



International Journal of Economic Research

ISSN : 0972-9380

available at <http://www.serialsjournals.com>

© Serials Publications Pvt. Ltd.

Volume 14 • Number 19 • 2017

Small Businesses and Effect of Capital Structure: A Conceptual Review

Indraah Kolandaisamy¹, Maran Marimuthu², K. Maran³, Shamsul Sulasi⁴ and Fahmida⁵

¹ School of Business Management, College of Business, University Utara Malaysia, 06010 Sintok, Kedah, Malaysia

E-mail: indra@uum.edu.my (corresponding author)

² Department of Management and Humanities, Universiti Teknologi Petronas, 32610 Seri Iskandar, Perak, Malaysia

³ Sairam Institute of Management Studies, Chennai, India

⁴ PAC Governance Management, Commercial & Strategic Relations, Malaysia Petroleum Management (MPM),

Kuala Lumpur City Centre, 50088 Kuala Lumpur

⁵ Universiti Teknologi Petronas, 32610 Seri Iskandar, Perak, Malaysia

Abstract: Small businesses are backbone of all countries developed and developing. They form substantial number of total businesses, contribute to Gross Domestic Production (GDP) and employment. This sector of economy plays significant role in economic development and growth of a country. Small or large business have their own capital structure i.e. the way firm's assets are financed. It can be equity or debt; it can also be a combination of both equity and debt. Most of the researches have discussed capital theories and determinants of capital structure in context of large firms. This paper discusses capital structure theories and determinants of capital structure theories in light of small businesses and determines that these can be applied on small businesses as well.

Keywords: Small Businesses, Capital Structure, Capital Structure Theories, Determinants of Capital Structure.

I. INTRODUCTION

Small businesses are the engine of growth and development in all countries[1]. They increase employment opportunities, trade and industry as well as create capital for the whole society. Small businesses have outperformed large companies in employment, originality and novelty in many countries. They also play imperative role in economic development and growth of Malaysia by good quality of their number, share in job market and their role in overall production in the country. Small businesses use local supplies for the production of their goods which saves country from burden of imports. All countries acknowledge the significant role that small businesses play in their economic development[2].

The importance of small businesses in Malaysia's economy is undeniable as 97.3 per cent of the establishments are SMEs, SMEs contribute 36 per cent of country's GDP, make up 67 per cent of country's employment and provide 18 per cent of Malaysia's export (Source: SME Corp: SME Census 2011). Further, significant contribution is made by small businesses to GDP and employment. Small businesses are considered the general employers in all countries. According to European Commission (2013), 99% of the businesses are small businesses in Europe. Small businesses are the highest employers as well as creator of employment opportunities[3]. It is important to know capital structure and determinants of capital structure of small businesses.

Every firm has its own capital structure. The method by which firm's assets are financed is known as capital structure. Firms can finance their assets through equity or debt; it can also be a combination of both equity and debt[4]. Theories of capital structure and determinants of capital structure have largely been discussed in respect of large businesses; this paper discusses theories of capital structure and determinants of capital structure in respect of small businesses.

II. LITERATURE REVIEW

Definitions of SMEs

There is no universally agreed definition of SMEs as different countries use different definitions. However, generally sales, assets and employee number are the criteria used for the defining SMEs[5]. Most commonly used criteria for defining SMEs are based on employees and sales; Malaysia also follows these two criteria. Further, SMEs are classified in two sectors which are manufacturing and services & others.

Table 1
Definition of SME in Malaysia

Category	Criteria
Manufacturing	Sales \leq RM50.0M or employees \leq 200
Services & Others	Sales \leq RM20.0 M or employees \leq 75

Source: SME Corp.

Capital Structure

Firms can finance their assets through equity or debt; it can also be combination of both equity and debt[4]. Equity refers to owners / shareholders money invested in business which is long term in nature and does not usually require repayment. It gets return in the form of drawings or dividends. Debt is the money invested in firm by creditors. It is an obligation, has effective repayment date and pays interest rate.

