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Small and Unincorporated Businesses as a Source of Information for Social Accounting Purposes

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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

What is Needed

It is hard to find disagreement among economic statisticians on the need for better data relating to small and unincorporated businesses. Suggestions for expansion of economic data collection abound with calls for improvements in this area; descriptions of the statistical underpinnings of social accounts are most apologetic in explaining the derivation of aggregates used to represent unincorporated business activities.

Considering the improvements that have been made in developing statistical measures for other areas of the economy—corporate business, governments, international transactions—and considering the number of pleas for improvement of the unincorporated area, the lag cannot be taken as inadvertence. It must be taken as reflecting unique and grave measurement problems.

Some of these problems are obvious: the great number of individual units involved, spread over a great number of different industries with different growth trends and behavior patterns; the small size, on the average, of each individual unit; the lack of appropriate records upon which to base reports. All of these make data collection difficult and expensive.

Progress that has been made in sampling methodology and in the increasing adoption by small businesses of accounting procedures suggest that, with adequate resources, some of these difficulties might be overcome or, at least, that substantial improvements might be made over the present state of the data. A more serious and fundamental difficulty, however, is that of defining the economic unit whose activities are to be measured. In the case of unincorporated business, or for that matter the small incorporated enterprise, we are dealing with an amorphous economic entity, part business, part household. Records may not be kept in such a manner as to distinguish

Note: The views expressed here are those of the author and do not necessarily reflect those of the Board of Governors or of other members of the Board's staff.

the activities of the business from those of the proprietor as a consumer. Even when kept, they may be artificial, for legal distinctions adopted for tax or other purposes do not necessarily provide differentiation that is of economic significance.

The hybrid nature of the entity poses difficulties for both of the social accounting systems now in operation in the United States—the national income accounts and the flow-of-funds accounts. These difficulties are greatest for the flow-of-funds system. Although the income and product accounts require separation of business and consumer activities, these distinctions need be made only with respect to expenditures on current account and to net income. The compilers of the income accounts are spared much difficulty by operating a system which does not embrace transactions in financial capital and in which all real capital transactions are imputed to the business sector.[1] Moreover, there is no need, on the product side of the accounts, to distinguish business transactions by legal form of organization.

The flow-of-funds accounting system cannot so avoid these difficult conceptual and statistical problems. The principle of sectoring in flow-of-funds accounts calls for grouping by "decision-making units," and the accounting for such decision-making units must cover their decisions in financial markets as well as in markets for goods and services. For the flow-of-funds system, therefore, legal form of organization may be relevant, for certain methods of

[1] In the latest official description of data sources and estimating procedures employed in constructing the national income accounts, (*U.S. Income and Output, A Supplement to the Survey of Current Business*, Dept. of Commerce, 1958), the national income compilers take a strong stand against making certain distinctions between business and consumer activities of entrepreneurs. This position is set forth as follows: "In the absence of empirical data, attempts have been made to segregate entrepreneurial saving on the basis of a variety of assumptions—all of them, however, based on the common premise that it is possible to distinguish the saving-investment transactions in which an entrepreneur engaged in his business capacity from those in which he engages in a personal or consumer capacity. We do not believe that the entrepreneur himself is aware of such a distinction; nor is such a distinction embodied in existing business accounting records. Accordingly, we do not plan to introduce this vivisection of the entrepreneurial personality into the national accounts" (p. 63).

In a subsequent section of the report, however, there is extensive discussion of the improvement of the method of allocating outlays for passenger cars as between consumer and business use: "The problem of making this allocation is complicated by the fact that passenger cars are frequently used partly for business and partly for personal purposes. In general, the attempt is made in the present estimating procedure to allocate to business use all passenger car outlays which are charged to business expense" (p. 81). It is difficult for this author to see the substantive difference between accepting a proprietor's judgment as to the proportionate business and consumer use he makes of a physical asset and accepting his judgment as to the proportionate use of a financial asset such as a commingled business and personal checking account, or a securities portfolio which may be pledged to obtain a business loan at one time, a consumer loan at another.

financing are either unavailable or extremely difficult to obtain without a corporate charter, e.g. issuing capital stock or obtaining funds from certain types of institutional lenders.

On the other hand, legal form may not always distinguish matters of substance in financing possibilities. The principal owner of a closely held, small corporation may find that lenders require pledge of his personal assets before lending funds to the corporation, just as the proprietor of an unincorporated business may have to pledge a personal asset, such as his house, to obtain credit needed for his business operations. Size rather than legal form may be a more important determinant of what constitutes a decision-making unit in some transactions, while legal form may be determining in another situation.

