

# Information Asymmetry, Small Firm Finance and the Role of Government

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**Abstract**

One of the most important and commonly quoted constraints upon the survival and ultimate growth of the firm is its ability to raise financial capital. As early as 1931, with the publication of the Macmillan Report, it has been suggested that a 'finance gap' exists for small firms owing to their disadvantaged position in the market for bank finance. It is argued by many that the fundamental cause of this finance gap is the information asymmetry that exists between the provider and the candidate recipient of finance. Arguably, the information asymmetry problem has been exacerbated in recent years by further centralisation in bank lending decisions and the introduction of computerised business credit-scoring.

The aim of this paper is to examine the proposition that informal forms of finance might play a significant role in overcoming both information asymmetry and the finance gap. To achieve this aim, a broad conceptualisation of the various types of non-bank finance (termed 'quasi-commercial' (QCOM) finance) is adopted to demonstrate their potential role in addressing these related problems. Through grounding interviews, a model is developed to demonstrate the position of different QCOM providers in the small firm finance market. Finally, the results of a survey to determine the current awareness and use of various forms of finance by small firms are presented. These results suggest that for many UK firms, a finance gap is not perceived to exist and that the use of non-bank finance remains very limited. Policy recommendations are made on the basis of the findings.

**Introduction and Background**

The aim of this paper is to determine how small firms currently obtain their finance and to explore the nature of the financing constraints they experience, with particular reference to the market failure of information asymmetry. This research constitutes part of a wider ACCA funded research project which seeks to investigate the use of various sources of informal finance by small firms, focusing in particular on the impact of the firm's strategic objectives and its stage of development on this use.

The paper will commence with a review of the literature concerning the small firm finance gap and will explore the problem of information asymmetry in the financing process. The methodology will then be discussed, describing the grounding interviews and survey employed. The results of the primary research are then explained and drawn together in a conclusion which discusses the salient findings and discusses implications for both small firms and policy makers.

**The Finance Gap and Information Asymmetry**

Small firms have traditionally encountered problems when approaching providers of finance for funds to support fixed capital investment and to provide working capital for the firm's operations. The presence and nature of a 'finance gap' for small firms has been debated for decades, ever since the Macmillan Report (1931) and most recently by Cruickshank (2000).

Binks and Ennew (1996) discuss the small business finance market within a principal-agent framework. Here, the small firm is the agent of the finance provider, and as such undertakes to generate returns from its investment projects on behalf of that provider. In a 'perfect markets' setting, with full information available to both parties in the contract, a finance gap would not occur. However, finance markets are characterised by a number of market imperfections, not least of which is the problem of information asymmetry. To understand this problem more fully, it is necessary to examine the situation of the provider as principal and the recipient firm as agent in turn.

**The Finance Provider**

Finance providers for SMEs range from venture capitalists and High Street banks right the way through to soft loan and grant providers. However, as noted by Binks and Ennew (1996), the main source of external finance provided for small firms is bank finance. Therefore, in discussing

information asymmetry in the principal-agent relationship, it is useful to consider the bank as the principal.

In a perfect markets setting, with perfect and costless information available to both parties, and no uncertainties regarding present and future trading conditions, the principal-agent relationship does not suffer from the market failure of information asymmetry. However, information in the real world is neither perfect nor costless, and additionally the small business finance market is characterised by risk and uncertainty regarding future conditions. Information is distributed asymmetrically between the bank and the firm. From the bank's perspective, it has incomplete information regarding the underlying quality of the project and the management of the small firm, giving rise to the problem of adverse selection (Stiglitz and Weiss, 1981). Furthermore, the management of the small firm may fail to perform to their full capabilities, giving rise to the problem of moral hazard. The latter arises because it is too costly for banks to effectively monitor small firm projects, thereby resulting in equilibrium credit rationing and a shortfall in debt provision (Binks and Ennew, 1996; Bester, 1987; and Bester and Hellwig, 1989).

The information asymmetry problem may not only result in good lending prospects being rejected by providers, but also poor prospects being accepted by providers, as discussed by Altman (1968). Altman defined the latter as a Type I Error and the former as a Type II Error, as illustrated in Figure 1 below.

		PROVIDER THINKS	
		Good prospect	Bad prospect
FIRM KNOWS	Good prospect	√	Type 2 x Error
	Bad prospect	Type I x Error	√

**Figure 1: Altman's (1968) risk categories**

In theory, the provider can reduce the risk of Type I/II errors by carefully screening firms at the outset and monitoring projects during the life of the loan. However, screening and monitoring are high cost activities associated with the lending proposition. If the lender is to recoup these costs then borrower interest rates may be increased, additional risk may be covered by demanding collateral or may be avoided altogether by rejecting the loan application. Of the Altman error categories, it is the Type II Error which is of most concern to the small business sector - that is, a good investment project which is incorrectly rejected by the lender. Common occurrence of this type of lending error would contribute significantly to a finance gap.