Debt can be short term and long term in nature. The short term debt has maturity up to one year and is usually required to meet working capital requirements of the firm. Running finance, overdraft, cash finance, letter of credit and bill of exchange are examples of short term financing. Long term debt is used to finance business investment needs which have long repayment period. It is used for purchase of plant & machinery and equipment. Types of long term debt financing are term loan and leasing. Capital structure refers to the way a firm finances its assets (combination of debt and equity). With regards to MM's findings

uncertainty remains intact as in the real world projects are not financed up to 100% by financial institutions[6]. Titman and Wessels[7] show that Costs and benefits are associated with debt and equity financing. Myers[8] argues that there is no universal theory for debt - equity choice and no reason to expect one. Further that there are several useful conditional theories.

Theories of Capital Structure

Modigliani and Miller[9] in their influential paper on the cost of capital, corporation finance and the theory of investment considered debt as irrelevant factor in capital structure decisions of businesses. Since then many papers have researched to give explanation between the different debt ratios across the firms. The theory of capital structure has grown into three categories i.e. existence of taxes and bankruptcy costs by DeAngelo and Masulis[10], information asymmetry between investors and business managers by Myers[11] and agency theory by Jensen and Meckling[12]. According to these theories, there are costs and benefits associated with financial contracting. Further, these theories can be applied to small businesses as well since they do not make difference between large and small firms.

Traditional View of Capital Structure

The traditional view is that cost of capital is function of capital structure. It argues that it is possible to find an optimal level of gearing which minimizes the company's WACC and maximizes market value of the firm. The financial manager has to determine the mix of debt and equity that minimizes the WACC. Further that the company loses cheap debt when gearing ratio is too low and when gearing ratio is too high financial risk as well as weighted average cost of capital (WACC) will increase which subsequently drops shareholders value. Thus, shareholders will demand high required rate of return when financial risk increases. In short, traditional view welcomes debt but if it is too high firm has to face financial distress. So, the debt has to be used rationally and as per the business requirements. Kayhan and Titman[13] stated that capital structure theory suggests firms have target debt ratio which is determined by tradeoff between costs and benefits of debt versus equity. Similarly, Leary and Roberts[14] explain that as per traditional view firms struggle to maintain optimal capital structure which balances costs and benefits related with various levels of financial leverage.

MM Arguments

The Modern Theory, developed by Modigliani and Miller[9] challenged the traditional view by arguing that capital structure is irrelevant to company value and cost of capital. They argue that value of company depends on its income stream and the degree of business risk but not on debt and equity. They hypothesized that type of capital structure company uses to finance its operations does not matter when markets are perfect. MM argued that a firm cannot change the total value of its outstanding securities by changing the proportion of its capital structure. In other words, the value of the firm is unaffected by the debt equity ratio. The companies can go up to 100% debt financing. No capital structure is any better or worse than any other capital structure for the firm's stockholders. MM proposition I explains that the value of the levered firm is the same as the value of the unlevered firm. Proposition II explains that the cost of equity rises with leverage because the risk to equity rises with leverage. The firm's cost of equity increases with its debt-equity ratio.

MM proposition I (without tax) says Value of Unlevered = Value of Levered = Operating Income/ required rate of return by shareholders

MM proposition II (without tax) says that the rate of return required by shareholders increases linearly as the debt / equity ratio is increased.

MM proposition I & II (with tax) says that the Value of a levered company = Value of an unlevered company + Tax rate \times Borrowing

Modigliani and Miller[15] argued that firms prefer to debt to other sources of funds, due to tax deductibility of interest payments. As such when effective tax rate rises firms would take more leverage in order to reduce taxes. In other words, the levered firm pays less in taxes than does the all equity firm. Thus, the sum of the debt plus the equity of the levered firm is greater than the equity of the unlevered firm.

Trade-off theory (TOT)

The paper of DeAngelo and Masulis[10] is considered base of trade-off theory of capital structure. They state profitable companies which have low non debt tax shields should use more debt if debt interest protects income from taxation. The theory states that capital structure decisions are influenced by tax and bankruptcy considerations of the companies. It refers to an idea that companies have optimum debt-equity ratio determined by trading off the benefits of debt with the cost. SMEs profit is usually less as such they do not need to have tax shields as compared to large firms so they have decreased amount of leverage.