Additional problems confront the flow-of-funds accountant. Within the noncorporate form of organization there are both sole proprietorships and partnerships. Some partnerships are exclusively business entities with clear distinctions maintained between operations of the business enterprise and of the household activities of the respective partners. On the other hand, in some partnerships, such as husband-wife or father-son arrangements, there may be no substantive distinction between business and personal activities.

The purpose of dwelling at some length on the conceptual requirements of the major social accounting systems is not to gain sympathy for the flow-of-funds accountant beset with these grave conceptual problems, nor to dismiss the major statistical problems encountered by the national income accountant in implementing his conceptually simpler decisions. Rather, it is necessary to emphasize these requirements in order to assess the appropriateness for inclusion in the accounts of existing data relating to small or unincorporated businesses, and to determine the most useful approaches that can be employed in undertaking new data collections. The focus of the following discussion will be on data obtained directly from these businesses—from their tax or other administrative records or from their responses on surveys—rather than on the data obtained from other parties to transactions with small or unincorporated businesses, e.g. estimating noncorporate cash holdings from surveys of bank deposits. The latter approach is the subject of another paper at this conference.

What Is Now Available and Used

In all of the complaining about the lack of data on small and unincorporated businesses, one should not lose sight of the fact that a substantial body of data is now being collected from these businesses and incorporated in the major social accounting systems. The information already used relates, for the most part, to transactions that are incontrovertibly business activities. In other words, where a sectoring decision between business and household accounts is obvious both to the reporter of the data and to the social accountant trying to fit it into his scheme of numbers, the distinction is carried through to the social accounts.

Inventories are probably easiest to distinguish as a purely business transaction. Here the record of obtaining reports from small and unincorporated business appears to be satisfactory. The Census Bureau includes such enterprises in its monthly surveys of manufacturing and trade sales and inventories, and reports a high degree of cooperation from respondents. In addition, there have recently been a number of improvements made in the benchmark data to which such monthly series can be tied, for the Internal Revenue Service is speeding up the tabulation of tax returns on sole proprietorships, partnerships, and corporations, is tabulating these data every year (rather than on alternate years for some components), and is tabulating both opening and closing inventories.

Expenditures for plant and equipment are another category in which transactions can be reasonably well identified as belonging to the business rather than the household-sector account (although problems arise with respect to the allocation of expenditures for passenger cars and for certain types of structures). The plant and equipment survey conducted by the Office of Business Economics and the Securities and Exchange Commission, which is used to develop current figures for the national income accounts on business construction and outlays for producers durable equipment (and for checking on estimates for earlier years derived by other methods), includes information obtained from small and unincorporated businesses as well as from larger incorporated enterprises. The survey is admittedly weak in industries where smaller business units predominate, but apparently not so weak as to preclude its use as a major guide in estimating key items in the income and product accounts or as an important tool in general economic analysis used by most economists.

Turning to the income side of the accounts, the basic information on income of small and unincorporated businesses come from reports filed by these enterprises—the tax returns submitted to the Internal Revenue Service (IRS). Ability to use these reports has been substantially enhanced in recent years by the increased currency and frequency of tabulation of the IRS returns, and by the audit study in 1949, which gave some clue as to the extent to which the tax-return data need to be adjusted in order to fit the requirements of the social accounts. The program for continuing improvement in the speed and comprehension of IRS data that is now under way will make these tabulations even more useful in the future, although more frequent audit surveys will certainly be needed.

Despite the improvements, however, there will always be a time lag of one or two years for which social accountants will have to estimate the series from other data sources. Moreover, the need for estimating necessary adjustments to IRS data for underreporting and nonresponse will undoubtedly continue. Most important, the IRS information provides no clue as to changes on a less-than-annual basis. This is undoubtedly the most serious gap in the series, for there is almost no information obtained directly on the monthly or quarterly changes in incomes of unincorporated businesses; and for small corporations, what is now available pertains almost exclusively to the manufacturing area.

Compensation of employees is another item in the national income accounts in which the basic records represent reports obtained directly from businesses, including small and unincorporated enterprises. In this case, the data utilized are the records prepared in connection with payments under social security laws. Reports are available on a regular basis for relatively small businesses; but for the very small enterprises, there are only occasional studies to provide appropriate benchmarks.

These are the major areas in which reports from small or unincorporated businesses are used directly or as an estimating basis for the national income accounts. It is impressive that as much information as has been noted above is available, albeit much of it as a by-product of the administration of tax or other law. It is evident, however, that the data available barely suffice to maintain national income accounts on a current quarterly basis.