The problem of information asymmetry and the resulting adverse selection and moral hazard are further compounded by certain trends which are evident in the banking sector. Firstly, competition in the banking sector is leading to greater market concentration. This has an important impact on the market for small firm finance as there is evidence that larger/universal banks are less well placed to build close relationships with small business customers than smaller/regionally-based banks (Bannock and Doran, 1991; Binks et al., 1991). Secondly, a broad trend is that banks are further centralising business lending decisions and/or limiting branch manager discretion to lend outside of very strict policy guidelines. The ultimate lending decision maker has thus become even more remote to the small business borrower. Thirdly, although authors such as Binks and Ennew (1996) argue that the introduction of expert systems and other knowledge-based decision support systems to bank lending should reduce information costs whilst raising quality and consistency in lending decisions, such developments may actually lead to a greater unwillingness to lend to firms with non-standard projects, particularly in highly innovative or high-technology sectors. Fourthly, recent evidence reveals a decline in the use of bank overdraft facilities and a move towards term-loan lending among businesses (Binks and Ennew, 1996). The result might be more cautious lending by banks, as such loans are not repayable on demand. Furthermore, there is likely to be a greater demand for collateral (business or private) to support loans with a longer maturity. Finally, it has been argued that short-termism continues to be a significant failure of the UK bank finance market (Edwards, 1987; Cruickshank, 2000).

To summarise, the general problem of information asymmetry can manifest itself in one of three ways: acceptance of the loan application but at a higher than risk-adjusted interest rate; acceptance but with strict collateral requirements; or outright rejection of the loan application. Acceptance but with higher than risk-adjusted interest rates can result specifically from the adverse selection problem or as a result of greater concentration in the market for finance. Acceptance but with more severe/strict collateral requirements is likely to result from moral hazard, compounded by the trend towards longer-term debt. Outright rejection of a loan application can result from moral hazard, market concentration, centralisation of lending decisions, and the increasing use of computer credit-scoring.

### **The small firm recipient of finance**

Now that the problems faced by the provider of finance have been discussed and the principal-agent relationship is better understood, it is useful to examine the problems faced by small firms when attempting to raise finance. The nature of the information asymmetry problem on the firm's side is that it cannot prove the quality of its investment projects to the provider of finance (usually the bank). Small firm managers often suffer from a lack of financial sophistication as they are often product or service specialists, not specialists in the area of finance. Thus, the information asymmetry problem is partly one relating to difficulties in the spheres of communication and credibility. This is compounded by the fact that new or recent start-up businesses may be unable to provide evidence of a good financial performance track record. Banks in particular rely on past financial performance as an indicator of the future profitability of projects. A closer relationship between the bank and the firm should reduce the information asymmetry regarding the firm's understanding of the lending constraints faced by bank managers (Watson, 1986).

Other small firm financing problems relate to the characteristics of the firm itself and the attitude and objectives of the owner-manager. Such characteristics include their diversity, their higher risk, their inability to provide strong collateral, and stage of development effects. Binks and Ennew (1996) note that there is no such thing as a typical small firm. This heterogeneity presents lenders with great difficulty in determining the risk associated with the firm's projects.

Due to the lack of business experience of many small owner-managers in the early years of the business, business risk may be more significant than for larger firms. Small firms generally have smaller financial reserves to draw upon in times of crisis and are also relatively highly geared compared to larger firms due to the difficulty and expense of attracting new equity finance. Thus, such firms are characterised not only by higher business risk but also higher financial distress risk. Banks tend to respond to this risk by adopting a capital gearing rather than an income gearing approach to lending. Thus, rather than focusing their attention on evaluating the income streams flowing from an investment project, they may focus more upon the value of collateral available in the event of financial distress. This creates a problem for small firms in that they often do not have significant fixed assets to secure upon in their early years of establishment. The stage of development, then, may be an important determinant of, and constraint upon, the type and amount of external finance raised. Small firm financing, then, will typically be heavily secured debt, with few incidences of external risk capital contribution (Cruickshank, 2000).

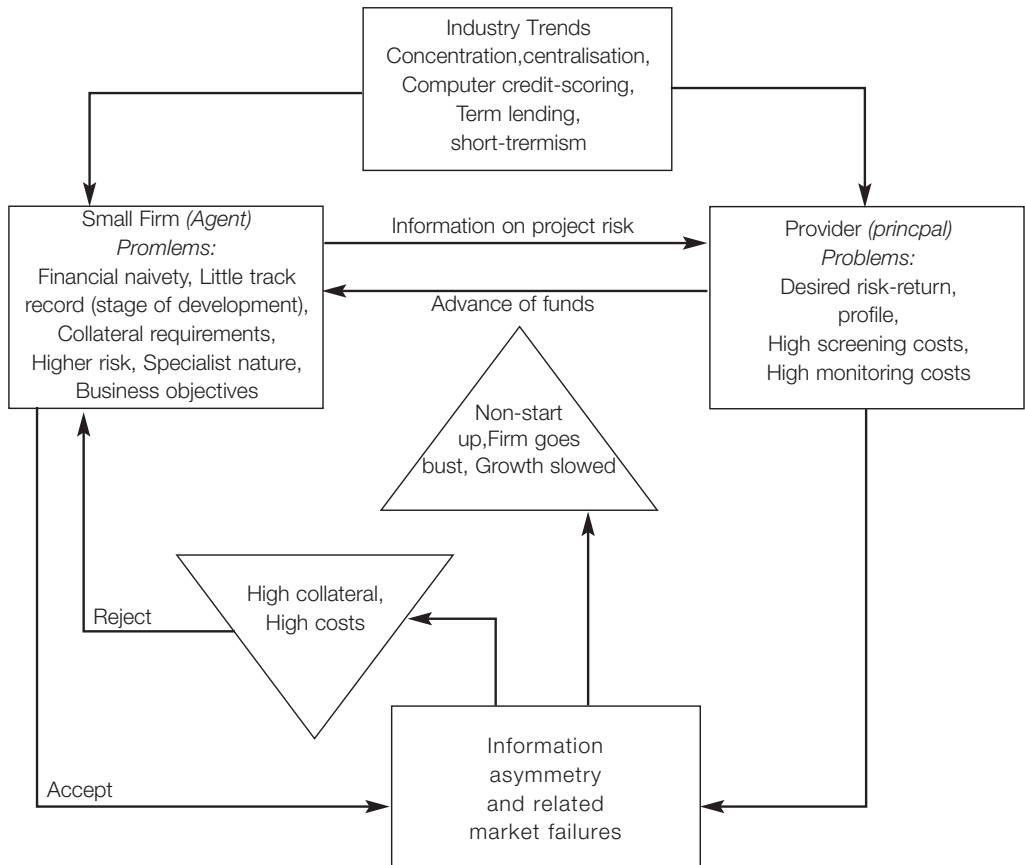
The attitude and objectives of the owner-manager can exert an important impact on the firm's ability to secure external finance. Such managers are often unwilling to provide personal assets as collateral. Furthermore, many small businesses have objectives other than growth as a priority (e.g. 'lifestyle businesses'). However, Binks and Ennew (1996) argue that many small firms will be forced to provide yield expansion to protect their limited liability status (which would otherwise be eroded by the provision of personal assets as loan collateral). A primary motive for starting a small business is to exert greater control over the work environment and to internalise the benefits of personal effort and risk-taking. In this regard, then, it is understandable that many small business managers would not countenance any dilution of this control through the introduction of outside equity from venture capitalists or business angels. Thus, the attitudes of managers may sometimes constitute an important constraint upon the range of external financing sources available to the firm.

