Australian Small Enterprises and their Business Banking and Finance Needs

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Abstract

Access to financing plays an eminent role for a small enterprise sector in any economy. Based on previous empirical studies small enterprises tend to suffer from limited access to financial resources across the globe. This study aims to investigate the current state of small enterprise financing, as the data within the Australian context appears to be limited.

This research study will employ data from the survey on small business banking and finance, conducted by Council of Small Business of Australia (COSBOA). The principal analytical technique will incorporate the usage of descriptive statistics. A review of the Australian small enterprise environment and business banking sector will be examined including an analysis of the effect of Global Financial Crisis on the small enterprises’ financing arrangements.

It is envisaged that this study will contribute to the existing literature on small enterprise financing, with an emphasis on financial constraints in the Australian small enterprise sector. Analysis of the data will present an insight into the actual reasons for small enterprises constraints associated with debt financing arrangements. As a result, it will make a contribution to the disputes on the effectiveness of small enterprise-bank lending arrangements in the research literature.

Introduction

Small enterprises are a key source of employment, economic growth, innovation and productivity in advanced as well as emerging economies, as such they are a crucial sector of an economy (OECD, 2006b). The importance of the small enterprise sector as the cornerstone of Australian economic prosperity is widely recognised (Perera & Baker, 2007). The recent global financial crisis affected, in one way or another, credit flows to all sectors in economies (Hodorogel, 2009). Further to this fact, small enterprises have been considered as most affected by the economic climate due to the effects of this credit crisis (Hodorogel, 2009). This study aims to explore small enterprises banking behaviour and investigate the possible effect of a small business-bank lending process on the access to financing.

While not every small enterprise has an opportunity to grow at a fast pace and turn into a much bigger entity, most owner-managers are concerned about financing their business, in order to sustain their business operations (Wickham, 2006). The reality is that every business can experience some sort of financial trouble (Drever, 2006). Small enterprises are the ones that require more attention, as they constitute a vital part of the Australian economy, their survival rate can have a significant impact on the economy (Perera & Baker, 2007). As such, the justification for analysing small enterprises financing arises due to the high vulnerability of these businesses.
Justification for the Research

The purpose of this study is to address some of the issues that surround small enterprises financing in general. Firstly, there is very little available data on the type of financing used by smaller enterprises (Cosh & Hughes, 2000), and it is not uncommon to find small enterprises having liquidity problems (Drever, 2006). Secondly, the existence and reasons of a “finance gap” for smaller enterprises have been on the agenda for decades, ever since the Macmillan Report (1931) and more recently investigated by Watson (2006b) and Hutchinson & Drever (2007). Thirdly, it is widely held that banks are the main source of finance for small enterprises (Cosh & Hughes, 2000). As a consequence, bank assessment of the riskiness of loan applicants and their resulting decision to grant credit (or not) are important for smaller enterprises, as been noted by Jacobson, Linde, & Roszbach (2005). Therefore, as Tucker & Lean (2003) suggested, taking into account the view of Binks and Ennew (1996), an analysis of the way in which banks operate as finance providers is necessary, as they represent the main source of finance for smaller enterprises.

The four major banks account for the greatest market share within the Australian banking sector. This has an important impact on the small enterprise sector, as there is evidence that larger/universal banks are less well placed to build close relationships with small enterprises (Bannock & Doran, 1991). A number of difficulties may arise for small enterprises in obtaining funds from banks. An OECD report (2006a) confirms this view by suggesting that the difficulties that small enterprises encounter when trying to access financing could be due to an incomplete range of financial products and services.

The way that business financing is conducted by banks nowadays has been affected by various factors, including the recent Global Financial Crisis. Ever since the crisis started, banks have been under pressure to provide viable financing to many important sectors of the economy, including the small business sector. Australian banks and other authorized deposit-taking institutions (ADIs) were affected by the financial crisis primarily through its impact on the cost and availability of funding (Reserve Bank of Australia, 2009). The financial crisis may have had a negative impact on most of the small businesses, thus reducing the development rate and increasing the number of bankruptcies (Hodorogel, 2009). According to KPMG report (2003) small businesses, want financial service providers that continue to bring new, improved products and services.