They are even less satisfactory for the needs of current quarterly flow-of-funds accounts. Where the national income accounts can be content with utilizing the data noted above to prepare estimates for an all-business sector total, the flow-of-funds accountant must break down this total into a noncorporate, a corporate, a farm, and a financial-institutions sector.[2] Since the samples on which the current data relating to business transactions are based are usually far too

[2] The national income accounts do allocate some of the major expenditure items as between corporate and noncorporate business, as part of the reconciliation between personal savings derived in the national income accounts and financial savings calculated by the SEC. This is published only annually, however, and with a substantial time lag.

small to permit current estimates of the corporate and noncorporate components separately, the totals must be allocated in terms of historical relationships. This is obviously unsatisfactory for volatile items such as inventory, where changes in the types of goods involved may well shift the inventory flows as between the corporate and noncorporate area, unless the allocation is made in considerable industry detail and the benchmarks are reasonably current. Admittedly, the current noncorporate account in the flow-of-funds system is far from satisfactory with respect to nonfinancial items.

It is in a far poorer state with respect to financial transactions. Here there are no benchmarks and no current statistical series. From tax records—a major benchmark for the nonfinancial transactions—we have available only one balance sheet tabulation in the noncorporate area, that relating to partnership returns filed for 1953–54. The reports were so fragmentary that tabulations could be made only in terms of broad categories of financial assets and liabilities, and, even so, usable balance sheets were obtained from only about 40 per cent of respondents filing tax returns. The tabulations suggest that the balance sheets filed were supplied by larger enterprises, and that the aggregates are probably not representative of the universe of partnerships. No balance sheet returns have ever been requested of sole proprietorships.

The Office of Business Economics of the Department of Commerce has collected information on small-business finance on several occasions.[3] Some of the studies were restricted to the financing needs of new businesses, and the resulting data could not, therefore, be generalized to the universe. In another study, efforts were made to collect financial statements along with information on financing needs, but compilations of these statements have not been published.

Two compilations of data based on reports submitted by small or unincorporated businesses have been explored on different occasions as possible sources of financial data for social accounts. One is the compilation of balance sheets and income accounts submitted by small companies to bank loan officers, a sample of which is drawn and tabulated each year by the Robert Morris Associates, a national organization of bank loan officers and credit men. The data presented distinguish three size categories of small businesses. They are quite detailed in terms of subsidiary industry classification, particularly in manufacturing, and the balance sheet classifications presented are pertinent to the categories needed for the social accounts. Unfortunately, no distinction is made as to legal form of organization,

[3] *Survey of Current Business*, December 1948, April 1950, November 1951, October 1955.

thereby limiting use of the data in conjunction with available information on corporate businesses.

Moreover, the sample cannot be regarded as representative of the universe being measured in the social accounts, in that the data represent the financial statements of successful borrowers from banks. There is reason, on the basis of certain studies conducted jointly by the Census Bureau and the Federal Reserve, which will be described in a later section, to suspect that small businesses who have obtained credit from banks represent only a minority of all small businesses and that they may well have financial characteristics quite different from the average business enterprise of that size.

Another possible data source examined is the tabulations compiled and published by an accounting firm which, through local franchised representatives, provides a mail accounting service for small businesses. As part of its service to customers, the firm tabulates the accounts it has prepared and publishes composite or average statements for certain lines of businesses. Again, there is reason to think that the sample of businesses involved is not sufficiently representative to warrant using these data as a basis for estimating the universe of small or unincorporated businesses.

A New Attempt

The need for filling a cell in a social accounting matrix rarely proves to be a sufficiently persuasive reason for obtaining the funds and other resources needed in order to conduct appropriate statistical surveys. Social accountants must be accomplished "free loaders," seizing upon data needs for other purposes in order to advance their own needs.

It has been unfortunate that general needs for information on small businesses have not been sufficiently pressing to occasion more surveys from which some clues for social accounting aggregates could be obtained. More recently, however, the financing problems of small business in an era of generally strong demands for credit have focused attention on the gaps in our information in this area. Specifically, in the course of Congressional consideration of proposals to provide new mechanisms for making credit available to small businesses, the Federal Reserve was asked to undertake a comprehensive study of small-business financing needs. Two phases of the study have been completed and made available to Congress and to the public generally.[4] The two phases completed include a set of back-

[4] *Financing Small Business*, Report to the Committees on Banking and Currency and the Select Committees on Small Business by the Federal Reserve System, 85th Cong., 2d. sess., April 1958.

ground studies dealing principally with longer-term trends in the structure and financing of small business, and a set of reports presenting results of surveys conducted among the principal lenders to small businesses. The third phase of the study has required more extensive preparation and planning, for in this phase an attempt is being made to determine financing needs of small business by intensive surveys of businesses themselves. The Bureau of the Census is collaborating with the Federal Reserve in these surveys, helping in the design of schedules and samples and acting as collecting agent.