### **Provider-recipient interaction in the presence of information asymmetry**

Figure 2 presents a model of principal (provider) and agent (small firm) interaction, noting that the former focuses upon high street bank financing. Information asymmetry and related problems such as adverse selection and moral hazard are central to the problems encountered by providers and, in turn, by small firms. Industry trends such as centralisation of the lending decision and greater reliance on computer credit scoring compound these problems for small firms. The ultimate effect on the small firm is acceptance but at higher interest rates, acceptance but with stricter collateral requirements, or rejection of the application for funds. It is the overall incidence and impact of all three which might give rise to a finance gap in the UK.

### **Quasi-Commercial (QCOM) Finance**

The success of developing world 'micro-finance' initiatives in combating poverty by enabling the poor to enter the market mechanism as small business owners has renewed interest in informal financing approaches in the developed world. From the early 1990s, the United States embraced the micro-finance philosophy as a means of combating social exclusion caused through long-term structural unemployment (Hulme and Edwards, 1997). In the UK, the Labour government's emphasis upon tackling social exclusion mirrors developments in the United States. The aim of one of the Policy Action Teams within the Social Exclusion Unit (established in 1997) is to encourage enterprise in deprived communities. In their first report (Enterprise and Social Exclusion, November 1999), access to finance is identified as one of the key obstacles to the development of enterprise in poor communities. Thus, there has been much recent interest in the opportunities that micro-finance and other forms of informal finance might offer in addressing the finance gap in developed countries.



**Figure 2: Information asymmetry in small firm lending**

### Defining the concept

In translating the concept of micro-finance from the developing to the developed world, the term has taken on a broader meaning. Indeed, it often appears that the term is used as a label for any type of non-bank finance provided to small (especially micro) firms. It is useful therefore to consider how micro-finance might be more clearly defined. Malcolm Lynch, a UK contributor to an International Labour Organisation seminar on the topic, defined micro-finance as:

1. A business loan of less than 10,000 ECU;
2. Made to a person or group of persons to undertake or finance a business or community enterprise start-up;
3. Financial support for the training of the unemployed for self-employment so as to enable them to more effectively use micro-finance and/or;
4. Mentoring schemes for the new entrepreneur. (International Labour Organisation, 1998)

Therefore, micro-finance, using this definition, is a particular type of informal finance that takes the form of a small loan to individuals (or a group of individuals) who are in some way 'socially excluded' to enable them to become self-employed or start a business. Assistance in the form of training or mentoring may also accompany the loan. Some writers include small grants under their definition of micro-finance. A good UK example is the Prince's Youth Business Trust.

However, this definition leaves us without a satisfactory means of conceptualising the many other forms of non-conventional finance that exist in the. Other forms of non-conventional finance include:

1. *Social banks* who only lend to businesses with clear social and environmental objectives;
2. Organisations who only lend to *co-operative* or *community based* enterprises
3. *Business credit unions* who only lend to their own member businesses;
4. *Mutual guarantee societies*;
5. '*Business angels*' (informal venture capitalists);

These lenders, unlike conventional banks, appear willing to accept the greater screening and monitoring costs involved in over-coming information asymmetry as there is a likelihood of an additional non-commercial payback in the form of psychic income (the satisfying of personal/individual wants (Wetzel, 1984)), and/or public policy (the satisfying of public/social wants).

Generally, 'non-commercial' criteria do not feature in the lending process of conventional banks who typically adopt a CAMPARI-type framework (Banking Liaison Group, 1999). However, other criteria, of a non-commercial nature, might be important to certain less-conventional lending bodies. Examples include the environmental, social or community impact of projects receiving finance, ethical considerations and psychic income generated.

Any lending body that employs CAMPARI-type criteria plus at least one of the above non-commercial criteria might be termed a 'quasi-commercial lender' and thus the provision of resources following the satisfaction of these extended criteria could be termed 'quasi-commercial' or QCOM finance. In this regard, then, lending bodies exist on a continuum whereby their lending criteria can be gauged anywhere from purely non-commercial through to purely commercial. At the commercial extreme exist conventional banks and the capital markets whereas towards the non-commercial extreme exist governments and charities providing grants and soft loans. In sum, micro-finance is simply one form of quasi-commercial finance. This study, in considering non-formal finance in a UK context, examines a wide range of mechanisms which fall within the new definition of quasi-commercial finance.

