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Techniques and Assessment of Small Business Capital

S Raja Narayanan and D Arthi
College of Business and Economics, Bahir Dar University, Ethiopia

Abstract
All businesses must have capital in order to purchase assets and maintain their operations. In general there are two types of capitals. In the case of debt capital, the cost is the interest rate that the firm must pay in order to borrow funds. For equity capital, the cost is the returns that must be paid to investors in the form of dividends and capital gains. The small business owners to determine a target capital structure for their firms. As a rule, the cost of capital for small businesses tends to be higher than it is for large, established businesses. The capital structure concerns the proportion of capital that is obtained through debt and equity. The optimal capital structure is the one that strikes a balance between risk and return and thereby maximizes the price of the stock and simultaneously minimizes the cost of capital. When evaluating a small business for a loan, lenders ideally like to see a two-year operating history, a stable management group, a desirable niche in the industry, a growth in market share, a strong cash flow, and an ability to obtain short-term financing from other sources as a supplement to the loan.

Keywords: Capital; Debt; Equity; Stock

1. Introduction
Capital, in the most basic terms, is money. All businesses must have capital in order to purchase assets and maintain their operations. Business capital comes in two main forms: debt and equity. Debt refers to loans and other types of credit that must be repaid in the future, usually with interest. In contrast, equity generally does not involve a direct obligation to repay the funds. Instead, equity investors receive an ownership position which usually takes the form of stock in the company.

2. Materials and Methods
This article is generally empirical and review in nature. This was basically to describe the different factors related to small business capitals, preferences and to suggest the strategic measure for small business owner and share holders. The reviver collects the data by standard reference books, monthly magazines and news papers.

3. Results
In order to discussion, the debt could be secured, unsecured and convertible and nonconvertible, they are issued with a maturity date. But, Equity is important stock used by the firms to raise the fund to finance their activity. As a result, they have residual claims on income and assets of the company. In Debt trust deed or indenture definitions the legal relationship between the issuing company and the debt trustee who represent the holder, the holder have the prior claim on the company's income and assets.

4. Discussion
The capital formation process describes the various means through which capital is transferred from people who save money to businesses that require funds. Such transfers may take place directly, meaning that a business sells its stocks or bonds directly to savers who provide the business with capital in exchange. Transfers of capital may also take place indirectly through an investment banking house or through a financial intermediary, such as a bank, mutual fund, or insurance company. In the case of an indirect transfer using an investment bank, the business sells securities to the bank, which in turn sells them to savers. In other words, the capital simply flows through the investment bank. In the case of an indirect transfer using a

financial intermediary, however, a new form of capital is actually created. The intermediary bank or mutual fund receives capital from savers and issues its own securities in exchange. Then the intermediary uses the capital to purchase stocks or bonds from businesses.

The Cost of Capital

Capital is a necessary factor of production and, like any other factor, it has a cost. In the case of debt capital, the cost is the interest rate that the firm must pay in order to borrow funds (Brigham and Eugene, 1989). For equity capital, the cost is the returns that must be paid to investors in the form of dividends and capital gains. Since the amount of capital available is often limited, it is allocated among various businesses on the basis of price. Firms with the most profitable investment opportunities are willing and able to pay the most for capital, so they tend to attract it away from inefficient firms or from those whose products are not in demand. But the federal government has agencies which help individuals or groups, as stipulated by Congress, to obtain credit on favorable terms. Among those eligible for this kind of assistance are small businesses, certain minorities, and firms willing to build plants in areas with high unemployment (Schilit, 1990)

As a rule, the cost of capital for small businesses tends to be higher than it is for large, established businesses. Given the higher risk involved, both debt and equity providers charge a higher price for their funds. A number of researchers have observed that portfolios of small-firm stocks have earned consistently higher average returns than those of large-firm stocks; this is called the small-firm effect. In reality, it is bad news for the small firm; what the small-firm effect means is that the capital market demands higher returns on stocks of small firms than on otherwise similar stocks of large firms. Therefore, the cost of equity capital is higher for small firms." The cost of capital for a company is a weighted average of the returns that investors expect from the various debt and equity securities issued by the firm (Brealey and Myers, 1991)