The approach being utilized is that of asking businesses about their financing experience in a very recent period: their attempts to obtain credit or capital, the extent to which these attempts were successful, the effect of no success or only partial success on their business operations. To provide depth of analysis, respondents are being asked to supply information on their financial structure, in the form of recent balance sheet and income accounts, as well as on their financing experience. These data are not being sought primarily to develop aggregates for social accounts, but rather to provide a basis for interpreting financing experience in the light of differences in financial structural aspects, such as liquidity, proprietor's equity, profitability, etc. Sample requirements for such a purpose are much smaller than would be the case if dollar aggregates were an objective. It is important to emphasize the focus of the surveys in order to assess properly the extent to which the results can be used in filling some of the gaps in the social accounts.

When a commitment was accepted to prepare a paper for this year's Income and Wealth Conference on the subject of small-business data and social accounting needs, it was hoped that a sufficient number of surveys would have been completed to serve as a basis for presenting definitive results to the Conference. In the usual course of events, the calendar has moved far more rapidly than the surveys. The first of the surveys—in the area of manufacturing corporations—is only now in progress, and analysis of the results will not be available until some time in 1960.[5] Full-scale surveys of retail unincorporated enterprises will not be undertaken until the

[5] The sample for the corporate manufacturing survey is based on a systematic selection of firms, with equal probability of selection within each of twelve classes. The twelve classes are defined so as to include three size classes (designated small, medium, and large) within each of four broad industry divisions (designated heavy durable, heavy nondurable, light durable, and light nondurable). The three size classes have been defined separately for each of the four broad industry divisions; this results in a size classification for each firm which is relative to that firm's industry division. The sample includes approximately 3,600 firms selected from fiscal-1958 Internal Revenue Service records with the cooperation and assistance of the IRS and the Federal Trade Commission.

spring of next year, and the results are not likely to be available until late in 1961.

The delay in getting full-scale surveys under way has not left us completely bereft of all information on the subject, however. Over the past year and a half, six pilot surveys, some of substantial magnitude, have been conducted in order to determine the most effective and economic methods of gathering the desired information. In these pilot surveys, schedules of different length and intricacy as well as both mail and personal interview techniques have been tested, and data-processing methods have been developed.

Pilot surveys have been conducted among small, medium, large, and giant corporations in manufacturing and retail trade, among unincorporated manufacturers, and among unincorporated retailers. Most of the corporate pilot surveys—pretest is a simpler word—have involved mail questionnaires. Two of the unincorporated pretests, one among unincorporated manufacturers and the other among unincorporated retailers, were also mail questionnaires; but in these, information on financing experience alone was sought, and no balance sheet or income data other than net sales were obtained. Two of the pretests, both in the area of unincorporated retailers, involved the use of personal interviews. In these pretests attempts were made to obtain information on financial structure as well as on financing experience. (It should be noted that in these personal interviews, the questioning about financial assets and debts was not as exhaustive or probing as the interviewing in the consumer finances survey. In many cases, the interviewer simply left the balance sheet with the respondent, who was asked to complete it and return it by mail.)

The pilot surveys have been very encouraging with respect to the primary focus of the studies, namely financing experience. Response rate has been very high in most, and there has been little difficulty in obtaining balance sheet and income account information from corporate enterprises. This is not surprising, however, in light of the success of the Federal Trade Commission's efforts in obtaining current financial reports from small as well as large manufacturing corporations.

In the unincorporated area, the major pretest involved an area probability sample designed by the Bureau of the Census to yield more than 200 areas or segments containing a high concentration of commercial establishments. Each of the segments was canvassed by a Census Bureau enumerator who had had previous experience with the Bureau's current business-reporting program. At each unincorporated retail establishment meeting the eligibility requirements of the survey, i.e. in business at least one year and having sales in 1958 of more than \$3,000, the enumerator introduced the survey and made an attempt to assist the owner in completing the questionnaire.

All respondents were asked to complete the part of the questionnaire dealing with financing experience. In addition to the questions on financing experience, half of the eligible respondents were asked to complete a fairly conventional and detailed income account and balance sheet relating to their business operations and an additional set of questions relating to personal assets, debts, and income not included in the business account. The other half of the sample was asked to answer a simplified set of questions about business assets and liabilities, personal assets and liabilities, and other income. If put into accounting form, the items about which questions were asked would approximate most but not all of the coverage of a conventional balance sheet. In most cases, it was necessary to leave the second part of the questionnaire with the respondent in order that he might have time to consult records in supplying the information.

As was the case in other pretests, questions relating to financing experience were readily answered by almost all respondents. In the unincorporated retail pretest, about 80 per cent of the 562 eligible respondents were able to complete this part of the questionnaire on the spot, and an additional 15 per cent completed it at a subsequent visit by the enumerator or returned a completed schedule by mail.