### **QCOM finance as a potential solution to the finance gap**

There are a number of different mechanisms through which the finance gap, as previously described, might be closed. The absence of full information on the quality of the firm's projects, a problem exacerbated by the phenomenon of adverse selection, could be addressed by greater screening of projects at the application stage and continued monitoring during the loan period. Whilst screening diminishes the problems associated with information asymmetry and adverse selection, greater monitoring can guard against moral hazard and encourage full performance of the investment project. The potential of different forms of QCOM in addressing the finance gap is explored below.

#### **1. Specialist lenders**

Small firm finance risk can potentially be better understood and dealt with by lenders who specialise in small firms, lending to certain sectors, lending within certain limits, or lending to firms with specific (e.g. social or environmental) objectives. Social banks currently undertake such a specialist role, relating to some of these sub-markets. Additionally, social banks are often able to borrow from their investors relatively cheaply by promising compensating returns in the form of psychic income. This increased rate spread can be at least partly used to cover the higher screening and monitoring costs associated with small firm finance.

#### **2. Mentoring schemes**

Both small firm business risk and screening/monitoring costs may be reduced with the appointment of an expert mentor. Part or all of the rewards to mentors come in the form of psychic income

derived from aiding a small business within the mentor's community. Mentors can be engaged to improve the screening process by helping the owner-manager to develop a more robust business plan, by helping to 'translate' the quality of the investment project to the provider of finance, and by providing continued monitoring. A number of micro-finance schemes employ the use of mentors in order to reduce lending risk. Further, the association of a mentor with a particular business may also facilitate access to further external sources of funding by reducing the screening and monitoring costs of providers (e.g. banks).

### **3. Matching agreements**

Matching agreements occur where one lender will match the funds of other lenders providing that at least one of those other lenders has undertaken rigorous screening/investigation of the loan candidate (and incurs the costs of so doing). Social banks can play an important role here, absorbing screening costs through higher spreads or even lower overheads. Alternatively, charities and quasi-governmental organisations may be willing to undertake screening activities on behalf of other matched lenders. Micro-finance providers such as the Prince's Youth Business Trust are often prepared to incur screening costs and play the pivotal 'first to commit' role in the matching process and even help to co-ordinate other parties in that agreement. Matching agreements, then, whilst not addressing the intrinsic risk of the individual small firm project, can reduce total screening costs across providers and also provide further diversification of that risk.

### **4. Mutual support groupings**

The provision of finance or the reduction in risk to an institutional provider can both be achieved by a collectivist approach to small firm borrowing. Businesses can join credit unions for the provision of lower-than-market-rate finance to members. This directly circumvents problems of the principal-agent relationship with respect to institutional providers by effectively rendering all member firms both principal and agent. Risk is thus internalised to the small firm sector. Businesses of like nature or philosophy can also engage in mutual guarantee agreements, these having the effect of minimising the risk to the provider and enabling relatively cheap borrowing from providers such as banks. Mutual guarantees reduce the need, then, for more rigorous investigation and are conducive with lower screening and monitoring costs.

### **5. Micro-finance initiatives**

Micro-finance initiatives involve the provision of small-scale finance through grants or soft-loans, to small firms often as part of a package of other services (e.g. training or mentoring). The provision of a grant may not necessitate high screening costs, relying more on simple eligibility criteria. The criteria for soft-loans will be more stringent, though are likely to rely more heavily on softer (QCOM) criteria than would be the case for banks. Again, screening costs can be relatively low and are borne by micro-finance providers as they are compensated by psychic income or are incurred as a matter of public policy.

### **6. Provision of risk capital**

The principal-agent relationship discussed previously relates mainly to debt finance, consistent with the dominance of debt in the small firm market for external finance. However, the provision of risk capital (external equity investment) by informal venture capitalists (business angels) can address each of the problems associated with the finance gap. The business angel will only make an equity investment in a firm once it has fully screened the business proposal and is allowed participation in the management of the firm. The provider thus becomes both principal and agent and the information asymmetry may disappear, depending on the extent of participation. However, an important problem remains for the provider of risk capital i.e. how to identify small firms which are worth investing in. There is an implicit understanding here that small firms are risky, but that the higher returns from identifying and investing in an entrepreneurial firm will compensate for this. The

information asymmetry problem thus re-emerges in a different guise, that is, the absence of a clearly defined market for entrepreneurial small firm finance. The solution is the creation of a network of business angels to facilitate a greater flow of information to and from potential providers, the costs of which might reasonably be borne by Government as a constituent of small business policy.

What is clear from considering the problems constituting the finance gap, high screening and monitoring costs and the higher risk associated with small firms, is that the six solution mechanisms discussed above suggest greater provision of QCOM finance. Put another way, QCOM finance can, in theory, be argued to provide practical solutions to the financing problems faced by small firms, potentially leading to closure of the finance gap. The main purpose of the primary data collection was to determine the extent of its current role in practice.

### Research Methodology

The aims of the primary research were achieved by means of a two-stage approach. Firstly, grounding interviews were conducted with providers and recipients of finance, as well as advisors and intermediaries in the small business finance market. Secondly, 1,000 small UK firms were surveyed to investigate current patterns in financing as well as difficulties encountered in the financing process.

**Phase 1:** The main purpose of the first phase of the research was to inform the researchers' understanding of current provider-recipient finance market interaction. The exploratory nature of this initial research phase therefore favoured a methodological approach that was inductive in nature. Consequently, a qualitative, interview-based approach was adopted.

