

The Bank Financing of Small Firms in UK: Issues and Evidence

Kevin Keasey
Robert Watson

ABSTRACT. This paper focuses on the, often strained, contractual relationships between banks and small firms in the UK. In the UK both the adequacy of the supply of debt finance to small firms (the so-called finance gap) and the contractual conditions attaching to it have frequently been seen as a major constraint on the development of the small firm sector. In this regard, the main UK clearing banks have been identified as the main culprits and have frequently been criticised for being too 'risk-averse', particularly in relation to the financial needs of rapidly growing small firms.

Our analysis of the theoretical and empirical literatures suggests, however, that the perception of a finance gap and other contractual conflicts between banks and small firms can be more adequately explained in terms of the differences in the economic functions, relative risks, payoffs and, therefore, the economic interests of the suppliers of equity and debt finance.

1. Introduction

In the UK both the adequacy of the supply of debt finance to small firms and the contractual conditions attaching to it have often been criticised by small business pressure groups, researchers, government agencies and the mass media (see Keasey and Watson, 1992 for a review). In spite of the fact that the main UK clearing banks provide around 90% of all small firm lending (Batchelor, 1989), they have been criticised for being too 'risk-averse' and as being responsible for creating the so-called 'finance gap' (for example, see Bolton, 1971,

Wilson, 1979), particularly in relation to the financial needs of rapidly growing small firms. As we indicate later in the paper, even if it could be unambiguously shown that substantial numbers of small firms with viable and highly profitable projects have been denied bank finance, it is far from clear that

- (i) an economically important gap with respect to debt finance actually exists, or,
- (ii) that the lending behaviour of the banks is unreasonable in this regard.

Analysis of the theoretical and empirical literatures suggests that the perception of a finance gap and other contractual conflicts between banks and small firms can be more adequately explained in terms of the differences in the economic functions, relative risks, payoffs and, therefore, the economic interests of the suppliers of equity and debt finance.

More recently, since the start of the UK recession in 1990, the main clearing banks post-contractual behaviour towards their small business customers has become the focus of criticism. Much of the mass media coverage of these conflicts has been based on the premise (and has therefore concluded that) the banks act as a profiteering cartel intent simply upon stripping small firms of profits via high bank charges and then forcing many into receivership by the sudden and unwarranted withdrawal of overdraft facilities. The underlying economic logic of such behaviour is, however, far from obvious because the banks do not profit from losing customers or from forcing solvent firms into liquidation.

As with the analysis of the debt finance gap, once the nature of the debt contract and the other contractual difficulties associated with small firm financing are highlighted, the plausibility of such claims become extremely doubtful. Indeed, from this perspective, the perception of a finance gap

Final version accepted on November 30, 1993

Kevin Keasey
School of Business and Economic Studies,
University of Leeds,
U.K.

and

Robert Watson
School of Management,
University of Manchester Institute of Science and Technology,
U.K.

and the ex post contractual conflicts with debt suppliers are simply opposite sides of the same coin. Though each can be expected to surface at different stages of the trade cycle, both problems are manifestations of the same inherent economic tensions. In this paper, we examine the economic basis of these conflicts between banks and small firms by focusing on the nature of the debt contract and the characteristics of small firm equity ownership and management. An empirical analysis of the financial structures and returns to debt and equity suppliers for a sample of small firms in the UK is also undertaken.

The remainder of the paper is structured as follows. In section 2 we examine the economic changes, policy initiatives and regulatory developments of the 1980s that had a significant impact upon the bank/small firm relationship. This section also contains a discussion of the differences between debt and equity finance and the characteristics of small firms that create an inherent conflict of interest with a debt supplier. In section 3 we empirically investigate the financing of small firms via an analysis of the published accounts of a sample of 110 UK small firms over the period 1986 to 1990. More specifically we examine how the capital structures and relative returns to equity and debt changed over the five year period. Section 4 explores the basis of the ex post conflicts associated with debt financing, especially those that surface during an economic downturn. In particular, we discuss the main difficulties faced by banks in accurately assessing their exposure to risk when small firm owner-managers have both the motive and opportunity to take ex post actions which increase the banks' exposure to uncompensated risk. Concluding remarks are presented in section 5.

2. The economic background

2.1. *The UK banking sector*

Since 1980, the UK banking sector has faced increased domestic and international competition due to several public policy initiatives that have significantly altered the economic and regulatory environment within which banks operate. For example, the abolition of exchange controls has opened up the UK domestic market to interna-

tional competition, whilst financial deregulation legislation has allowed other financial institutions (such as building societies) to offer a full range of banking facilities, including the provision of current accounts. As a consequence the UK banks have discovered that they can no longer rely upon an uncompetitive domestic market to supply them with a cheap source of funds from non-interest bearing current accounts. This, along with the 1987 Basle Agreement, which increased the minimum capital adequacy ratios of banks, has significantly increased the costs of making loans.

As profit margins on lending have been squeezed, the banks have competed more vigorously in terms of the prices of their other services. This has led to the elimination of implicit cross-subsidisation and to the passing on to the customer of the costs of supplying specific services. Hence, while those customers with deposits have gained from a more competitive rate of interest, charges for many other services have had to be introduced and/or be increased to reflect the marginal cost of supplying these services. This, as might be expected, has made banks unpopular with customers who previously obtained these services free or at a subsidized rate. As Chrystal (1992 p. 54.) has noted,

it is ironic that banks have been criticized, often by politicians, for responding in the only way possible to new regulatory requirements imposed by the political authorities themselves.

2.2. *The growth of small firms in the UK*

Over the past 10 to 15 years, small firms have been perceived to be an increasingly important part of the UK economy (see Stanworth and Gray, 1991 for a review of the evidence) with all the main political parties preaching the economic benefits of developing a more vigorous and internationally competitive small firm sector. So much so, that even by 1982 over 100 policy measures designed to help existing small firms and/or encourage the creation of new firms were in operation. Although many of these policy initiatives have met with limited success (Keasey and Watson, 1993a), particularly in terms of the small size and limited economic potential of many of the new enterprises created (Storey and Strange, 1992), the number of both UK small firms and the self-

employed increased dramatically over the 1980s. Despite the economic marginality of much of the greatly enlarged UK small firm sector, by the late 1980s there was much talk of the small firm having an important role to play in reconstructing not just the economy but also the national psyche via the creation of an 'enterprise culture' (Bagguley, 1991).