Information on financial structure proved much harder to obtain. Even with intensive follow-up—letters, phone calls, and, in many cases, return visits by enumerators—almost a fifth would not or could not provide an income statement for the most recent year, a statement of no greater complexity than that required for income tax purposes. About a fourth did not provide a sales-profit history going beyond the year preceding the interview. (Sales and profit data were requested for the preceding three years.) Almost a third did not provide the detailed balance sheet, a seventh did not provide the simplified balance sheet, and two-fifths did not provide information on personal assets, debts, and other income. These figures are not additive, naturally, and despite the inability to obtain specific types of information from certain respondents, approximately half of the schedules were fairly complete, and from 10 to 15 per cent more could probably be used for most analytic purposes. Analysis refers to classifying financing experience by financial characteristics of respondents. Analysis of response on financing experience classified only by size and subindustry group would certainly have adequate statistical foundation, considering the 95 per cent response rate achieved on the financing experience part of the questionnaire.

The purpose of pilot surveys, or pretests, is to assess the feasibility of particular approaches to data collection and to identify any "bugs" in procedure. The pretest conducted in the unincorporated retail area has served these purposes well. The need for certain changes in questions on the schedule and in instructions to enumerators have been made obvious. The pretest also suggested certain ways of improving the response rate on financial-structure data, possibly by raising the cut-off on size (the $3,000 annual sales cut-off used in the pretest may be unnecessarily low), possibly by being willing to accept more often estimates not based on accounting records.[6]

Other alternatives exist which, while detracting somewhat from the scope or precision of the study, would still permit a substantial amount of analysis of financing experience in terms of financial structure and raise some hope—albeit faint—of the possibility of developing certain aggregates. The results of the pretests suggest that by being willing to forego certain detailed cross-classifications, the response rate might be adequate for the analyses in mind. For example, it is hoped to be able to analyze financing experience related to financial structure within each of five broad lines of retailing and, within each line, separately for large and small unincorporated retailers. Such detailed analysis may not be possible with a response rate on financial-structure information no higher than that achieved in the pretest, but even this minimum (and improvements should raise it for the full survey) would permit analysis by size without differentiation by line of business.[7]

[6] One cannot afford to be too sanguine about the ultimate response rate, however. The circumstances of the interview process are, in most cases, far from ideal. Mr. Broida refers in his paper to the distractions encountered in family interviews—the blaring television set, the presence of friends, neighbors, children, and pets. Any or all of these may be encountered in the interview of a proprietor of a small retail establishment, and in addition there is likely to be the most important distraction of all—the customer. Considering all the potential difficulties, most of which were realized, the very high rate of response on the financing experience part of the questionnaire may be taken as a tribute to the charm and persistence of Census enumerators, as well as to the interest of respondents in the subject matter. Even the lower rate of response on financial-structure questions looks surprisingly good in retrospect.

[7] One sampling problem raised by the various pretests that have been conducted, not particularly germane to the use of survey data for social accounting but perhaps of broader general economic interest, is the relatively small proportion of businesses seeking any form of external financing other than trade credit and the even smaller proportion of respondents indicating unsatisfactory results in their attempts to get credit. These findings, while based on small samples designed to test methodology rather than to produce substantive results, appeared consistently in pretest after pretest. They suggest that a very large sample might be needed in order to have enough cases to analyze in detail the relationship of financial structure to financing experience for "dissatisfied borrowers," or that intensive follow-up and, perhaps, case studies will be needed in order to gain appropriate insight into the basic causes of inability to get credit.

Relevance to Social Accounts

What then can we expect—or hope—that a survey of the type described could contribute to the development of social accounting definitions or aggregates, keeping in mind that response rates would likely be somewhat better than those achieved on the pretest, but still fall substantially short of 100 per cent reporting of assets and liabilities?

With respect to definition, the survey may throw some light on the extent of "commingling" of financial assets. By studying the number of instances in which separate business and personal cash or security accounts are reported, we may get some clues as to the extent to which separate financial accounts are maintained by unincorporated businesses. Enumerators were instructed not to prejudice respondents in this matter, leaving to them the decision as to what constituted business assets and liabilities and what was to be reported as personal.

These data will have to be used with great caution, however, for a number of factors could distort the results. First, missing entries in the listing of personal assets or debts could reflect more unwillingness to respond or misunderstanding of the question rather than complete commingling of records. Second, the survey situation is one in which a respondent might feel it desirable to aggrandize his business financial position. The inquiry relates to business financing experience and ability to obtain credit. A respondent, particularly one who has not been successful in obtaining funds, might wish to present his financial statement in the most favorable light by including his personal assets in his business financial statement in order to contrast it more sharply with his unsuccessful financing efforts. (Fortunately, for the purposes of using the data to estimate the extent of commingling, dissatisfied respondents have generally accounted for a relatively small proportion of businesses interviewed in all of the pretests.) Even if separate accounts are maintained, there can be no assurance, of course, that the separation is a matter of substance rather than convenience. A great preponderance of commingling, however, would tend to indicate the direction in which sectoring decisions should be slanted.