Although the range and variety of products available to smaller enterprises have expanded, the management of the banking relationship continues to be problematic (Binks & Ennew 1996). In addition to this, Carey & Flynn (2005) confirm that change to the credit offered to smaller enterprises depends on the capital requirements approach employed by banks. An examination of business banking lending in Australia will provide valuable data on how products and services have been changed to incorporate the requirements of small enterprises.

Justifications for further research into the determinants of small enterprises financial constraints, which are supported by the literature, are as follows:

- It is important to determine the awareness of the range of financing sources available to the small enterprises and identify the gaps in the current credit management arrangements for small enterprises within Australian market (Drever, 2006).
- As reported by Drever & Hutchinson (2007) and Behr & Guttler (2007), there has been relatively little attention paid to small enterprises’ credit management and small enterprise-bank relationship lending.
- Promoting awareness of the range of financial products and services offered by banks will enable small enterprises to understand current financing arrangements, as credit management is not fully understood by small enterprises (Pike, Cheng, & Chadwick, 1998).
- There is generally a shortage of comprehensive, detailed data and objective analysis about the small enterprise banking market in Australia (KPMG, 2003). Therefore, this study may contribute to the literature on Australian small enterprises.
Inadequate bank lending is one of the greatest concerns for smaller enterprises, which has been reinforced by the recent Global Financial Crisis (Hodorogel, 2009; Yellow Pages, 1999). There appears to be a disproportionately great number of empirical studies about the financial decisions of large firms relatively to those for small enterprises (Daskalakisa & Psillakib, 2008). According to Binks, Ennew & Reed (1992) despite the apparent importance of bank finance, the issue of banking relationships has been relatively under-researched, particularly in the context of smaller enterprises.

**Literature Review**

Small enterprises are crucial for all economies and are a key source of economic growth in advanced as well as emerging economies (Luo, 2009). There is a growing recognition of the importance of small enterprises to economic development (Abor & Biekpe, 2007). Small enterprises are recognised worldwide to be a key source of dynamism, innovation and flexibility in advanced industrialised countries, as well as emerging and developing economies (OECD, 2006b). There is no commonly accepted definition of small enterprises. However, criteria to define small enterprises may include turnover, assets, employment numbers, and management characteristics (Lee & McGuiggan, 2008). Australian Bureau of Statistics (2009) identifies small enterprises as having the following characteristics:

- small enterprises have less than 20 employees
- independent ownership and operations;
- close control by owners/managers who also contribute most, if not all the operating capital; and
- principal decision-making by the owners-managers.

Majority of small enterprise owner-managers are concerned about successful financing of their business, as this enables them to promote the stability of their business operations (Binks & Ennew 1996). Financial stability within any type of business is vital as “a sound financial position brings security for employees, offers customers the prospect of good service and investment in future offerings, and promises suppliers a demand for their output” (Wickham, 2006). It is not unusual to find small enterprises experiencing some level of financial difficulty, either when such businesses require access to finance for assistance in meeting working capital requirements, or for funding the longer-term assets. This view was supported by Drever and Hutchinson (2007), as the consequences of becoming illiquid can be severe to the point of bankruptcy or insolvency. The recent Global Financial Crisis has affected credit flows to all sectors in economies to some degree and small enterprise sector was not an exception, as small enterprises were considered the most sensitive to these unstable economic conditions worldwide (Hodorogel, 2009).

There are significant numbers of small enterprises that could use funds productively (OECD, 2006b). Hawtrey (1997) argued that despite financial deregulation, having occurred many years ago, the small enterprise sector is yet to benefit from an improved supply of finance. If the small enterprise sector does not have access to finance for investment, the capacity to raise investment per worker, and thereby improve productivity and wages, is seriously impaired (OECD, 2006b). When small enterprises cannot find the financing they need, brilliant ideas may be lost, and this represents a loss in potential growth for economy (OECD, 2006b). Malhotra, Chen, Criscuolo, Fan, Hamel & Savchenko (2007) reported that micro, small and medium enterprises (MSMEs) complained about the lack of access to finance and that this constrained their growth and competitiveness.