The main benefit of debt is the tax advantage of interest deductibility from company tax[15]. The disadvantages of debt include potential cost of financial distress i.e. bankruptcy[16, 17] and agency cost arising between owners and financial creditors[12].

Pecking order theory (POT)

Myers[11] explain that capital structure of firm is planned to mitigate inadequacy in investment decisions of firms caused by information asymmetry between managers, investors and creditors. This theory sheds light on capital structure decisions of SMEs. According to pecking order theory with asymmetric information firms prefer to use internal sources of capital first and opt for external sources when internal sources are inadequate and equity as a last resort. This is because internal sources are easily available to SMEs and access to external sources of funds is limited. Holmes and Kent[18] admitted that pecking order theory is consistent with small business sectors as they are owner-managed and do not want to dilute their ownership. Owner-managed businesses usually prefer retained profits because they want to maintain the control of assets and business operations. N Berger and F Udell[19] argue that in fact degree of information opacity is key factor which distinguishes SME financing from large business financing. This results in SMEs relying on private capital markets and large businesses relying on public markets. As such SMEs depend on banks for financing. Further, cost of capital is usually higher for SMEs as compared to large business which is due to loan size and riskiness of SMEs as compared to large businesses. Banks charge high interest rates to high risk loans and low interest rates to low risk loans.

Agency theory

This theory relates to conflicts of interest between lenders and business owners of SME. Jensen and Meckling[12] have stated agency costs as important determinant of business's capital structure decisions.

Business owners undertake projects for their benefit at the expense of creditors and do not maximize the value of firm. Therefore, creditors try to protect themselves with various covenants and monitoring. Holmstrom and Tirole[20] report that lenders deal with agency costs by closely monitoring the borrowers in many ways i.e. inspection of firm's balance sheet, cash flow position, ratios and its management. Jensen and Meckling[12] state bankruptcy costs as determining cost along with monitoring costs and incentive effects with high leveraged firm in determining level of debt in companies. The agency theory has link with trade-off theory.

Capital Structure Determinants

Firm features like size, age, growth rate, profitability, risk, volatility of cash flow, non-debt tax shields, asset structure and industry characteristics have been defined as factors in determination of optimal capital structure by Titman and Wessels [7], Michaelas et al[21] and F Sogorb[22] on their papers on capital structure determinants. Michaelas et al[21] reported capital structure of small firms is time and industry dependent. Further, their result indicates that maturity structure of debt raised by SMEs is influenced by time and industry specific effects. Proenca et al[4] find asset structure, liquidity and profitability as the determinants of capital structure of Portuguese SMEs. Myers[11] says that fixed assets can support increased quantity of debt.

III. DISCUSSION AND CONCLUSIONS

The theories of capital structure do not differentiate between small and large businesses as such these theories can be applied to small businesses as well. In essence, the size effect with regard to capital structure choices is not rigorously discussed in the literature. A number of researches conducted in context of different countries reflect that the determinants of capital structure do have impact on capital structure of small businesses but however, the findings may be inconsistent between large and small companies.

Most of the determinants of capital structure like size, age, growth, profitability, growth, net debtors, stock turn over and asset structure are relevant to small businesses [21]. Further, Sogorb-Mira [22] found profitability and non-debt tax shields are negatively related to debt whereas growth, size and asset structure are positively to capital structure of small businesses. Berrell, et al. [23] have supported pecking order theory for small businesses. The conclusion of empirical study of Michaelas, et al. [21] is that agency and asymmetric information costs have an effect on the level of debt in small firms. Both pecking order and trade-off theories explain capital structure of small businesses [4, 24]. In view of this, further empirical studies are required to address this phenomenon as this has a significant impact on firms' long term value.