With respect to the use of the data as a basis for estimating aggregates for the social accounts, surveys such as those pretested and those contemplated are not designed to fill one of the most serious gaps in statistics on unincorporated business, namely, data on less than an annual basis. It is likely that no monthly or quarterly calculation of net income is made by a large number of small businesses, although current records of certain business assets and liabilities, such as cash accounts, trade credit, and installment debts outstanding, are probably available. The surveys do not bear directly on this problem, however; and one may only infer that with a relatively large part of the universe unable or unwilling to provide annual accounts, the task of developing monthly or quarterly reporting would be a difficult one.

Whether the survey proves useful in providing annual benchmarks, particularly for balance sheet items, will depend in large measure on the over-all response rate and its distribution by size of respondent. Judging from available data on the receipt-size distribution of unincorporated business, from which one can reason to the asset-size distribution, the bulk of the total dollar value of noncorporate assets is probably held by larger business units.[8] If the bulk of nonresponse in the survey is among very small firms—such appears to have been the case in the pretest—then the deficiency in reporting would be a more serious limitation for use of these data in analyzing financing experience than it would be for developing financial aggregates.

On the other hand, the significance of such a reporting deficiency might vary from item to item on the balance sheet. If, for example, bank credit is generally not used by very small businesses, then the failure to obtain as many balance sheet returns from this size group in the survey may not be a serious a limitation in estimating aggregate bank debt owed by noncorporate retailers as it would be in estimating total trade debt, which is much more pervasive throughout the size distribution. Pretest results have not been available long enough—and the sample is probably not large enough—to be able to evaluate the variation in reporting by business-size class for each item on the balance sheet. The size of sample contemplated for the full-scale survey, approximately 8,000 firms, should be adequate, however, to permit some comparisons of balance sheet structures by size, particularly if there is no need to cross-classify by size and by line of business. If the balance sheets that are obtained from very small businesses prove to be sufficiently homogeneous, then it may be possible to use these in estimating aggregates for a wider range of balance sheet items.

Even if the sampling error attributed to any single estimated dollar aggregate proves too large to permit prudent use directly in the social accounts, the relationships among balance sheet items disclosed by the survey may prove useful at least as a guide to appropriate estimating techniques. Thus, the flow-of-funds accounts estimate of trade credit for its unincorporated-business sector is based largely on the relationships among receivables, payables, sales, and inven-

[8] Eleanor J. Stockwell, *Financing Small Business*, p. 150.

tories of small corporations. A completely different technique is used by the SEC in estimating net trade credit of noncorporate business in the reconciliation of personal and liquid savings; the calculated figure is the residual after deducting net trade credit received by other sectors, e.g. consumers or governments, from the net credit extended by corporations. The survey may be able to indicate whether the relationships of selected balance sheet and income account data for small corporations are more relevant to the noncorporate situation than the use of the residual technique. Similarly, survey results may yield other relationships which can be applied to other aggregates in order to estimate noncorporate financial assets and liabilities.

Such use of survey data has been both defended and attacked in connection with other surveys where the results of blow-ups of survey information have yielded totals that differ substantially from aggregates computed independently from nonsurvey sources. There would be little purpose served here in reviving this argument, particularly since there are so few aggregates from any source against which to check estimates in the noncorporate field. All that can be said with assurance is that if the aggregates developed from the proposed survey on, say, bank loans to unincorporated business, are added to the data available from other sources on bank loans to corporations, and the combined sum differs markedly from the figure on business loans that can be obtained directly from bank records, we are likely to see a revival of the heated discussions that swirled about the consumer finances surveys in recent years.

COMMENT

LOUGHLIN F. MCHUGH, Department of Commerce

Mr. Brill's paper is divided into three parts: two brief sections on needs for and the present state of information on small- or unincorporated-business financing, and a more extended section on the current FRB attempt to develop more adequate information in this field through a survey in which the small firm is directly approached and requested to supply information from its financial records. This latter section contains the principal new contribution to the subject under discussion, but in view of the fact that the results of the survey are not yet available, the author has been confined to comments on the nature of the effort and to presentation of some findings from the pretests.