The vulnerability to an economic downturn of many of the new enterprises created during the expansionary late 1980s became evident in 1990 when failure rates increased dramatically (see Keasey and Watson, 1993b). Even so, the political rhetoric that small enterprises were somehow necessarily more 'flexible', entrepreneurial, innovative and competitive, than large 'rigid', 'bureaucratic' organisations, did not help the banks in putting across their case when their conflicts with small firms, created largely by the economic downturn, surfaced in late 1990.

2.3. *Small firm debt and equity finance*

An important consequence of the growth in the numbers of micro enterprises over the 1980s has been the increase in the level and a change in the distribution of risk in the economy. The empirical evidence presented in the next section indicates that the banks played a large role in financing the expansion of our sample of UK small firms over the 6 year period up to 1990. However, in addition to debt finance, firms also need to obtain equity finance. This is because the main economic function of equity is to provide long-term risk capital, where the return is contingent upon the success of the enterprise. Since debt suppliers contract to receive a fixed return irrespective of how well or badly the firm is performing, equity acts as the financial buffer that enables the firm to absorb the inevitable uncertainties of business life.

Typically, however, the owner-manager's personal sources of equity finance are quickly exhausted, particularly for those with new and/or growing firms. The lack of financial and other managerial expertise within the small firm, the high fixed costs of acquiring and accessing information of adequate quality on a timely basis and the volatile economic performance of many businesses frequently means that outside equity investors experience problems in effectively moni-

toring the actions of owner-managers. The problems associated with exiting, due to the lack of a public market for their shares, compound these difficulties and outside equity finance may often be unavailable if the above problems are not satisfactorily overcome.

Any unwillingness to seek and/or difficulties experienced in obtaining equity finance may result in a too heavy a dependence upon debt finance, particularly short-term bank loans and overdrafts. Short-term debt finance is obviously a highly risky means by which to finance any sort of long-term investment since there is always the possibility that the finance will not be renewed. It is also clearly an unsuitable substitute for long-term risk capital for firms with volatile cash flows and/or low equity bases — features characteristic of many small and/or young firms. Such highly levered enterprises will be exposed to considerable additional financial risk whenever current cash flows prove to be insufficient to meet prior debt obligations. Of course, as debt repayment obligations are independent of firm performance, the converse is also true — namely, that when the firm is performing well all increases in value above that required for debt servicing belongs to the equity holders.

A lack of sufficient equity finance can therefore be expected to lead to difficulties in obtaining even very short-term debt finance. As debtholders do not participate in upside gains, they will be generally unwilling to bear business risks that potential equity investors refuse to accept. Indeed, because of the typically small margins on bank lending, it takes a comparatively large number of good loans to cover the losses of just one bad loan. Moreover, debtholders will be wary of providing too high a proportion of a firm's finance due to the fact that the return distribution of equity for incorporated businesses is truncated on the downward side which makes the equity of a levered firm analogous to a call option (see Black and Scholes, 1972). Because of the presence of limited liability, the payoff function to a risk neutral owner-manager will be:

$$\text{Max } [P - (1 + i)D, 0]$$

where P is the net cash flow accruing to the firm, D is the debt and i is the interest rate on the debt. As Stiglitz and Weiss (1981) have noted, this is a convex function which, because of the restricted

downside potential, motivates the owner-manager to act in a more risk preferring manner. Quite simply, in the event of failure, i.e., when $P - (1 + i)D < 0$, part of the cost of failure, i.e., $(1 + i)D - P$, will be borne by the debtholder. This provides the owner-manager with incentives for undertaking actions which expose debt holders to greater risks or otherwise reduce the value of their financial claims.

In addition, the incentives and opportunities for the owner-manager to gamble with outside investors' claims are, as will be discussed later, greatly enhanced when the firm becomes financially distressed. The 1986 Directors' Disqualification Act, which allows for the disqualification of directors that have gambled excessively with creditors funds, is clearly an attempt to mitigate this problem. However, as the courts have recognised, the vast majority of small firm failures occur because of managerial inadequacies and unexpected economic downturns rather than as a result of a deliberate attempt to cheat creditors. Hence, this legislation, even if its main provisions were known and understood by owner-managers, is unlikely to have much of an impact on their behaviour (see Keasey and Watson, 1993b, for a review).

The most common contractual solution adopted by the banks to reduce their exposure to risk, is to offer primarily short-term, frequently reviewed loans and overdrafts and to secure these on the personal assets of the small firm owner-manager. This effectively ensures that the owner-manager continues to personally bear all the business risks associated with his/her actions without the banks needing to engage in costly monitoring activities. However, it is precisely these aspects of the debt contract which have become the focus of recent criticisms.

3. The banking financing of small firms: some recent UK evidence

3.1. *The sample and data*

To assess the relative position of the bank financing of small firms across the late 1980s, we analyse the published accounts of a sample of UK small firms.¹ The data on small firm accounts was provided by local bank branches. This will form a backcloth against which to judge both the extent of

bank financing and the recent conflicts between the banks and small firms.

The sample consists of 110 small firms² based in the Yorkshire region of the UK. Evidence from other UK studies (Bradford, 1993) indicates that the financial and sectoral characteristics of the sample are generally representative of UK small firms and that the sample does not appear to display any obvious regional biases. The following statistics describe the basic features of the sample for the period 1985 to 1990:

Turnover — the sample has a mean of £308,140 and ranges from a minimum of £17,240 to a maximum of £822,730 in 1985 and for 1990 the mean is £446,481 with a range from a minimum of £78,786 to a maximum £1,443,980.