Capital Structure

Since capital is expensive for small businesses, it is particularly important for small business owners to determine a target capital structure for their firms. The capital structure concerns the proportion of capital that is obtained through debt and equity. There are tradeoffs involved: using debt capital increases the risk associated with the firm's earnings, which tends to decrease the firm's stock prices. At the same time, however, debt can lead to a higher expected rate of return, which tends to increase a firm's stock price. Because the optimal capital structure is the one that strikes a balance between risk and return and thereby maximizes the price of the stock and simultaneously minimizes the cost of capital (Brigham and Eugene, 1989)

Capital structure decisions depend upon several factors. One is the firm's business risk—the risk pertaining to the line of business in which the company is involved. Firms in risky industries, such as high technology, have lower optimal debt levels than other firms. Another factor in determining capital structure involves a firm's tax position. Since the interest paid on debt is tax deductible, using debt tends to be more advantageous for companies that are subject to a high tax rate and are not able to shelter much of their income from taxation.

A third important factor is a firm's financial flexibility, or its ability to raise capital under less than ideal conditions. Companies that are able to maintain a strong balance sheet will generally be able to obtain funds under more reasonable terms than other companies during an economic downturn. Brigham recommended that all firms maintain a reserve borrowing capacity to protect themselves for the future. In general, companies that tend to have stable sales levels, assets that make good collateral for loans, and a high growth rate can use debt more heavily than other companies. On the other hand, companies that have conservative management, high profitability, or poor credit ratings may wish to rely on equity capital instead.

Sources of Capital

DEBT CAPITAL Small businesses can obtain debt capital from a number of different sources. These sources can be broken down into two general categories, private and public sources. Private sources of debt financing, include friends and relatives, banks, credit unions, consumer finance companies, commercial finance companies, trade credit, insurance companies, factor companies, and leasing companies (Schilit, 1990). Public sources of debt financing include a number of loan programs provided by the state and federal governments to support small businesses.

There are many types of debt financing available to small businesses—including private placement of bonds, convertible debentures, industrial development bonds, and leveraged buyouts—but by far the most common type of debt financing is a regular loan. Loans can be classified as long-term, short-term, or a credit line. They can be endorsed by co-signers, guaranteed by the government, or secured by collateral—such as real estate, accounts receivable, inventory, savings, life insurance, stocks and bonds, or the item purchased with the loan.

When evaluating a small business for a loan, lenders ideally like to see a two-year operating history, a stable management group, a desirable niche in the industry, a growth in market share, a strong cash flow, and an ability to obtain short-term financing from other sources as a supplement to the loan. Most lenders will require a small business owner to prepare a loan proposal or complete a loan application. The lender will then evaluate the request by considering a variety of factors. For example, the lender will examine the small business's credit rating and look for evidence of its ability to repay the loan, in the form of past earnings or income projections. The lender will also inquire into the amount of equity in the business, as well as whether management has sufficient experience and competence to run the business effectively. Finally, the lender will try to ascertain whether the small business can provide a reasonable amount of collateral to secure the loan.

EQUITY CAPITAL Equity capital for small businesses is also available from a wide variety of sources. Some possible sources of equity financing include the entrepreneur's friends and family, private investors, employees, customers and suppliers, former employers, venture capital firms, investment banking firms, insurance companies, large corporations, and government-backed Small Business Investment Corporations (SBICs).

There are two primary methods that small businesses use to obtain equity financing: the private placement of stock with investors or venture capital firms; and public stock offerings. Private placement is simpler and more common for young companies or startup firms. Although the private placement of stock still involves compliance with several federal and state securities laws, it does not require formal registration with Securities and Exchange Commission. The main requirements for private placement of stock are that the company cannot advertise the offering and must make the transaction directly with the purchaser.

5. Conclusion

Public stock offerings entail a lengthy and expensive registration process. In fact, the costs associated with a public stock offering can account for more than 20 percent of the amount of capital raised. As a result, public stock offerings are generally a better option for mature companies than for startup firms. Public stock offerings may offer advantages in terms of maintaining control of a small business, however, by spreading ownership over a diverse group of investors rather than concentrating it in the hands of a venture capital firm.

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