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Investigation on Preferred Source and Pattern of Funding Small Business

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Abstract

This study attempts to identify the most preferred type of source of financial funding entrepreneur uses at each stage of business development and their choice of fund for the different purpose of business activities. Survey questionnaires were used to collect data from 116 small business owners and managers selected for this study. Data were then analysed and interpreted using frequency and percentage. The highest percentage determined the source that is most preferred choice of financing by the entrepreneur for the respective stage of business development and usage of the fund in their business.

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Keyword: financing; pecking order theory; trade-off theory, entrepreneur; small business; source of fund

1. Introduction

Entrepreneurs play an important role in moving the economic development in the country through commercial activities. Entrepreneurs can also help the government to increase the production of products and expenditures of consumers in the government’s bid to handle the economy crisis. According to Cassar (2004), financial capital is important to an entrepreneur it needs a financial funding source to start operating. Financial funding is very important to small business and is an important factor to entrepreneur to be successful in business. Small businesses had difficulty financing through equity financing and retained earnings. In this concern, this study has been done to investigate the selection of financial funding by entrepreneurs in a business life cycle and its preferred source of fund usage of small business. The

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result from this study is expected to serve as a guideline to entrepreneur who needs information on financing small business.

2. Literature Review

Adequate financial funding is important in every stages of entrepreneurship business cycle (Ferreira et al., 2000). There is a need to have suitable source of capital to fund a company in every stages of the business (Ang, 1991; Berger & Udell, 1988). This means that the requirement for financial funding and the preparedness of source for each advancement stage will change when the company is developing. External financial funding and internal financial funding are two important dimensions in financial funding source (Walker, 1989). Thus, this study is conducted to determine the most preferred type of financial funding for small business at each stage of business development and in its fund usage.

2.1 Equity financing

Frederick et al., (2006) explained that equity financing is money invested in the business with a binding obligation on entrepreneur. Equity is the best business financing option to start a business (Frederick, 2006), especially in the research and development of new products. Most entrepreneurs in startup businesses will choose equity financing (Cassar, 2004). Equity financing is often involved with the transfer of ownership and dividend refund for the money which has been spent (Frederick, 2006). Small businesses usually do not go for equity financing from the public.

2.2 Internal sources of financing

Financial structure and monetary policy has no real investment relationship in a perfect capital market (Modigliani & Miller, 1963). The financial structure of a company, such as internally generated cash flow, debt status, or payment of dividends, etc. will not affect the market value of companies. Thus, entrepreneur has certainty over their preferred internal financing, their management on risk and their desire to control and the business possible degree of financial exposures (Bates, 1991, 1997, Haynes & Haynes, 1999; Coleman, 2000). Berger and Udell (1998) and Huygehebaert (2001) stated that in business start-up, most businesses rely on internal financing because of difficulty in obtaining external financing. Cassar (2004) reported that most entrepreneurs in start-up businesses will choose equity financing. As a business grows, the trade-off theory states that a firm can derived optimal debt ratio through a trade-off between cost of bankruptcy and tax advantage of borrowing (Scott, 1977). Rise in profitability result in reduces of expected costs of financing distress. In this case, the firm will have better tax benefits through leverage. Entrepreneur would prefer debt over equity if the business is not facing financial distress.

2.3 External source of financing

According to Fazzari et al., (1988), small business will choose external funds than internal source to normalize its business investment if larger cash flows are needed. Study by Rajan and Zingales (1998) showed that for country that has a better capital market, the industry will be more dependent on external financing compared to countries with low capital market where entrepreneur will rely on external funds. Demirguc-Kunt and Maksimovic (1996) concluded that for developing country with good legal system, company uses external financing to finance its growth. This proved that external financing is an important source for financing growth, development and expansion of a business.

2.4 Debt financing

Debt financing is an important source of business throughout the business life and in a financing option for start-ups (Bates, 1997, Cassar, 2004). It is also important for the success of the company (Evans & Jovanonic, 1989). Most entrepreneurs start their businesses with financing growth through
equity and then they will continue to use these types of debt financing to develop the business's value. Due to the fact that organizational capital in the new company is still developing, owner either uses personal social capital or if the personal social capital is not enough, others social capital will be used (Arregle et al., 2007).

2.5 Working capital

A study carried out by Gertler and Gilchrist (1994) proved that external financing is more suitable for use as working capital. This is due to transaction costs, agency problems or asymmetric information for internal funds. However, the study conducted by Stiglitz and Weiss (1981) showed that symmetry may not cause credit rationed borrowers in using debt financing approach. Therefore, further study will need to focus on the subject to find out what kind of funding sources are used by entrepreneur.

2.6 Capital expenditure

According to Donaldson (2007), company will use capital expenditure to acquire and improve current assets e.g., equipment and property. Most ordinary business expenses are either expensed or capitalized, but sometimes companies will choose their preferred source.

2.7 Other types of fund use

According to the capital structure theory, firms have a pecking order in funding their activities and they prefer internal finance to external finance (Myers & Majlir, 1984). The relationship between profitability and leverage is negative (Kester, 1986; Huang & Song, 2006). Higher profitability results in improvement of capital flow to a business enterprise and in this case, the sufficient retained earnings generated could be used as internal source of fund. This reduces the amount of debt financing and consequently the leverage level as well. Other funds in a company include fixed investment, operating expenses (a counterpart of capital expenditure), and other types of company investment access are for future benefits to the company business (Ciaran & Bhaird, 2010). Fazzari et al., (1993) explained that most fixed investment will require external funding support, and internal funding is only required when there is lack of external resource. Operating expenses are daily expenses of a company and this include sales and administrative expenses, research and development, labor costs and other business expenses.