Sectors — the number of firms in Services is 27; Construction, Chemicals and Extractive Industries is 18; Metal Goods, Engineering and Other Manufacturing is 34 and Distribution, Transport and Communication is 31.

Company Age — the firms range in age from a minimum of 3 years to a maximum of 224 years. The median of the distribution is 13 years, whilst the mean, which is unduly influenced by the few extreme values for firms which claimed to be of very old vintage, is 20 years. Thus the sample consists of a mix of reasonably well established and young firms.

Number and Type of Directors — the median number of company directors is 2 and the range is from 1 to 6. Not surprisingly, the sample of firms contain many family businesses, with some 41.8% of the sample having at least 1 other member of the family as a director. Interestingly, 24.5% of the sample has husband and a wife teams as directors. Furthermore, the average age of the board of directors is 46 years, with a minimum average age of 30 years and a maximum of 64 years. In terms of gender, 74.8% of the 270 directors in the sample are male.

Number and Type of Loans — the mean number of loans per firm is 1.64 with 88% of the sample having 2 loans or less. Only 8.2% of the sample did not have some form of debt finance. Of the loans in the sample, 92% of the loans came from banks, with the mean level of bank loans equalling £22,656, overdrafts equally £48,022 and other loans equalling £3,168. Thus, for loans in total, the mean amount equals £73,847.

Loan Security — only 7.3% of the overall sample did not have to provide some form of security. In fact, of those with loans only 2 cases did not have to provide some form of security. Of the firms with loans (101 cases) 47% had to provide unlimited personal guarantees, whilst 25% provided no personal guarantees but instead secured the loans solely on the business assets. In terms of the amount of security, the mean level of security for the sample is £115,710 and the average security ratio is 2.95. These

figures may be an underestimate of the security provided because they do not allow for cases of unlimited security on personal and business assets. However, it also needs to be realised that the provision of security is often 'lumpy' due to the fact that the assets (often the personal home of one or more of the directors) providing the security are indivisible. Thus when a loan of £50,000 is secured on the property of the owner, the property may be valued at a £100,000 — the non-divisibility of this asset implies that the security ratio is 2 to 1. Hence, the security ratio may simply reflect the lumpiness of the owners' assets, rather than being indicative of any 'excessive' concern with security by the banks towards the granting of small firm loans.³

Loan Status — most of the loans (89%) were classified as sound by the bank branches. Only 8.2% of firms were (or had been) under scrutiny during the study period and only 1 firm (0.9%) was in the recovery department. Finally, only 2 firms (1.8%) in the sample had failed — one being a creditors' voluntary liquidation and the other was currently in administrative receivership.

3.2. *Descriptive analysis of the financial information*

The purpose of this section is to describe the broad asset and financial structures of the sample. This will allow the relative position of bank financing to be assessed. Tables I and II show the financial summaries in terms of nominal £000's, whereas Tables III and IV report the financial data in terms of common size statements where all profit and loss account items are expressed as a percentage of turnover and all balance sheet items are expressed as a percentage of total assets.⁴

3.2.1. *Balance sheets*

Consideration is first directed to the summaries of the raw accounts (Table I). Average fixed assets increased in nominal terms by over 100% for the period 1986 to 1990. Not surprisingly, given the high levels of activity in the property and vehicle markets in the late 1980s, land and buildings and motor vehicles seem to account for a major part of the increase in fixed assets. However, it is clear that land and buildings account for the largest proportionate increase and that motor vehicles actually formed a marginally declining proportion of fixed assets. Given the inflation in the property sector during the late 1980s and the option provided by UK Company Law of revaluing freehold land and buildings,⁵ it is unclear whether there has

been any real increase in the fixed asset base of the sample. Current assets showed a far lower nominal increase than fixed assets (only 28%) and are dominated by trade debtors (approximately 50% of the current assets for 1990) and stocks and work-in-progress of various kinds account for most of the remaining balance.

Across the whole period current liabilities stayed roughly in balance with current assets. In terms of the nominal figures, bank overdrafts accounted for the largest absolute increase, with trade creditors showing the next largest absolute increase. In 1990 bank overdrafts and trade credit each provided approximately 32% of the current liabilities of the firms in the sample. Longer term loans are on average small relative to these short-term sources of finance. Thus in terms of debt finance, the sample is similar to other studies which have invariably found that short term bank finance and trade credit are the major sources of finance. However, although longer term loan finance is somewhat less than either trade credit or overdrafts, it did show a remarkable increase across the period (the mean level increasing from £12,500 in 1986 to £35,500 in 1990). If total bank finance (defined as owing to banks less than and more than one year plus secured and unsecured loans) is considered, the sample showed an increase in the mean level from £42,100 in 1986 to £82,100 in 1990. Thus, in nominal terms, the banks provided almost a 100% increase in finance to small firms across the period.

In comparison to the increases in bank finance, the pattern of equity finance looks decidedly different. Defining equity finance as consisting of directors' loans, called up share capital, (unrealised revaluation) reserves and retained profits, the total for 1986 was £52,800. Thus, in 1986 equity finance was approximately 25% greater than bank finance. Whereas in 1990, equity finance (inclusive of unrealised holding gains) equalled £82,500 and was only providing, on average, marginally more finance (£400) than the banks.