REFERENCES

- A. Gill & N. Biger, "Barriers to small business growth in Canada," *Journal of Small Business and Enterprise Development*, vol. 19, pp. 656-668, 2012.
- E. Mahembe, "Literature review on small and medium enterprises' access to credit and support in South Africa," *Underhill Corporate Solutions. National Credit Regulator (NCR): Pretoria, South Africa*, 2011.
- M. Ayyagari, A. Demirgüç-Kunt, & V. Maksimovic, "Small vs. young firms across the world: contribution to employment, job creation, and growth," *World Bank Policy Research Working Paper*, 2011.

- P. Proença, R. M. Laureano, & L. M. Laureano, "Determinants of Capital Structure and the 2008 Financial Crisis: Evidence from Portuguese SMEs," *Procedia-Social and Behavioral Sciences*, vol. 150, pp. 182-191, 2014.
- S.-u. Rahman, "A comparative study of TQM practice and organisational performance of SMEs with and without ISO 9000 certification," *International Journal of Quality & Reliability Management*, vol. 18, pp. 35-49, 2001.
- M. Marimuthu, "Corporate Restructuring, Firm Characteristics and Implications on Capital Structure: an Academic View," *International Journal of Business and Management*, vol. 4, p. p123, 2009.
- S. Titman & R. Wessels, "The determinants of capital structure choice," *The Journal of finance*, vol. 43, pp. 1-19, 1988.
- S. C. Myers, "Capital structure," *Journal of Economic perspectives*, pp. 81-102, 2001.
- F. Modigliani & M. H. Miller, "The cost of capital, corporation finance and the theory of investment," *The American economic review*, pp. 261-297, 1958.
- H. DeAngelo & R. W. Masulis, "Optimal capital structure under corporate and personal taxation," *Journal of Financial Economics*, vol. 8, pp. 3-29, 3// 1980.
- S. C. Myers, "The Capital Structure Puzzle," *The Journal of Finance*, vol. 39, pp. 574-592, 1984.
- M. C. Jensen & W. H. Meckling, "Theory of the firm: Managerial behavior, agency costs and ownership structure," *Journal of financial economics*, vol. 3, pp. 305-360, 1976.
- A. Kayhan & S. Titman, "Firms' histories and their capital structures," *Journal of Financial Economics*, vol. 83, pp. 1-32, 2007.
- M. T. Leary & M. R. Roberts, "Do firms rebalance their capital structures?," *The journal of finance*, vol. 60, pp. 2575-2619, 2005.
- F. Modigliani & M. H. Miller, "Corporate income taxes and the cost of capital: a correction," *The American economic review*, pp. 433-443, 1963.
- A. Kraus & R. H. Litzenger, "A state preference model of optimal financial leverage," *The journal of finance*, vol. 28, pp. 911-922, 1973.
- E. H. Kim, "A mean variance theory of optimal capital structure and corporate debt capacity," *The Journal of Finance*, vol. 33, pp. 45-63, 1978.
- S. Holmes & P. Kent, "An empirical analysis of the financial structure of small and large Australian manufacturing enterprises," *The Journal of Entrepreneurial Finance*, vol. 1, pp. 141-154, 1991.
- A. N Berger & G. F Udell, "The economics of small business finance: The roles of private equity and debt markets in the financial growth cycle," *Journal of Banking & Finance*, vol. 22, pp. 613-673, 1998.
- B. Holmstrom & J. Tirole, "Financial intermediation, loanable funds, and the real sector," *the Quarterly Journal of economics*, pp. 663-691, 1997.
- N. Michaelas, F. Chittenden, & P. Poutziouris, "Financial policy and capital structure choice in UK SMEs: Empirical evidence from company panel data," *Small business economics*, vol. 12, pp. 113-130, 1999.
- F. Sogorb-Mira, "How SME uniqueness affects capital structure: Evidence from a 1994–1998 Spanish data panel," *Small business economics*, vol. 25, pp. 447-457, 2005.
- M. Berrell, J. Park, J. Wu, J. Song, & C. Zeng, "An empirical evidence of small business financing in China," *Management Research News*, vol. 31, pp. 959-975, 2008.
- J. López-Gracia & F. Sogorb-Mira, "Testing trade-off and pecking order theories inancing SMEs," *Small Business Economics*, vol. 31, pp. 117-136, 2008.