All recipients and intermediaries interviewed in the first stage are based in the South West of England whilst providers included organisations based in other UK regions. Interviews lasted between 30 minutes and two hours and were based around a semi-structured interview plan. Most were held at the interviewee's place of work, though a minority were telephone interviews. All were tape-recorded and interview summaries were developed as a means of disaggregating the collected data.

**Phase 2:** In the second phase of the project, a questionnaire survey was implemented based upon a sample of 1,000 small UK firms drawn from a commercial database. The firms were selected to conform to certain criteria - they should have less than 10 employees, a sales turnover of less than £2.5 million, and should be drawn from all industrial sectors. A draft questionnaire was piloted among a small sub-sample of local businesses. This was particularly important given the often sensitive nature of questions. The survey was released in early November 1999. Data from responses was entered into an 'SPSS' database application for analysis.

### Findings of phase 1

For phase 1, a variety of providers (8), intermediaries/advisors (4), and recipients (8) were interviewed:

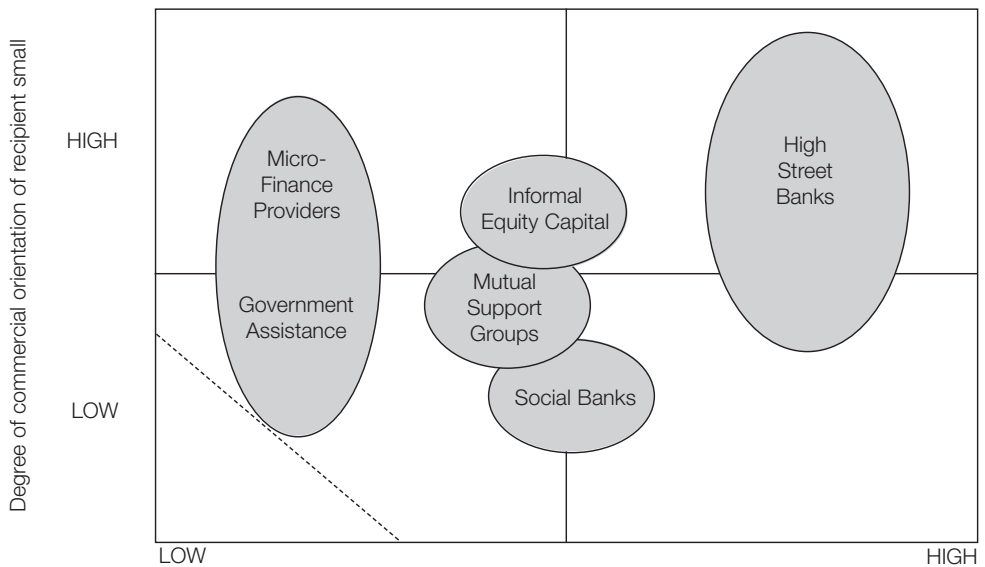
*Providers:* High Street banks; micro-credit providers; social banks/lending institutions; informal venture capitalists; business credit unions; mutual guarantee societies

*Intermediaries/advisors:* national and regional chartered accountants; Business Link; Enterprise Agencies

*Small businesses:* Typesetting; office interior design; mail order company; restaurant; furniture producer; web site designer; printing and computer refurbishing

The small firms interviewed all had some commercial goals which drove their businesses and thus could all potentially borrow from strictly commercial lenders (such as High Street banks). A subset maintained social goals and thus was potentially eligible for financing from certain social banks/lenders.

All small firms, regardless of their ultimate goals, appear to experience similar financing constraints: poor collateral, fears of dilution of control, and lack of financial track record. The subset of small firms which maintain social goals have a peculiar set of problems. There is a tangible conflict between their commercial and social goals, which means that social lenders may be wary of their ultimate motives for social borrowing whereas commercial lenders may be wary of lending to a firm that does not appear to embrace the discipline of the market.



**Figure 3: Model of provider-recipient interaction in the small business finance market**

### Degree of commercial orientation of providers

Figure 3 provides a strategic space perspective on the market for small business finance. It shows the association between the degree of commercial orientation of recipient firms and the degree of commercial orientation of the providers. High Street banks have a high degree of commercial orientation and typically provide finance for commercially oriented firms. However, as shown in the Figure, they also provide some finance schemes for community enterprises. Informal venture capitalists are characterised by a high degree of commercial orientation in that they demand a market return on their investment. However, they also derive a significant psychic income from their investments. Similarly, mutual support groups and social banks both provide for firms with a relatively low commercial orientation, though social banks still require a commercial return, with the social lending goal reflecting their market differentiation rather than accepting sub-market returns. Micro-finance providers tend to have a lower degree of commercial orientation, and, in the developed world, are often charities or receive significant Government assistance. Many, however, provide loans to a wide range of small firms, including those with a purely commercial orientation. Their focus is more upon the degree of social exclusion of the owner-manager than the objectives of the business.

## Findings of Phase 2

The aim of the survey phase of the research was to determine: the extent of awareness of various forms of small firm finance, focusing in particular on QCOM forms; the extent of use of these forms of finance; and to identify the issues which are important to small firms seeking finance. The response rate from the survey of 1,000 small firms was disappointing though perhaps unsurprising: 103 firms returned usable responses. This response rate can largely be attributed to the sensitivity of the financial matters addressed by the survey.