In the first section—"What Is Needed"—Brill highlights the woeful state of available financial information on unincorporated business, pointing out that our lack of knowledge is due partly to the inadequate state of business records, partly to the rather prohibitive expense of gathering adequate data in this area, and partly to the amorphous nature of the entity. To me, the striking feature of this recital is that despite the inadequate state of primary statistics which he so clearly shows, the Board wants to go on trying to accomplish the most difficult of all efforts in this area—that of segregating the operations of the unincorporated businessman as an entrepreneur and as a consumer. He points to the admitted inadequacy of small-business information for national income accounting purposes, and he correctly stresses the even greater lack of financial and nonfinancial data for flow-of-funds purposes. Still, there seems to be insistence by the Board on the even more formidable—if not impossible—goal of segregating the dual aspects of the unincorporated businessman's activities not only on an annual but on a quarterly basis! Toward the end of this paper, there is, however, a hint that the Board's present decision may not be irrevocable.

In the second section Brill points out that some information on unincorporated business is now at hand and used, noting that, for the most part, this body of data covers transactions that are incontrovertibly "business-type" and hence, I would add, are at least not subject to the criticism of vivisection. Here he refers specifically to inventory, plant and equipment, and income estimates, which have long been incorporated in the national income accounts.

At this point, Brill's comments may lead the unwary reader to the unwarranted conclusion that such noncorporate data as are now gathered and used in the process of making aggregate estimates for national income purposes are also in tolerable shape for other purposes, such as for use in the quarterly flow-of-funds accounts. Brill later on explicitly denies this (page 317).

I must confess I feel the general tone of Brill's remarks on what is available and used is too buoyant. For example, in referring to inventories, he says, ". . . the record of obtaining reports from small and unincorporated business appears to be satisfactory." This might be construed as indicating that *estimates* based on the reports are satisfactory; but he refrains from going this far, and has in mind, I take it, only the record of cooperation; even in the latter restricted context, I feel the use of the word "satisfactory" greatly overstates the case.

If anyone should be lulled into a sense of security as to these estimates, I would like to suggest a reading of the statement on page 98 of *U.S. Income and Output*, dealing with over-all quarterly inventory changes. When it is recognized that that statement must be as guarded as it is with respect to changes in *total* inventories, I think it will also be recognized that for the noncorporate portion it probably would not be possible to make a statement guarded enough.

These data have serious shortcomings even when they are used only in combination with the more reliable corporate data, as in the national income and product accounts. For use separately to provide estimates for the noncorporate-business sector, as in the quarterly flow-of-funds accounts, they would be completely inadequate.

It is appropriate in this context to enter an objection to Brill's implication on page 324 that entrepreneurial business income should exhibit a volatility resembling that of corporate profits. The annual figures, for which relatively reliable data are available, should have suggested to Brill that noncorporate income is a much more stable item than corporate profits. This is because the former is a mixed labor-property income whereas the latter is a residual-property return; and because relatively stable businesses, such as in retail trade, account for a much larger proportion of entrepreneurial income than of corporate profits. There is every reason to believe that on a quarterly basis also, noncorporate business income would be much more stable than corporate profits, even if we could make a more adequate allowance in the figures for changing profit margins than we can at present.

The Federal Reserve Survey

We are all looking forward with interest to the results of the current Federal Reserve survey of small-business financing. As described by Brill, it is obviously a large-scale effort which we hope will illuminate a few of the dark spots in a generally gloomy picture. As one who was connected with a similar but much smaller project in this field, I can fully appreciate the careful planning and pretesting which has gone into the study. I hope that Brill's guarded estimate as to the expected results will prove unduly low.

I have only a few comments on what he has to say about the survey plan. First, I get no sure notion of the period to be covered by the survey. I have in mind a concern that the time periods may be different for trade and manufacturing. If so, this would appear to be an unfortunate introduction of an additional variable, the reasons for which are not clear to me.

Secondly, it is with considerable regret that I read that the needs for aggregate information had to take second place in this survey, and I have no doubt Brill and other members of the Board research staff were likewise troubled. It seems to me that here was an exceptionally fine opportunity to push aside some of our more basic ignorance in this respect. The plan of the study, however, turned rather in other directions, principally toward "financial experience" which, while useful per se, is not in my view so valuable in providing us with basic knowledge in this dark area. I recognize this may be a personal and somewhat parochial view and that, taking all factors into account, including the source of pressure for the study, the situation had to be as it turned out.

Granting the necessity of stressing "financial experience" rather than national accounting needs, I would be inclined to question the apparent unwillingness of the Board to try to quantify the magnitude of the unmet credit demands of small business. Perhaps it was to be expected that a regulatory agency such as the Board would shy away from such a task. I recognize also the difficulties involved in such an attempt, having tried it in Commerce on a much smaller scale. Nevertheless, I think the effort worthwhile; and unless it is made, we may not progress far in evaluating the adequacy of our financial institutions in meeting small-business needs.

