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SUMMARY AND CONCLUSIONS

Small business forms the backbone of the American system of free private enterprise, and the present study is an attempt to describe in general terms the manner in which one type of enterprise in this section of our economy finances its operations. The initiating impulse was provided by the decline of the commercial bank loan during the 1920's and 1930's, but the scope of the study was broadened to include a general survey of the economic character of small manufacturing corporations. Stress is laid on the manner in which small companies obtain and utilize their funds, the profitability of such enterprises, and their susceptibility to discontinuance. In particular it has been attempted to clarify the meaning of profits, as applied to a small business, to point out the financial symptoms of approaching discontinuance, and to analyze the promptness with which these symptoms become evident.

Data for such an analysis as that attempted here are not generally available. In recent years United States Treasury Department compilations of corporation income tax returns have permitted some financial analysis of small enterprises by broad industrial divisions; but the tabulations for the present study have made available, for the first time, detailed financial data on samples of small manufacturers in narrowly-defined industries over a period of 11 years, 1926-36. The data are compiled from the federal income tax returns of about 1,000 corporations, whose assets in 1926 amounted to less than $250,000 each, classified into samples of manufacturers of bread and cake, men's clothing, household furniture, stone and clay products, and machine tools and accessories.

These five sample industries were selected as representative of the various types of production in which small enterprises are able to maintain themselves. Thus two of these industries manufacture non-durable goods (baking, men's clothing), and the others produce durable goods; at least one (machine tool) is subject to a highly unstable demand, and in another (baking) demand is notably stable; some are big-inventory industries (for example, men's clothing), and in others inventory figures less prominently (for example, machine tool); one of the group (men's clothing) has very little investment in capital assets, while the others have a relatively large amount of capital tied up in land, plant and equipment. It is believed, therefore, that the samples studied here, although they constitute but a minor segment of all small manufacturing corporations, provide the basis for a fairly representative analysis.

The important observations drawn from the examination of these data, briefly summarized in the following pages, may be schematized as follows:

1. Small corporations provide little more than a living for their owner-operators; their profits, in the sense in which that term is customarily applied to large corporations, are meagre.

2. The failure rate among these small corporations is high, and the financial characteristics of ultimately discontinued companies begin to differ from those of more successful contemporaries several years in advance of the time of discontinuance.

3. Small corporations obtain a relatively large amount of their funds from short-term borrowings, among which accounts payable appear to be increasing in importance and notes payable (presumably bank borrowing) either decreasing or just holding their own.

4. During the prosperous years of the period covered, these small companies made some expansion of their land and plant; but in order to finance the enormous operating losses of the depression years and the necessary retirements of short-term obligations they were forced into a liquidation of assets which not only seriously impaired their working capital but also largely counteracted their pre-depression expansion of land, plant and equipment.

As to the first point, the profitability of large corporations is commonly measured by net income after all charges (including income taxes), but if this criterion is applied to small manufacturing corporations it reveals a poor profit record even for companies that weathered the great depression. The owners of a small corporation are generally also its officers and managers. A measure of profitability which ignores this fact - by considering officers' compensation as an expense of doing business - paints an unrealistic picture of the success of a small enterprise.

The owner of such a business considers it, in the first instance, as a job - a position that is his as long as he keeps the enterprise out of bankruptcy. Whether a net return is earned on the equity capital invested in the business is a secondary consideration. The owner makes no distinction between the return received for his managerial services and that for his capital. In fact, in many small corporations the relationship between officers' compensation and dividend disbursements is determined as much by tax requirements as by any other consideration.

Thus in the small manufacturing corporations under review, stock ownership appears to have had its main value as a claim to a job. But more than half of the companies discontinued operations during the years under survey, and therefore many of these would-be executives paid a stiff price for a temporary job. Fortunately for the owners, in the industry where the discontinuance rate was highest - men's clothing - their equity was relatively small.

Even though the discontinuance rate among small companies is high, the approach of impending collapse is reflected in their financial structure several years before the event occurs. A comparison of selected credit ratios for continuing and discontinuing companies reveals signs of comparative weakness in the latter as early as four or five years before the date of discontinuance. The men's clothing companies, whose existence is precarious at best, were more tardy in their response to unfavorable business conditions; but their distress signals are observable from their records for as many as three years prior to their disappearance from the business scene.