## Nature of the sample

The results showed that 66 per cent of the respondents were first time businesses, most of which were private limited companies. The respondents were predominantly micro businesses, with 67.6 per cent employing five people or less and with the mean number of employees being six. For this sample, 70.5 per cent were businesses with a turnover of £500,000 or less, and 85 per cent had total assets of £250,000 or less. There were a relatively small proportion of start-ups within the sample of respondents, with only 16.2 per cent of firms in existence for less than five years. As the survey reflects both the current and past experience of small firms in the market for external finance, this was not felt to be a significant limitation. However, given that micro-finance (though not all firms of QCOM finance) is usually associated with start-up finance, certain results may need to be interpreted with a degree of caution. In terms of the demographic characteristics of the owners of the firms sampled, the great majority were found to be mature (76.6 per cent over 40 years old), white (94.7 per cent) and male (90.8 per cent).

## Awareness of QCOM finance

Table 1 illustrates the awareness amongst respondent firms of a range of QCOM financing options. The majority of firms are unaware of non-bank sources of finance. They are, however, more aware of both formal and informal venture capital opportunities than the other options. This may reflect the advanced stage of development of many of the sample companies. Given their length of establishment and the marketing efforts of quasi-governmental providers such as Business Link and Enterprise Agencies, the lack of awareness amongst the respondents of these providers is quite surprising. It may reflect that the role of these organisations is perceived to be more that of intermediary than provider. Very few firms were aware of the existence of mutual support group providers such as business credit unions and mutual guarantee societies, awareness of social banks was particularly low, and few firms were able to articulate other sources of external finance.

Form of finance	Awareness of form %
Formal venture capital	49.5
Informal equity capital (business angels)	33.3
Business Link grant/loan	21.9
Prince's Youth Business Trust grant/loan	21.0
Enterprise Agency grant/loan	17.1
Loan obtained through membership of a business credit union	7.6
Loan obtained through membership of a mutual guarantee society	7.6
Other source of external funding	4.8
Social bank loan	1.9

**Table 1: Awareness of various forms of QCOM finance**

The lack of awareness of non-bank sources may result from a lack of need by most small businesses to know about alternative sources. Indeed, they may be entirely happy with the range of sources available from the commercial sector.

### Use of external finance

Table 2 illustrates a relatively high dependence on the bank overdraft facility as the main source of external finance, with a surprisingly low proportion of firms raising finance through bank term loans or other sources. The reliance on bank overdrafts might suggest that small firms place great importance on the flexibility offered by short-term debt as opposed to longer-term debt with structured repayments. Alternatively, it may simply reflect the fact that the sample contains a high proportion of well-established firms which are cash generative and thus have a lower requirement for external finance.

Form of finance	Successful in obtaining %
High Street bank overdraft facility	64.8
High Street bank term loan	21.0
High Street bank term loan (guaranteed by SFLGS)	10.5
Family and/or friends	17.1
Other source of external funding	2.9
Informal equity capital (business angels)	1.0
Formal venture capital organisation	1.0
Business Link grant/loan	1.0
Enterprise Agency grant/loan	1.0
Social bank loan	-
Loan obtained through membership of a business credit union	-
Prince's Youth Business Trust grant/loan	-
Loan obtained through membership of a mutual guarantee society	-

**Table 2: Use of various forms of QCOM finance**

The dominance of bank sources of finance contrasts starkly with the low use of most QCOM sources, the only exception being finance provided by family and friends. The latter represents a proportionately small but nevertheless important source for a significant minority of businesses.

It is interesting to note the significant minority of firms which have made use of the Small Firms Loan Guarantee Scheme (SFLGS). The use of this scheme by firms may be one reason why a wider range of financing options, such as that provided by mutual guarantee societies, are not used. Indeed, Cruickshank (2000) proposes that the government should switch its financial support away from the SFLGS and towards an enlarged venture capital fund programme. If this were to occur, this might provide an impetus for growth for mutual guarantee societies and other QCOM providers.

### Issues in raising small firm finance

Table 3 illustrates that most firms regard High Street bank financing and family/friends finance as easy to acquire, which again suggests that for most firms a debt finance gap does not exist. What the survey did not address was whether the scale of finance and other specific term details agreed were satisfactory to the recipient. However, only 24.8 per cent of firms regarded the provision of

external finance as either inadequate or very inadequate. Indeed, a surprisingly high 31.4 per cent of firms do not make any attempt to raise any form of external finance, suggesting that many firms are financed adequately from private sources or from internal finance generation.

Form of finance	Perception that acquisition is easy %
Family and/or friends	88.9
High Street bank term loan	86.3
High Street bank term loan (guaranteed by SFLGS)	81.8
High Street bank overdraft facility	79.1

**Table 3: Perception of ease of acquisition of various forms of finance**

Given the information asymmetry that exists regarding the quality of the small firm's investment projects, lenders may demand security for advances or only lend as part of a matched funding agreement. This is borne out by the survey findings which show that for those firms using High Street bank term loans 81.8 per cent had to provide security against the advance, as did 72.1 per cent of firms arranging an overdraft facility. At present there is little evidence of matched funding arrangements being pivotal to the lending process, although qualitative findings suggest that this is a requirement of growing importance.

Table 4 shows how respondents rank the difficulties faced when raising external finance. For most of the financing difficulties listed in the table, only a minority agreed that they were significant. The most common difficulty (for 50 per cent of respondents) appeared to be a lack of knowledge by finance providers about the nature of the respondent's business. Interestingly, 42.7 per cent of respondents also admitted that their lack of knowledge about lending criteria used by providers represented a significant difficulty whilst 42.4 per cent of firms identified difficulties in accessing information about available finance. These three difficulties demonstrate the centrality of information asymmetry in provider-recipient small business finance market interaction.