The Common Size balance sheet displayed in Table III confirms the above picture of the financing of small firms. It shows that the only short term finance category to show an increase in relative position is bank finance. Thus as suggested above, short term bank finance became an increasingly important source of funding for small firms over

TABLE I

		MEAN VALUES IN £000's				
Balance sheet		1986 N = 72	1987 N = 90	1988 N = 102	1989 N = 102	1990 N = 91
A	Fixed assets					
	Land and buildings					
	— Freehold	15.3	19.1	19.2	31.0	35.3
	— Leasehold (over 21 years)	6.4	7.0	8.5	9.9	13.7
	Plant and machinery	13.7	15.0	17.1	20.6	21.1
	Fixtures, fittings, tools and equipment	5.0	5.2	7.0	7.4	9.0
	Motor vehicles	18.7	23.1	23.7	31.7	40.6
	Leased assets	0.6	0.6	0.6	0.7	0.9
	Fixed assets (TOTAL)	59.8	70.0	76.1	101.3	121.6
B	Investments	0.7	0.9	0.9	1.4	1.4
C	Current assets					
	Stocks					
	— Raw materials	12.9	10.7	11.5	12.0	12.2
	— Work in progress	8.4	10.9	12.5	14.7	13.9
	— Finished goods	16.8	17.8	15.7	16.0	19.2
	Debtors					
	— Trade	57.3	57.6	62.4	69.6	72.4
	— Others	2.6	2.3	4.3	3.9	5.6
	— Pre-payments	2.0	2.1	2.0	2.4	3.0
	Listed investments	0.0	2.3	2.2	3.7	2.8
	Cash at bank and in hand	7.9	6.8	7.8	10.2	8.8
	Other current assets	1.8	1.6	1.3	3.3	2.7
	Current assets	109.8	111.8	119.7	135.8	140.6
D	Current liabilities — due within 1 year					
	Owing to banks	29.6	27.3	27.2	39.5	46.6
	Creditors					
	— Trade	37.9	39.4	44.1	43.9	45.5
	— Others	8.7	9.9	10.1	12.3	11.5
	— Preferential	7.1	7.1	7.4	8.3	8.8
	Taxation					
	— Current	6.2	5.8	6.1	7.1	6.9
	Hire purchase/leasing agreements	4.5	5.7	6.7	7.2	8.6
	Other short term liabilities	8.7	9.6	8.7	12.2	15.9
	Current liabilities	102.6	104.6	110.4	130.7	143.9
E	Net current assets (liabilities)	7.2	7.3	9.3	5.1	-3.2
F	Amounts due after 1 year					
	Owing to banks	6.1	7.7	8.3	15.6	18.0
	Mortgages/secured loans					
	— Up to 5 years	0.5	0.8	0.6	3.4	3.0
	— 5 years or more	1.2	0.7	1.5	1.8	2.8
	Unsecured loans	4.7	7.6	10.6	10.4	11.7
	Amounts due after 1 year	12.5	16.8	21.0	31.2	35.5
G	Other liabilities/provisions					
	Directors loans	7.8	10.5	11.5	11.4	11.3
	Taxation					
	— Future	0.2	0.0	0.0	0.2	0.3
	— Deferred	3.2	2.4	1.6	2.1	2.5
	Specific provisions other than tax/dividends	0.8	0.9	1.2	1.6	2.1
	Other liabilities/provisions	12.0	13.8	14.3	15.3	16.2
H	Net assets (A + B + C - D - F - G = H)	43.2	47.5	51.0	61.3	68.1
J	Capital and reserves					
	Called up share capital	5.2	5.7	6.9	7.3	8.1
	Reserves	2.8	4.6	5.3	9.0	12.2
	Profit and loss account (adverse)	37.0	38.6	40.8	47.4	50.9
	Less intangibles	1.9	1.3	2.1	2.1	3.0
	Surplus resources	43.2	47.5	51.0	61.3	68.1

TABLE II

	1986	1987	1988	1989	1990
Profit and loss account — period	12 Months	12 Months	12 Months	12 Months	12 Months
Turnover (less returns)	308.1	341.6	360.4	398.9	446.5
Cost of goods sold (if available)	209.8	241.0	245.0	267.7	292.5
Gross profit/(loss)	98.3	100.6	115.4	131.2	154.0
Depreciation	9.5	10.5	12.3	15.1	15.8
Repairs/renewals	3.8	2.4	3.0	3.5	4.4
Directors withdrawals/remuneration	24.4	26.1	26.3	31.7	32.6
Interest paid					
— Bank	4.3	4.2	4.6	7.0	9.2
— Hire purchase	0.9	1.0	1.1	1.8	1.9
— Leasing charges	0.6	2.9	0.9	0.3	1.3
— other	0.5	0.4	0.3	0.5	1.7
Other items	0.1	0.5	3.6	3.6	-0.4
Net profit before tax (NPBT)	11.2	11.3	14.5	13.2	18.3
Non-recurring items	0.1	0.6	0.3	-0.3	-0.2
Taxation					
— Current	3.5	2.4	3.4	4.1	4.9
— Future/deferred	0.5	0.4	0.2	0.3	0.3
Dividend					
— Paid and proposed	0.6	2.1	2.0	3.8	5.2
Balance added to profit and loss account	6.5	6.2	8.6	5.2	7.9

the late 1980s. Interestingly, the relative gain by short term bank finance offsets the reducing share of trade credit. In other words, it appears that short term bank finance is being substituted for trade credit. The increase in the relative position of short term bank finance is supported by the increase in the relative position of longer term bank finance. In general, the banks share of the funding side of the balance sheet increases from 22.6% in 1986 to 29.3% in 1990. In comparison, the equity financing position increases from 24% in 1986 to 25.9% in 1990.

Thus over the late 1980s it is evident that the banks played a major role in funding the growth of small firms. By 1990 their stake in funding small firms was almost equal to that of equity finance. However, this gearing up by firms over the period meant that, when the economic downturn occurred in late 1990, many firms were financially vulnerable and rapidly became distressed when earnings began to decline.