Three ratios proved to be particularly sensitive portents of discontinuance - net working capital to total assets, current assets to current liabilities, and net worth to total debt. The first two of these indicate the extent to which the working capital of an enterprise is being "frozen," while the last indicates the relative magnitudes of the owners' and creditors' claims on the assets of the enterprise.

But the conclusion that financial statements provide unmistakable signs of approaching failure several years before the unhappy event must not be abstracted from its industrial context. There is strong evidence that the length of this prediction period varies from one field of manufacture to another, with differences in the resistance of small enterprises to the forces of adversity. Furthermore, the present discussion is based on a post hoc analysis that does not provide an infallible method for foreseeing the approach of discontinuance.

The susceptibility of these small corporations to discontinuance provides the logical explanation of the infrequency of long-term debt among their obligations. Only the owners, whose ownership enables them to have a job and to reap the gains of prosperous years, dare take the risks involved in investing long-term funds.

Thus most of the borrowed capital is obtained through short-term obligations: notes and accounts payable constitute a larger percentage of total assets of small than of large corporations. Over the period covered by the present study, 1926-36, the accounts payable of these small manufacturers constituted an increasing proportion of their total assets, while notes payable either declined, in relation to total assets, or remained stable. Meanwhile, however, the total assets of these companies were decreasing, in dollar terms, partly because of a shrinkage of inventory holdings in dollar terms, itself a consequence of the fall in raw material prices during the 1930's. This decline in inventory values reduced the need for short-term financing, with bank loans being the first to be retired.

But this circumstance alone does not explain the constancy of notes payable and the rise in the relative importance of accounts payable. Several other forces must have been operating in the same direction. First, competition among the large raw material suppliers undoubtedly caused these concerns to offer the small manufacturer sizable amounts of credit. Second, it is very likely that the conservative lending policies of the banks during the early 1930's served to discourage many small businesses from seeking bank credit in the 1933-36 recovery period, and to impel them to look elsewhere for funds. Finally, an additional factor operating to explain the shift from bank to trade credit might well be the bank's analysis of credit risk.

In their short-term financing the small corporations studied here tended not only to reduce their reliance on bank as compared with mercantile sources, but also - as the increase in their ratio of cash to notes payable indicates - to reduce the scope of their net debtor relationship to banks. At the same time they cut down their ratio of receivables to accounts payable, an indication that they were extending less trade credit in relation to the trade credit they received. Over the period 1926-36 their cash holdings were almost as large as their bank debts, and they obtained more credit grants from raw material suppliers then they extended to their own customers.

During the period as a whole these small manufacturers did not expand their land, plant and equipment. In the prosperous years of the late 1920's and the recovery years of the middle 1930's they made some net additions to their plant and equipment. But the severe operating losses sustained during the depression years - plus the necessity for retiring short-term obligations - required a liquidation of assets which not only nullified the fixed property expansion of the prosperous years but also cut sharply into working capital. The current items were particularly flexible during the course of the cycle. Current asset liquidation during cyclical contraction provided the bulk of the funds used to pay off current debts and to finance operating losses. During cyclical expansion, on the other hand, retained profits and short-term borrowings were utilized to increase current and fixed assets, especially the former.

From a study such as this, one is tempted to draw broad generalizations respecting the future of small business in the economic life of the United States. But many of the factors bearing on this question - particularly the political and social ones - have not been discussed in the present study, and without an appraisal of small business from these other points of view a forecast of their future is not possible. The data examined here do indicate, however, that the financial affairs of small businesses cannot always be judged by the same criteria applied to large enterprises: profitability is a case in point. Also they reveal that large amounts were withdrawn from these corporations as officers' compensation and dividends during years when earnings were either meagre or actually negative, and when funds invested in new plant and equipment might have materially improved the companies' competitive positions. Such withdrawals are not necessarily an indication of imprudent management (the owners may have piled up personal savings as surpluses for their businesses), but they justify a presumption in that direction.