Difficulty	%
Lack of knowledge by finance providers about my (small) business(es)	50.0
Lack of securable assets	48.4
Lack of knowledge by my (small) business(es) about lending criteria used by providers	42.7
Difficulty in finding out about available finance	42.4
Lack of financial performance track record	22.5

**Table 4: Financing difficulties encountered by the business**

A significant proportion (48.4 per cent of respondents) regarded a lack of securable firm assets as an important problem in the finance raising process. This contrasts with the relatively small proportion of firms that view a lack of financial track record to be a significant difficulty (22.5 per cent of respondents). For businesses that are more recent start-ups, one would expect the lack of financial track record to be a more important problem, as noted in the case of the firms interviewed in phase one of this study.

#### **Impact of stage of development, firm objectives and location on use of external finance**

Chi-square analysis was employed to determine whether the stage of development and objectives of the firm have a significant impact on its choice of external finance source. The influence of firm location was also explored.

The stage of development of the firm was proxied by the number of employees, the level of sales, the growth of sales, total assets employed, and the age of the business. The results showed no variations in relation to age of business, growth in sales and number of employees. However, there were some variations relating to current total assets employed and current sales. There appears to be a significant relationship (at the 10 per cent level of significance) between firm size and use of external finance. Of those firms with total assets of less than or equal to £50,000, 75.5 per cent used external finance, compared to 59.6 per cent with total assets exceeding £50,000. This suggests that those firms who have a lower asset base are more likely to use external finance.

Certain significant relationships were determined with respect to the firm's choice of financing form. Of those firms with sales of £250,000 or less, 26.5 per cent used finance from family and friends, compared to only 8.9 per cent for firms with sales over £250,000. This scale effect was significant at the 5 per cent level. This suggests that family and friends, although important providers of finance, are only financially able/willing to support smaller ventures. There is also a scale effect with respect to the use of bank overdraft facilities. Of those firms with total assets of less than or equal to £50,000, 71.7 per cent used a High Street bank overdraft facility compared to 55.3 per cent for firms with total assets exceeding £50,000 (significant at the 10 per cent level). This illustrates a stage of development effect, again showing that those firms who have a lower asset base are more likely to use bank finance. The objectives of the firm were measured in terms of the sales growth objectives for the next financial year and the motivation for the owner manager starting up the firm. The chi-square results show that there was no significant association between the business objectives variables and the firm's use of different forms of external finance. However, the small number of firms using sources from across the range in our data set meant that it would be impossible to identify variations relating to certain finance forms. Therefore, it is still possible that there may be a relationship between firm objectives and external financing sources which could not be identified from this analysis since its purpose was to examine the position of the 'average' firm rather than firms using specific sources of finance. In order to identify whether such variations exist, it would be necessary to construct a stratified sample with significant representation of firms using different types of external finance.

Although no association was found between business objectives and the choice of financing form, a significant relationship (at the 10 per cent level of significance) was determined between the growth objectives of the firm and its use of external finance generally. This indicates that a smaller proportion of firms with low growth objectives used external finance when compared to firms with high growth objectives (61.7 per cent and 79.2 per cent of firms respectively).

To examine the relationship between firm location and success in obtaining external finance, the sample firms were categorised into a number of different groups. One such division was achieved by dividing the firms into two groups, the first containing those firms located in the north of the England (plus Scotland, Wales and Northern Ireland) and the second containing firms in the south. However, the general result for all categorisations was that no significant regional variations exist, although interestingly there is some indication that firms in the south of England are more successful in obtaining term loans guaranteed under the Small Business Loan Guarantee Scheme (significant at the 5 per cent level).

In sum, there is little variation amongst the sample firms in terms of associations between use of external finance and stage of development, firm objectives and location.

### **Impact of owner-manager age, gender, and ethnic origin**

It was found that ethnic origin and age exerted no measurable impact on either the use of external finance generally or the choice of specific forms of external finance. It should be noted, however, that in the case of ethnic origin there were few non-white respondents and thus further research in

this area is required to validate these findings. In relation to gender, there was no measurable variation in the use of external finance between male and female business owners, other than in one instance. It was found that use of bank term loans was significantly greater (at the 10 per cent level of significance) amongst male respondents. However, again, there was a limited response from female business owner-managers. Overall, these results illustrate that there is little evidence of exclusion from external financing on the basis of demographic factors.

## Conclusions and Implications

The aim of this study was to investigate the need for and use of micro-credit and other sources of finance in small firms. Phase 1 found that for certain types of firm (e.g. community businesses), QCOM finance played an important role. However, Phase 2 revealed that for small businesses in general, both awareness and use of QCOM finance were extremely limited. Indeed, the survey found that where firms do use external finance, this is most likely to come from conventional sources, and in particular High Street banks. Surprisingly, a significant minority of firms used no external finance at all.

The potential rationale for use of QCOM finance was initially explored by means of a review of existing literature. Phase 1 added to this understanding through an examination of the market served by each of the main QCOM providers as well as considering the factors that sampled SMEs felt were important in determining their use of such provision. Factors identified include financial track record and stage of development, the role of support, advice and mentoring, and the constraints of collateral and goal divergence. These results informed the development of a model of provider-recipient interaction in the market for small business finance and provided a framework for the development of the questionnaire survey in Phase 2. During this second phase, when asked about financing difficulties, only a minority agreed that the factors listed in the questionnaire were significant, although some of those difficulties recognised demonstrated the pivotal role of information asymmetry. Furthermore, only a small minority of firms regarded the provision of external finance as inadequate. This leads us to question the existence of a debt finance gap for the majority of small businesses. Most firms appear satisfied with the provision of external finance currently available and the majority do not recognise significant constraints in accessing this finance. Therefore, they have no reason to use QCOM finance. The chi-squared analysis showed that, apart from some limited effects related to size and the growth of objectives of the business, there were few significant variations in either the choice of different financing forms or the use of external financing generally. This suggests that neither stage of development nor business objectives are important determinants of the use of external finance.