According to Schiffer (2001) small enterprises found accessing financing more difficult than larger enterprises. According to Binks & Ennew (1996) for the vast majority of small enterprises, it is unrealistic to expect to fund from internal sources, unless large elements of personal equity are available from owners, family or friends. As a result, debt finance is typically the major source of external funding for small enterprises (Behr & Guttler, 2007; Luo, 2009; O'Donohoe, Hanley, &
Lyons, 2006; World Bank, 2007). Small enterprises are usually more credit constrained than larger enterprises in the economy due to financial sector policy distortions and lack of know-how on the part of the banks (World Bank, 2004c). Drever (2006) argued that financial problems (lack of funds) constrained the development and growth of small enterprises, as many of them are unable to access the same kinds of growth funding often available to large enterprises (Watson, 2006a). One of the principal findings in the research studies conducted by Keasey & Watson (1993), Storey (1994) and Timmons (1978), is that small enterprise sector exhibited a greater propensity to fail than bigger enterprises. Further to this fact, according to KPMG report (2003) smaller enterprises, in comparison to larger ones, face higher interest rates on credit, due to their high rates of failures.

The Australian banking system has been subject to a considerable change since the Campbell Committee (1981) introduced a recommendation that the banking system should be deregulated. Banks had to adjust from being, in effect, capital rationers largely free of risk exposures, to being risk-managing competitive financial intermediaries (Nielsen, Terry, & Trayler, 1998). According to Financial Stability Review conducted by the Reserve Bank of Australia (2009), borrowing by businesses from banks has been declining since late 2008. This has reflected both reduced demand for credit in the current environment and, to some extent, tighter lending standards. Credit risk is a key factor in management of a commercial bank. There are a number of reasons why commercial banks tend to deny credit facilities to small enterprise. These reasons include, an abnormally high small enterprise failure rate, little or no collateral to offer, inability to realistically assess small enterprise creditworthiness and soaring administrative costs (Shanmugam, 1988). The other major negative small enterprise-related factors, which affect the bank lending to small enterprises, are their lack of credit history and improper risk management and information systems (Ulster & Raa, 2003). As a consequence, banks’ ex-ante assessment of the riskiness of loan applicants and their resulting decision to grant credit (or not) at some risk-adjusted interest rate, are important for small enterprises (Jacobson, et al., 2005).

While it is clear from previous studies that small enterprises face a great number of barriers when obtaining access to finance, it is still necessary to analyse in more depth the roles that banks might have in determining the availability of external finance to the small enterprise sector in Australia. The relationship between banks and small enterprise owner-managers is not always clear and there are often misunderstandings with regard to bank charges, interest rates and securities (Fletcher, 1994). The special role performed by lending banks has led, economists to develop the concept of “relationship lending” during the nineties (Montoriol Garriga, 2006). Relationship-based lending, is one in which a loan decision is based on information that takes time to accumulate and relies on qualitative facts that both are relationship-specific and difficult to transfer or communicate to others (Cressy, 2002).

Relationship lending is particularly common in the case of small enterprise lending because they typically rely on bank loans for a substantial part of their financing needs (Ono & Uesugi, 2009). Relationship lending is characterised by close monitoring, implicit long-term contractual agreements and the collection of soft information over time (Montoriol Garriga, 2006). Diamond (1984) explains that relationship lending implies the existence of specific information on the borrower, which is available only to the financial intermediary and the customer (cited in Hernandez-Canovas & Martinez-Solano (2008)). Of the many sectors to which banks make loans, it is mainly to the small enterprise sector that funds are loaned with reluctance and reservation (Bourke & Shanmugam, 1990). According to a World Bank report (2007) because of the time and effort involved in understanding the borrower’s business and financial needs, relationship lending is costly for the lender and therefore, requires either high spreads or large volumes to be viable.
Survey Analysis
COSBOA has conducted a survey on small business banking and finance in Australia, which was released on 23 April 2010. Survey included 16 questions and the following rating scales were used to elicit responses: Likert, dichotomous and category. The coverage of the survey offers an opportunity to explore the data for the analysis of the small business banking in Australia. In total 173 businesses expressed their view on various dimensions of small business banking and finance (Council of Small Business in Australia, 2010). The analysis of the survey responses will incorporate the usage of descriptive statistics.

93.1 % (161 businesses out of 173, who answered the question) of the respondents were small business owners who expressed their opinions on the current state of small business banking and finance.