3.2.2. Profitability and relative returns

The average profitability of the sample was consistently high over the 6 year period. For instance,

in 1990 the average profits before interest payments and directors fee as a percentage of turnover was approximately 16%, and as a percentage of total assets this equated with a return of some 46%. However, in each year directors' fees were approximately some 70% of total operating profits. Since this represents funds withdrawn from the business, it is clear that typically only a small proportion of the firms' earnings will be directly available for satisfying creditor claims.⁶ Attention will, therefore, be directed towards the relative returns to bank and equity finance. To analyse the gross returns to each party, interest payments relative to the book value of debt are compared to directors remuneration and dividends as a percentage of the book value of equity.⁷

Table II indicates that in 1986 the payments to equity finance equalled £25,000. This is approximately a 48% return on the average invested capital of £52,000. In comparison, interest payments equalled £4,300 in 1986 and this gives an approximate return of 10% on the bank finance of £42,100. This difference in the returns to the two types of finance is marginally diminished when 1990 is considered. Equity finance received

TABLE III

		COMMON SIZE STATEMENTS				
Balance sheet — Dated		1986 N = 72	1987 N = 90	1988 N = 102	1989 N = 102	1990 N = 91
A	Fixed assets					
	Land and buildings					
	— Freehold	5.3	6.9	6.7	10.4	10.1
	— Leasehold (over 21 years)	2.7	3.0	3.4	3.1	4.2
	Plant and machinery	6.7	6.9	7.7	6.9	6.5
	Fixtures, fittings, tools and equipment	3.4	3.6	4.7	4.5	4.9
	Motor vehicles	13.0	11.8	10.5	11.0	12.0
	Leased assets	0.4	0.3	0.3	0.2	0.4
	Fixed assets	31.5	32.5	33.3	36.1	38.1
B	Investments	0.3	0.3	0.3	0.6	0.5
C	Current assets					
	Stocks					
	— Raw materials	7.0	5.4	5.6	4.9	4.9
	— Work in progress	6.9	6.9	6.9	6.9	6.3
	— Finished goods	8.6	9.8	8.6	7.7	7.7
	Debtors					
	— Trade	35.6	34.6	34.7	33.5	31.6
	— Others	1.5	1.6	2.7	1.7	2.7
	— Pre-payments	1.1	1.2	1.1	1.1	1.3
	Listed investments	0.0	1.2	1.4	1.4	1.2
	Cash at bank and in hand	6.8	5.6	5.0	4.8	4.6
	Other current assets	0.6	0.8	0.7	1.4	1.2
	Current assets	68.2	67.2	66.4	63.3	61.4
D	Current liabilities — due within 1 year					
	Owing to banks	14.6	14.7	14.0	18.3	18.3
	Creditors					
	— Trade	25.0	23.6	23.6	21.3	21.7
	— Others	8.0	6.0	6.1	6.3	6.1
	— Preferential	3.9	4.1	4.4	3.8	4.3
	Taxation					
	— Current	3.6	3.7	3.5	3.6	2.9
	Hire purchase/leasing agreements	3.5	3.1	2.8	2.7	2.8
	Other short term liabilities	6.3	6.0	4.7	4.4	5.6
	Current liabilities	64.9	61.6	59.1	60.2	61.7
E	Net current assets (liabilities)	3.3	6.1	7.3	3.1	-0.3
F	Amounts due after 1 year					
	Owing to banks	3.2	3.7	4.2	6.1	5.9
	Mortgages/secured loans					
	— Up to 5 years	1.0	0.9	0.3	0.9	0.8
	— 5 years or more	0.4	0.2	0.3	0.4	0.9
	Unsecured loans	3.4	4.1	4.8	4.0	3.4
	Amounts due after 1 year	8.0	8.9	9.6	11.4	11.0
G	Other liabilities/provisions					
	Directors loans	9.3	9.2	7.8	6.2	5.5
	Taxation					
	— Future	0.1	0.0	0.0	0.1	0.1
	— Deferred	1.3	0.9	0.6	0.6	0.6
	Specific provisions other than tax dividends	0.7	0.3	0.6	0.5	0.8
	Other liabilities/provisions	11.4	10.4	9.0	7.4	7.0
H	Net assets	15.7	19.1	22.3	21.0	20.3
J	Capital and reserves					
	Called up share capital	3.2	3.2	3.9	3.5	4.2
	Reserves	0.8	1.4	1.6	2.1	2.5
	Profit and loss account (adverse)	13.0	15.3	17.9	16.6	15.1
	Less intangibles	1.3	0.8	1.1	1.2	1.4
	Surplus resources	15.7	19.1	22.3	21.0	20.4

TABLE IV

	1986	1987	1988	1989	1990
Profit and loss account — period	12 Months	12 Months	12 Months	12 Months	12 Months
Turnover (less returns)	100.0	100.0	100.0	100.0	100.0
Cost of goods sold (if available)	63.1	66.1	63.2	63.3	61.7
Gross profit/(loss)	36.9	33.9	36.8	36.7	38.3
Depreciation	3.0	3.4	3.7	4.1	3.9
Repairs/renewals	0.9	0.6	0.9	0.9	1.1
Directors Withdrawals/remuneration	9.6	8.8	8.8	9.8	9.6
Interest paid					
— Bank	1.5	1.4	1.4	2.0	2.5
— Hire purchase	0.3	0.4	0.4	0.4	0.5
— Leasing charges	0.3	0.2	0.2	0.1	0.2
— Other	0.3	0.2	0.1	0.2	-0.4
Other items	1.2	0.9	1.1	0.4	-0.4
Net profit before tax (NPBT)	4.4	4.3	4.2	2.7	2.8
Non-recurring items	0.1	0.0	0.1	-0.1	0.0
Taxation					
— Current	0.0	0.8	0.9	1.1	0.9
— Future/deferred	0.3	0.2	0.1	0.0	0.0
Dividend					
— Paid and proposed	0.2	0.8	0.5	1.1	1.0
Balance added to profit and loss account	2.8	2.7	2.6	0.6	0.7
Ratios					
— Current assets / current liabilities	1.2	1.2	1.2	1.2	1.2
— Stock / turnover × number of days	43.4 Days	41.8 Days	40.4 Days	41.0 Days	41.2 Days
— Debtors / turnover × number of days	68.5 Days	61.5 Days	63.0 Days	67.5 Days	60.7 Days
— Creditors / turnover × number of days	43.5 Days	41.9 Days	43.3 Days	40.8 Days	37.4 Days
— Gross profit / turnover × 100	36.9 %	33.9 %	36.8 %	36.7 %	38.3 %
— Net profit before tax / turnover × 100	4.4 %	4.3 %	4.2 %	2.7 %	2.8 %

£37,800 on an average invested capital of £82,500 and thus obtained a 46% return. In contrast, interest payments were £9,200 on bank finance of £82,100 and therefore, the return equalled approximately 11%. Although the differences between the returns slightly diminished over the late 1980s, it needs to be remembered that both types of finance provided approximately equal funding in 1990. Furthermore, in payment for providing approximately equal funding, the banks received roughly a quarter of the returns paid to equity finance. The "fairness" or otherwise of these large differences in the relative returns to equity and debt finance is not an issue addressed in this paper. Nevertheless, this pattern of returns is exactly what one would expect given that, unlike equity holders, banks do not contract to bear business risk or to receive any of the upside gains

from the enterprise. In short, debt holders contract to receive a *low but certain return*.

