time does come to raise money through these routes. Besides, the firms can be creative in finding ways to raise profits, without having to look to external sources, and it will give the added confidence of business savvy.

Disadvantages associated with bootstrap financing may include, for example, higher cost (loans from public financing companies) and loss of ownership control (venture capital). The availability of bootstrap financing may also result in the funding of start-up firms that are not viable. The lack of funding from traditional sources of capital, especially from financial institutions, may be a signal that the proposed business is not a good idea. The ability to launch the firm using bootstrap capital may result in the launch of a company that has limited chance for success (Van Auken, Neeley, 1996).

SUMMARY

The success of a firm often depends on the entrepreneur's ability to identify and access sufficient sources and levels of capital. The impact of a weak initial financial structure can result in poor operating performance. Developing a comprehensive understanding of capital acquisition can help owners explore alternative financial plans, develop contingent plans, and make informed decisions.

Traditionally small firms can use some sources of capital included funds from personal savings and borrowing from financial institutions. Bootstrap financing appears to be a common way of coping with limited access to capital markets for small business owners. This method employs resources other than traditional financing to keep the enterprise afloat and it is important to small firms due to their lack of access to traditional capital markets.

Bootstrap capital can complement or can reduce dependence on traditional sources of capital. This financing method complements traditional sources of capital and should be incorporated into finance theory. The direct relationship between risk and the use of bootstrap financing is consistent with finance theory.

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