3 Research Methodology

Survey questionnaire was used in this study for data collection. Quantitative method is preferred because of its holistic usage. Questionnaire is an easier way to gather information and to obtain relevant answers from research questions done by the studied respondents (Tuckman, 1984). According to Walker (1989), the best approach in defining a company's stage is to use the company's demographic placing at that time. Thus, this study used purposeful sampling method targeted at selected respondents. The samples of this study comprise of 116 owners and managers of businesses from Klung District Chinese Chamber of Commercial and Industry. Data collected from this study was analyzed using the Statistical Package for Social Science (SPSS) 17.0. This software analyses data statistically collected and presented the analysis results in table forms enabling easier interpretation and understand of the findings. Descriptive analysis was used in this study to explain thoroughly about the demographic of respondents. Descriptive analysis was also used to identify the financial funding sources most preferred by entrepreneurs in the respective development stages of business and fund usage.

4. Findings and Discussions

A total of 155 sets of questionnaire were distributed to the targeted respondents listed in the Klung District Chinese Chamber of Commercial and Industry business directory. Thus, this gives a respond rate
of 75 per cent. A total of 78 respondents are owners and the remaining 38 are managers. They are the respondents who know the financial situation of their business. These small businesses ranged from restaurant, car business and workshop, clothing, book and stationery shop, optometry shop, telecommunication, photoshop, salon and spa electrical shop to clinic and others which include wedding and florist shop. A total of 30 (26%) businesses has been in operation for less than 5 years, 31 (27%) between 5 to 10 years, 28 (24%) between 10 to 15 years and the remaining 27 (23%) of the responded businesses have been in operations for more than 15 years. This distribution indicates that half of the respondents have operated up to 10 years and the other half have been in operation for more than 10 years.

In contrast to past researches where they focused on the bigger companies, in this study the respondents are from the small businesses to investigate financing patterns. Financing decision is a crucial issue as it is about optimal financing mix and values of the business. The respondents of this study are the owners or managers who have accessed to relevant and reliable information of their respective businesses where they will act in the best interests of their business. This study also takes on a proposal by Berger and Udell (1998) to investigate further on financing of small business through business growth in a financing cycle. According to them, small businesses may be thought of as having a financial growth cycle in which financial needs and options change as the business grows, becomes more experienced and more transparent. Financial funding comes from two main sources, either the internal and external fund. Owner's money, money from the business, money from friend and family member are among the internal fund. Bank borrowing, and borrowing from other people are external fund. There are four stages in business development. These are the start-up, the development, the expansion and finally the maturity stage. Result shows that most of the respondents (55 of them or 47.4% of the total respondents) use their own money to start up a business and 48 of them (41.4%) borrow from bank as their preferred source of financial funding. Only 13 or 11.2 per cent uses family and or friend as their choice of financing their business. However, none of the respondent borrows money from other people as start-up capital. The main reason may be due to the difficulty of getting funding from bank and other agency.

In business start-up stage, this study finds that entrepreneur preferred internal fund. Using own money to fund a startup business is internal funding the capital and this does not incur any transaction costs. As such, entrepreneur would prefer internal financing to minimize financing cost. During the development, expansion and maturity stages, this study found that entrepreneur preferred to borrow from banks. Small business start-up normally will encounter capital market restrictions. Asymmetric of information creates a wedge between the cost of internal and external funds where external funds are more expensive (Kasseeah, 2012). As business grows, entrepreneur becomes more experienced and has accessed to more information. As business grows, more money is needed to purchase new shop and this fund that is needed is also bigger in amount. Trade-off Theory is about achieving an optimal capital structure through the trading-off of the costs and benefits of debt. In this case, debt financing through bank borrowing seems to be the choice when business relocates to another place. This may be due to the fact that a bigger sum of money is need as capital when it comes to business development and achieving an optimal capital structure through the trading-off of the costs and benefits of debt as suggested by the Trade-off Theory. Profitable businesses that are able to expand will have possibly having high positive cash flows would normally pay high taxes. Use of debt financing enables the business to benefit from interest tax shield and in this way it reduces the business cash flow as there is bank interest to be paid due to new borrowing for expansion. Pecking Order Theory prescribed that business firms use internal finance first, then debt and only when such choices are not feasible, financing through equity is used. However, literature has revealed that small businesses usually don't go for equity financing from the public as this would lead to dilution of ownership and loss of control. Thus, the financing through debt and financial institution
become their preferred choice when small business develop and expand their business. Entrepreneur chooses to use internal funding when comes to working capital as their preference for financing. Internal fund like business money is usually used to fund operation capital. Working capital is usually small in amount and uses cash in hand as compare to external fund where procedural processes are needed (Cassar, 2004).

5. Conclusion

Results indicated that most of the respondents use their own money to start up their business. During business development, expansion, and maturity stages, entrepreneur prefers to borrow from bank. For working capital, entrepreneur prefers the internal fund as their main source. As for capital expenses, including the purchase of motor vehicle, new building, machinery and renovation works, they prefer to use external funding. Other expenses including shifting to new location, opening new branch and business expansion, both internal and external sources are their preferred source of funding.

It is suggested that this study should be carried out in a larger scale to cover the different ethnic races and across the different states. These will lead to the examination of the macroeconomic factors, environment and corporate governance which can affect leverage.

References