3.3. The financing of small firms

The above statistics indicate that bank finance and owners' equity provided almost equal proportions (about 31% each) of the overall funding of small firms in 1990. The 31% of funding provided by banks consisted of 17% short term (overdraft) finance and 14% longer term loans. Furthermore, 55% of the total funding of small firms was short term, with the banks providing roughly a third of this short term finance. Of the longer term bank finance, approximately a third was unsecured. The majority of both the bank overdrafts and longer term loans were secured on either just the directors' personal assets or a combination of business

and personal assets. The average security ratio of assets to loans was slightly under 3, which is remarkably similar to the figures reported by both Cowling *et al.* (1991) and Binks *et al.* (1992). The statistics also indicate an increased reliance upon short-term debt relative to equity over the expansionary period to 1990 and this certainly increased the vulnerability of firms to the subsequent economic downturn.

As noted in the introduction to this paper, a perennial theme of small business representatives and government sponsored Committees of Inquiry (Macmillan, 1931, Bolton, 1971, Wilson, 1979) has been the notion of a "finance gap" in relation to small firm financing. While we accept that such a perception is widespread, it is far from clear from the above and other published evidence that this perception has any firm grounding in reality. A number of studies have certainly indicated that many small businesses often experience difficulties in obtaining finance and/or are dissatisfied with the terms and conditions attaching to it (see Binks *et al.*, 1988, Storey *et al.*, 1988, Cowling *et al.*, 1991). These studies have, however, also indicated that a significant proportion of owner-managers are highly reluctant to seek external equity finance and have never attempted to obtain debt finance from sources other than the bank. Interestingly, the study by Cowling *et al.* found that 70% of their sample of small firm owners had never considered external equity from banks as a source of long term finance and furthermore, 61% said that they would object to banks having an equity stake in their firms. Thus, although the banks have been criticised for not providing equity finance — which is only partly true anyway since the largest venture capital organisation in the UK (3Is) is actually owned by the main clearing banks — it is the small firm owners themselves who seem to be most opposed to equity finance.

4. Debt finance, risk assessment and ex post conflicts

Even in the best of times, the small firm sector is characterised by high business risks and enterprise failure due to their low degree of product and/or market diversification, reliance upon relatively few customers and/or suppliers and dependence upon the continued good health,

energies, business acumen and financial probity of the owner-manager. Moreover, the closely-held ownership and management structures of small firms provides owner-managers with opportunities to take actions which dilute creditor claims. Any actions by the bank which attempts to prevent any such wealth transfers will, therefore, bring it into conflict with the owner-manager. Indeed, conflicts between banks and their small firm customers seem to be inevitable given the relative payoffs to debt and equity holders and the vagaries of the business environment within which contractual rights and obligations are negotiated.

This suggests that the earnings of small firms (either actual or anticipated) will generally be a poor indication of a bank's security. The more relaxed financial reporting regulations, the scope for manipulation and the endemic uncertainty associated with small business operations clearly renders the quality, reliability or timeliness of the financial information produced by small firms insufficient to provide reliable risk assessments (see Keasey and Watson, 1991, for a review). The bank's security will, therefore, have to be closely related to the realisable value of the firm's tangible assets — plus any sums recoverable from the personal wealth of the owner-manager if the finance has been partly secured by personal guarantees. Only these funds (net of any realisation costs) will typically be available for distribution to creditors if the firm is liquidated.

The basic problem for the bank is that, as the owner-manager obtains private benefits from the firm as a going concern, he/she cannot be relied upon to act in the best interests of other investors when the value of the firm as a going concern falls below the liquidation value of the firm's assets. Consequently, debt contracts usually allow control to be transferred to the debt supplier whenever the going concern value falls below the liquidation value. This could, in principle, be achieved by setting the debt level equal to the (net) liquidation value since this would ensure that the debtholder only bears risks to the extent that future liquidation valuations are uncertain.

Of course, in practice, future liquidation values are usually far from being certain *ex ante* because they can be radically affected by the actions of the firm's management and *ex post* changes in the level of economic activity. Thus, once the con-

tracting parties have agreed to the design of the financial contract, an *ex post* conflict arises, particularly if the probability of financial distress increases significantly due to some exogenous event.

With this form of contractual arrangement, conflicts can arise from differing perceptions of firm value and prospects by the two parties. In situations approaching financial distress, differences in perceived value (and hence appropriate courses of action) will be particularly likely. As analyses of the differences in the Official Receiver's and owner's perceptions regarding the causes of failure demonstrate (see Storey, 1982 for a review), owners are generally more 'optimistic' in this regard and their forecasts are, therefore, unlikely to provide a reasonable basis for debtholder decision making.

Economic recessions will also increase the business risk of small firms at the same time as their assets are providing decreased security for the banks. The differences in perception are a function of the fact that each party is primarily concerned with different aspects of the return distribution. The owner-manager, because he/she obtains the full benefits of any upside gains, is naturally primarily concerned with the upper tail of any return distribution but will only be interested in downside risk up to the point when the current value of his/her investment falls to zero. In contrast, the bank does not share in any upside gains and may lose up to 100% of its investment if the firm defaults. Thus the recent conflicts may be largely due to different perceptions of the consequences of exogenous shifts in the macro-economy.