It is now possible to consider whether QCOM finance can play a role in addressing the financing issues faced by small firms. Overall, findings suggest that whilst in theory there is a role to be played by QCOM finance, in fact its current role is limited for most firms. Indeed, for the average firm the evidence suggests that there exists no debt finance gap. However this and other research suggests that there may well exist an equity finance gap (see Cruickshank, 2000), though evidence in this study with regard to such a gap is anecdotal. Furthermore, whilst for the great majority of firms there appears to be no debt finance gap, the very nature of social exclusion is that it affects only the minority. Therefore it is impossible to rule out potential for financial exclusion of certain groups of owner-managers and their firms.

The above conclusions in part reflect some of the limitations of this study. In particular, there is a difficulty in reconciling the objectives of (i) determining the use of various forms of external finance (requiring a representative sample of UK small firms) and (ii) examining variations in use between distinct subcategories of firms using QCOM finance (requiring a stratified sample). Employment of a stratified sample may have revealed variations in use that were not evident from this study. Other limitations were the disappointing response to the survey and the potential for response bias, the

latter possibly resulting in a larger number of responses from more successful businesses which are less characterised by financial problems. Accordingly, further research is warranted, employing a stratified sample, to more accurately capture variations in use of QCOM finance across firms of different types and a larger scale survey.

### **Implications for small firms and policy**

For the majority of small firms, the existence of QCOM finance has few implications. Most firms do not experience problems accessing external finance from commercial providers. However, there exists a subset of firms that meet specific non-commercial criteria concerning owner-manager characteristics and/or business goals and operations. These firms may be able to access finance from QCOM providers and therefore need to be aware of the full range of options available. In addition, such firms need to consider the relative merits of different forms of QCOM finance. Examples of the potential considerations include the fact that informal risk capital will demand equity involvement and consequently control dilution, and that social banks may require 100 per cent security (which may not always be available). Furthermore, the scale of finance offered by many QCOM providers is relatively low compared with finance provided by banks. The implications of QCOM finance are perhaps particularly important to the pre-start-up business, which can at this stage in its development advantageously tailor its stated objectives to the requirements of specific QCOM providers in order to access funding.

*The findings of the study suggest that there is little justification for policy action with respect to the majority of small businesses, as there does not appear to exist a significant debt finance gap. The implication of this is that policy prescriptions should be focused in nature, addressing the needs of the minority of firms for which a finance gap still exists. Evidence from this and other studies suggests that such a gap exists for certain small businesses. These include those firms who might be characterised as micro start-ups owned by individuals who are socially excluded and, at the other extreme, small businesses with high growth-potential who may well be operating in the high-technology sector. For the former, a debt finance gap arguably exists. With respect to the latter, interview evidence indicates that the under-provision of equity finance (risk capital) is the key issue.*

To address the debt finance problem of socially excluded owner-managers, the extension of support for micro-finance and QCOM finance more generally may help to overcome the financing difficulties encountered. One example of how this is currently being achieved is the additional support provided by Government for the services offered by the Prince's Youth Business Trust. However, there are constraints to the growth of such activity due partly to limits in the number of volunteer mentors within a given community. There also exists an important caveat that mechanisms must be established to ensure that certain QCOM providers are not merely used as a means of accessing softer finance by firms that could otherwise access commercial sources. Thus, the strict application of qualifying criteria should be adhered to. Finally, it should be noted that, were certain initiatives to obtain significant financial support from Government, this might be seen as a move away from the strategy of 'picking winners' (high growth-potential firms), which has been a feature of recent policy (Storey, 1994), towards social support for job creation amongst very small low-growth firms. The advantages in terms of cost-benefit of such a shift in policy are debatable.

One further limitation of extending support for QCOM finance provision is that commercial financial provision is firmly embedded within UK business culture. Therefore, a move towards more co-operative or interventionist models of finance provision would require a significant culture shift. However, attempts to encourage commercial banks in the US to address the problem of social exclusion through the Community Reinvestment Act (1977), whilst producing a positive impact on certain social groupings, have also given rise to criticism in recent years. Further, such a system would not necessarily transfer well to the UK setting.

To address the existence of an equity gap for high growth-potential businesses, it is suggested that the government extend their financial support to widen the network of Business Introduction Services and improve the flow of information between investors and entrepreneurs. Government has focused to date on closing the debt gap through schemes such as the Small Firms Loan Guarantee Scheme. Cruickshank (2000) argues that Government policy should be refocused to address the problems associated with insufficient risk capital and illiquid equity markets for small firms. Given the fact that most of the small firms in this study feel that debt provision is adequate, this change in emphasis would appear to be sensible.

Overall, there would seem to exist a policy dilemma in the provision of external finance to small businesses: should the Government provide support for a QCOM sector which has limited scope and the potential to undermine commercial activities, or should they encourage commercial providers to broaden their already wide scope and adopt a more inclusive approach? Perhaps the solution is to support both COM and QCOM providers on the basis of their respective strengths in the market for small business finance, whilst at the same time providing sufficient information such that firms can determine more easily in which market appropriate sources of finance are to be sought.

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