80.9 % (140 businesses out of 173, who answered the question) of the respondents have indicated that they principally used the Big Four banks (NAB, ANZ, Westpac, CBA) for their business banking needs.

In general, 30.1 % (52 businesses out of 173, who answered the question) small business owners reported that they were not satisfied with the products and services offered by their current financial institution; 27.7% (48 businesses out of 173, who answered the question) reported that they are somewhat satisfied with the products and services offered by their current financial institution. 64.1% (109 businesses out of 170, who answered the question) confirmed that they had experienced a change in the terms or policies of their financing arrangement in the past 18 months. Further to this information, 63.1 % (77 businesses out of 122, who answered the question) of small business owners surveyed explained that they had experienced an increase in fees, charges and interest rates in the past 18 months.

In addition, 88.7% (149 businesses out of 168, who answered the question) confirmed that they had not changed banks/financial institutions in the past 18 months.

Majority of the respondents - 69.8% (120 businesses out of 172, who answered the question) had indicated that access to affordable credit/finance was very important to operate their small business on a day to day basis. In addition, 68.6% (118 businesses out of 172, who answered the question) had confirmed that access to affordable credit/finance was very important to expand their business.

Significant number - 37.3% (28 businesses out of 75, who answered the question) of the respondents reported that they had been unsuccessful in getting access to credit/finance in the past 18 months due to the lack of security.

Dominant number - 42.4% (72 businesses out of 170, who answered the question) of the respondents would use more credit/finance to seize expansion opportunities; 38.8% (66 businesses out of 170, who answered the question) would use credit/finance to fund growth; 37.6% (64 businesses out of 170, who answered the question) would use credit/finance to improve cash flow.

Vast majority confirmed – 91.3% (157 businesses out of 172, who answered the question) that a competitive banking and finance industry is very important for small businesses. Vast majority of the respondents - 82.6% (142 businesses out of 172, who answered the question) indicated that small businesses in Australia currently do not have access to a competitive banking and finance industry.

Dominant number of small business owners – 57.4% (97 businesses out of 169, who answered the question) tended to believe that Government fund to finance small businesses would help them to get access to an affordable credit and finance.

Main Results
Small enterprises tended to do their banking needs with the Big Four banks; and reported that it would be better for their business if they could switch financial institutions more easily. Majority of the respondents also indicated that they were not satisfied with the products and services offered by their
current financial institution. In addition, small enterprises advised that they could not easily switch between financial institutions, due to the high costs involved. As a result, a vast majority of small enterprises did not change banks/financial institutions.

Dominant number of small enterprises had confirmed that they experienced increase in fees, charges and interest rates in their financing arrangement. Significant number of respondents had confirmed that it was very important to have an access to affordable credit/finance to operate a small business on a day to day basis and to expand the business as well. Survey results also show that from the start of Global Financial Crisis terms and conditions have affected the way business banking is conducted. Partly, due to a reason that small businesses reported that lack of security was one of the major reasons for not getting access to credit/finance. This could be interpreted, as an additional protection from banks perspective, against possible business failure.

Further, a majority of business owners indicated that they would use additional credit/finance to seize expansion opportunities, fund growth and improve cash flow. This shows that financial constraints hamper business growth and innovation in the small enterprise sector. Dominant number of small enterprises confirmed that a competitive banking and finance industry is very important for small businesses. In addition, significant number of business owners tended to believe that small businesses in Australia currently have no access to a competitive banking and finance industry.

Conclusion
This research study reiterated growing recognition of the importance of financing to the small enterprise sector. An empirical overview of the literature shows that analysis and investigation of small enterprises’ financial constraints within Australian market appear to be limited. The literature review revealed that there are not enough empirical studies about financial decisions of small enterprises and that information about the banking behaviour of small enterprises in Australia is incomplete. Furthermore, research literature appeared to have insufficient information about the determinants of financial constraints.

This study analysed results from survey on small business banking and finance in Australia, conducted by COSBOA. Small enterprise owners appeared to have a low satisfaction with the products and services offered by their current financial institution. They have also experienced a change in terms and conditions of the financing arrangements. Furthermore, small enterprises owners reported that they would use additional credit/finance to seize expansion opportunities, fund growth and improve cash flow. In general, survey results indicated that credit financing still remains a number one concern for the small enterprise sector in Australia.

References