The Commerce Survey

In commenting on the availability of data (or lack thereof) relating to financial flows in the small- or unincorporated-business area, Brill refers to Office of Business Economics studies on small-business financing, and notes that the compilations of one part of such a study were not published. Since I had a hand in this latter study, I think it might be of interest to this group to say a few words about our experience; this may be helpful in the context of the survey now under way at the Federal Reserve Board.

We asked a sample of small- and medium-size business firms to report the funds raised in the year ended June 30, 1954, and the funds wanted but not obtained in this period. In addition, for the newer firms, we asked for a statement on initial capital investment and the sources of such financing.

Results of the survey of financing "needs" in the year under review were published in the *Survey of Current Business*.[1] Of the 1,600 new firms responding to our questionnaire, almost 1,000 supplied what we, for working purposes, called "usable" balance sheet data. However, we ran into the same reporting problem which the Federal Reserve is apparently now encountering: a good portion of the respondents filing these data did not send in complete balance sheets.

[1] Loughlin F. McHugh and Jack N. Ciaccio, "External Financing of Small- and Medium-size Business," *Survey of Current Business*, October 1955.

Some of these could be completed with use of a tolerable amount of judgment on our part. Others would have required more arbitrary treatment, particularly if complete balance sheets were sought.

I might, however, give you a few of the tentative findings which we felt were supported by the survey (which covered manufacturing, trade, and construction). About half of the initial capital requirements went for fixed facilities, of which three-fifths were "new" and the remainder "used." Inventories accounted for a fourth of total initial requirements. Other current assets accounted for the predominant part of the remainder.

Personal saving supplied about half of the initial funds needed; one-fifth came from friends and relatives; one-seventh was provided by suppliers; and the remainder—about one-seventh—was obtained from institutions, mainly in the form of bank loans and mortgages.

While new firms in wholesale trade appeared to use relatively less plant and equipment than the average for other firms surveyed, in almost all other major respects the industry uniformity was really striking—the 50 per cent share of personal savings, the 20 per cent ratio for "friends and relatives," and the close-to-one-seventh ratio for supplier credit held by industry. Institutional credit seemed to be used to a somewhat greater-than-average relative extent by construction firms and in lesser degree by manufacturers.

The breakdowns by legal form also did not show many striking differences. Noncorporate firms in the sample tended to show more relative use of funds for fixed facilities, and this seemed to hold on an industry basis as well. Corporations reported greater relative dependence on personal saving. Combined with the "friends and relatives" category, these more-or-less informal sources accounted for three-fourths of requirements in the case of corporations and over two-thirds in the case of noncorporate business. It is perhaps of interest that the role of institutional funds appeared to be of greater relative importance for new noncorporate firms, and this seemed to hold regardless of industry. Mortgaged homes appear to have supplied a sizable share of the initial capital requirements of these firms.

The intent of collecting balance sheet information on new firms was to analyze similarities and differences with the findings of our earlier postwar studies of new firms in manufacturing and retail trade.[2] Once more, the similarities far outweighed the differences. This fact, in combination with the uniformities cited above, seems to suggest that the important feature in this area of financing is the newness and

[2] Lawrence Bridge, "Capital Requirements of New Trade Firms," *Survey of Current Business*, December 1948; and by Bridge and Lois E. Holmes, "Capital Requirements of New Manufacturing Firms," *Survey of Current Business*, April 1950.

small size of the firm and that such factors as legal form, industry, and even a different over-all economic environment are of far lesser importance. In this latter connection, the foregoing remark is not intended to suggest that the same results would eventuate if strong recessionary tendencies prevailed instead of the generally prosperous conditions of the postwar period.

While on the subject of our survey, I might point out that we carried out a small-scale field attempt to check on the adequacy of the original returns and, in particular, the *unfilled*-demand reports by both new and older firms. We found, for example, that a small but not negligible proportion of firms actually reported their "satisfied-unsatisfied" status in a manner which we felt was contrary to instructions; this was true both for those reporting they were satisfied as well as those who said they were dissatisfied.

Some of those seeking more funds than they received were clearly "reaching for the moon"; not only were these instances of demands out of all relation to previous experience but, in some cases, it seemed clear that their financial condition would warrant refusal by any prudent standard.

Generally speaking, we also detected a tendency for the dissatisfied to have a poorer financial record than those who were satisfied.

But when all this had been said, it still seemed evident to us that there was a core of apparently legitimate financial demand which was not being met under then-existing institutional arrangements.

In general, our experience in these surveys clearly supports the view expressed by Brill that perhaps some meaningful financial aggregates may be developed from small-business financial records; but to accomplish this, the size of sample should be quite large, much personal judgment will enter the editing (as well as the actual reports), and perhaps intensive "follow-ups" will be needed to check and interpret the results.