Other conflicts may arise because of the incentives for the owner-manager to act in a manner which results (by accident or design) in a shift in the distribution of business risk onto the bank. These incentives are greatest when the owner-manager has a relatively low equity position. For example, an owner-manager with a low equity position (inclusive of personal guarantees) has a clear incentive to take excessively risky decisions using creditors' funds. Banks are acutely aware of this possibility and may, therefore, view liquidation as the preferred course of action if it perceives that continuation will result in increased exposure to risk without any corresponding increase in

expected returns. Thus, what from the owner-manager's viewpoint may seem to be an economically irrational liquidation decision may, from a bank's perspective, be just prudent banking and the only way of reducing its over-exposure in a depressed market.

Another source of potential conflict is the ability of the owner-manager to reduce the cash base, and thereby diminish the security of the debt prior to the bank being able to take action. From the owner-manager's perspective it is often desirable to remove equity from the business, say in the form of increased managerial remuneration, if the firm looks to be in financial difficulties. Indeed, because the bank's cash can be used to pay off other creditors, it is particularly vulnerable in this regard when a firm becomes financially distressed.

Given the above, the ever present need for banks to cheaply monitor and to protect the security of their investments, requires them to impose a range of contractual safeguards which creates potential conflicts between themselves and their small business customers. Perhaps the only way such conflicts could be reduced would be a more plentiful supply of equity finance to small firms. However, as we have indicated, small firm owners are often unable and/or unwilling to have the involvement of external equity partners. Indeed, it may be that the apparent finance gap exists precisely because small firm owners are unwilling to blind themselves to agreements that require them to share control and upside gains with equity partners. Since the debt contract does not allow banks to share in these upside benefits, it is not surprising that they are only willing to enter agreements which allow them to take actions *ex post* which ensure that they are not exposed to business risks for which they are not compensated.

A lack of appreciation by small firm owners of the crucial difference between the relative risks and returns accruing to debt and equity holders, would seem to be one of the chief reasons why small firm-bank relations are often strained. During 1991 the main UK clearing banks were on the receiving end of a lot of criticism from small businesses, particularly those experiencing financial difficulties. The criticisms were wide ranging and included claims of insensitivity over the handling of small firm accounts, over-charging in terms of interest payments, of applying bank charges

without informing the customer, being overly eager in calling in their loans and demanding too high a level of security. The media and small business pressure groups were not slow to take up these issues and even the 'quality' newspapers devoted several pages to the 'horror stories' recounted by small business owners. Now that the media interest in the issue has diminished, it has become obvious that the main cause of the large increases in small business failures was the recessionary impact of the government's high interest rate monetary policy, and that many of the most serious complaints were based upon a few heavily cited, and unrepresentative, cases. Although the Cowling *et al.* (1991) and Binks *et al.* (1992) studies were critical of the banks on some counts, both reached similar conclusions; namely, that the reporting of the mid 1991 conflicts between banks and small firms was largely 'hysterical' and that the popular horror stories represented an unrepresentative minority and were certainly not the norm. This conclusion is supported by the Treasury and Bank of England inquiry (Financial Times, July 18th, 1991) and the report by the Director General of Fair Trading (Financial Times, June 28th) which both found there was no evidence of an organised cartel or collusion between banks in their dealings with small firms.

In reply to the accusation of abusing their monopoly power by increasing their margins on small lending precisely when firms were most financially vulnerable, the banks have argued that this simply reflects their increased monitoring costs and greater exposure to business risk in economic downturns. The recently published evidence from surveys of small business owners (Cowling *et al.*, 1991 and Binks *et al.*, 1992), however, indicate that most small firms pay interest rates only some 2 to 4 % above base rates and that bank margins on small firm lending have increased only marginally as the recession deepened. Perhaps the major source of recent concern has been the perception that a significant number of small firms have failed because the banks were too ready to call in the receivers whenever any hint of financial problems came to light. These concerns were inevitably fuelled during 1991 and 1992 by the downturn in macroeconomic activity because, as Chrystal (1992) has noted:

Money lenders have had a bad press in recessions ever since Biblical times. In this regard, banks do not cause the problem — rather it is the inevitable outcome of a business downturn. The bank simply conveys the news that negative cash flow cannot go on for ever.

The banks' concern with protecting the security of their investments merely reflects the nature of the debt contract — lenders do not share in upside potential and, therefore, do not expect to bear any uncompensated downside risks.

5. Concluding remarks

This paper has examined the, often strained, relationships between banks and small firms by focusing upon the nature of the debt contract and the ownership and management characteristics of small firms which create problems for both parties in accurately assessing their exposure to business risk. Given the potential business risks involved, the empirical evidence presented regarding the extent of bank financing over the boom period of the late 1980's, does not suggest that in general firms were being denied bank finance. The arguments and analysis indicate that the more recent ex post contractual conflicts between banks and small firms can be largely seen as being due to a combination of economic factors not of the banks' making. Briefly, changes in the banks' competitive and regulatory environment and the public policy emphasis upon encouraging new start-ups had, by the late 1980, led to the creation of many economically marginal, inadequately managed and financially vulnerable small firms. When these factors are coupled with a heavy reliance upon debt finance and the difficulties associated with monitoring and controlling the actions of the small firm owner-manager, then conflicts between banks and small businesses became an ever present possibility. With the onset of the deepest UK post war recession in late 1990 conflict became inevitable. The impact of the downturn upon the commercial property and private housing sectors seriously undermined the main source of the banks' security for small firm loans and the banks had to take actions which reduced their exposure to increased levels of uncompensated risk.

The media coverage of bank-small firm conflicts indicate that banks are currently not highly

regarded by a significant proportion of their small business customers. Nevertheless, the causes of much of the conflict, the economic downturn and the competitive pressures on the banks, are outside the control of both the banks and their small business customers. Other major causes of conflict — the inadequacies of the small firm management team, the use of short-term bank finance as a substitute for equity, and the difficulties of assessing business risk and monitoring owner-manager behaviour — could, however, be mitigated to some degree by better communication and a greater understanding of the nature of the debt contract by small business owners.

We conclude that a more adequate understanding of these issues will be a prerequisite for reducing tensions and for improving the relationships between banks and small businesses in the future. Indeed, when economic recovery begins, this will be crucial as many firms will need substantial amounts of additional working capital to expand production. However, because of the not unreasonable perception of the banks that small businesses are likely to be particularly high risk propositions, the availability of this finance will be vitally dependent upon small firms and banks working in a more cooperative manner in sharing information and assessing risks.

Notes

¹ The sample and data used in this study are discussed in more detail in Keasey and Watson (1992).

² It will be noted from the tables, that the actual number of firms varies from year to year. This is because, in order not to introduce a 'survivorship bias', data provided by several new firms started and that of firms which failed during the period have been included. The actual results for the sub-sample of surviving firms (and for which full data for all five years were available) were very similar to those shown in the tables.

³ The referee suggests an alternative hypothesis for the security ratio: namely, that it reflects the banks' belief that on average, after administrative costs, only 50% of the assets' value remains to satisfy their financial claims. Although in section 4 of this paper we also make use of the argument that net realisation receipts are often likely to be significantly lower than what small business owners anticipate, we are not aware of any empirical evidence regarding bankers' beliefs or experiences on this matter.

⁴ The figures presented in the common size statements are an 'equally weighted' average of the individual ratios computed for each firm in the sample. For example, the equity of total

assets ratio in the common size statement was calculated as follows:

$$\frac{1}{n} \sum_{i=1}^n (\text{Equity}_i / \text{Total Assets}_i) \times 100.$$

Hence, because the larger firms are given more weight, value-weighted ratios of the form:

$$\frac{\Sigma (\text{Equity}_i)}{\Sigma (\text{Total Assets}_i)} \times 100$$

computed from the data shown in Tables I and II are unlikely to equate exactly with the figures shown in the common size statements of Tables III and IV.

⁵ The non-profit and loss account reserves (labelled simply as reserves on the balance sheets), in fact represent revaluation of freehold land and buildings. Hence, since the revalued assets are still being used by the business, increases in these reserves are "unrealised gains" and do not represent any actual increase in the equity funds put into the business.

⁶ The referee has suggested that some proportion of the directors' remuneration should be viewed as an expense (wages) rather than as a return on equity capital. Whilst this may be so, it does not affect our argument which is simply that these withdrawals by the owners will not be available to satisfy creditor claims. We ought also to add that, if it is being argued that a significant proportion of directors' remuneration is a necessary expense (owners' wages), then the average return on equity would be so low that relatively few of the firms in the sample could be viewed as economically viable enterprises — and certainly not businesses that could realistically expect a rational outside (debt or equity) financial supplier to invest in!

⁷ This method of comparison clearly understates the total return to equity since it does not take into account the additional implied return represented by the undistributed (i.e., retained) earnings for the year. Moreover, by focusing on the banks' gross returns (i.e., ignoring all the banks' costs), we necessarily overstate the actual profitability of small firm lending. Despite the above, the comparisons are adequate for our main purpose which is to indicate the relative size of the firms' cash flows that are appropriated by each of the two main suppliers of finance.

References

- Batchelor, C., 1989, 'The Banks Fight Off their Critics', *Financial Times*, February 14th, p. 21.
- Bagguley, P., 1991, 'Post Fordism and Enterprise Culture', in R. Keat and N. Abercrombie (eds.), *Enterprise Culture*, London: Routledge.
- Binks, M., C. Ennew and G. Reed, 1992, 'Small Businesses and their Banks 1992', *Forum of Private Business Report*, December.
- Bolton, J. E., 1971, *Small Firms: Report of the Commission of Inquiry on Small Firms*, HMSO, cmd 4811, London.
- Bradford, J., 1993, 'Banks and Small Firms: An Insight', *National Westminster Bank Review* (May), 13–16.

- Chrystal, K., 1992, 'Don't Shoot the Manager: Do Banks Deserve the Recent Adverse Publicity?', *National Westminster Bank Review* (May), 44–54.
- Constand, R. L., J. S. Osteryoung and D. A. Nast, 1991, 'Revolving Asset-Based Lending Contracts and the Resolution of Debt-Related Agency Problems', *Journal of Small Business Finance* 1(1), 15–28.
- Cowling, M., J. Samuels and R. Sugden, 1991, *Small Firms and Clearing Banks*, Association of British Chambers of Commerce report.
- Keasey, K. and R. Watson, 1991, 'The State of the Art of Small Firm Failure Prediction: Achievements and Prognosis', *International Small Business Journal* 9(1), 11–30.
- Keasey, K. and R. Watson, 1992, *Investment and Financing Decisions and the Performance of Small Firms*, National Westminster Bank report.
- Keasey, K. and R. Watson, 1993, *The Management of Small Firms: Ownership, Finance and Performance*, Oxford: Basil Blackwell.
- Keasey, K. and R. Watson, 1994, 'The 1986 Insolvency and Disqualification of Directors Acts: Their Impact on Small Firm Financing', *Small Business Economics* 6(4), 257–266.
- Macmillan Committee, 1931, *Report of the Committee on Finance and Industry*, HMSO, cmdnd 3897, London.
- Stanworth, J. and C. Gray (eds.), 1991, *Bolton 20 Years On: The Small Firm in the 1990s*, London: Paul Chapman.
- Stiglitz, J. and A. Weiss, 1981, 'Credit Rationing in Markets with Imperfect Information', *American Economic Review* 71(4), 393–410.
- Storey, D., 1982, *Entrepreneurship and the New Firm*, London: Croom Helm.
- Storey, D., R. Watson and R. Wynarczyk, 1988, 'Fast Growth Northern Businesses', Department of Employment Research Paper Series, No. 67, December.
- Wilson Committee, 1979, *The Financing of Small Firms: Interim Report of the Committee to Review the Functioning of the Financial Institutions*, HMSO, cmdnd 7503, London.

Copyright of Small Business Economics is the property of Kluwer Academic Publishing / Business and its content may not be copied or emailed to multiple sites or posted to a listserv without the copyright holder's express written permission. However, users may print, download, or email articles for individual use.