U.S. Senate Committee on Small Business and Entrepreneurship
The Impact of the Credit Crunch on Small Business

Testimony of
Samuel D. Bornstein, CPA, MBA, BME
Professor of Accounting and Taxation
School of Business, Kean University

April 16, 2008

Introduction:

Good afternoon, Chairman Kerry, Ranking Member Snowe, and members of the Committee. Thank you for inviting me to discuss the credit crunch and its impact on small business.

For the past 30 years, I have been a Professor of Accounting and Taxation, as well as a CPA and Consultant in public practice. This unique combination of experience as an educator and practitioner has given me an interesting perspective and insight into this topic. Since 2000, I have researched the small business failure phenomenon. In recent years, my research has evolved into the impact of the subprime mortgage crisis on small business.

Background:

The credit crunch can trace its beginnings to the inception of subprime mortgages. During the period of mid 2002 through September 2005, when interest rates were exceptionally low and there was a booming real estate market, we experienced the biggest refinancing boom in history. Loan underwriting standards were often ignored. Even the least credit-worthy borrower had access to this easy money. Loans were made regardless of bad credit histories and low or no documentation of income. This "perfect storm" where both lender and borrower were happy, prompted easy access to cash.

As many as 80 percent of Americans refinanced their homes during that time, included in this statistic are small business owners who cashed-out the equity in their homes to capitalize their newly created or existing businesses. Interest rates on adjustable rate loans dropped to under 4 percent, while some homeowners opted for fixed rates as low as 5 percent. Furthermore, as a result of the newly created concept of securitization, lenders were eager to sell-off these loans, thereby giving them a new pool of cash from which to make more loans. For many small business owners, refinancing their homes was the easiest way to meet their small business cash flow needs. Small firms chose this option over other traditional sources of financing, such as regular commercial or SBA guaranteed loans, because home-equity loans did not require the same level of cumbersome paperwork, including financial statements, income documentation, and an established credit history, as business loans.

Small business owners were drawn into subprime mortgage financing by the ease in which they could access cash to quench their continuous need for capital. They were attracted by the initially

enticing “teaser rates” and low monthly mortgage payments and were not concerned about the resets that would follow in two to three years, which would spike the interest rates and increase their monthly payments. Small business owners assumed that they could avoid these higher monthly mortgage payments by either selling their homes, at a substantial profit, or refinancing their mortgages at the anticipated lower rates.

While interest rates were low and the small business owner’s main underlying asset, his or her home, was appreciating in value and easily sold, the small business owner had access to cheap capital and took advantage of this unique opportunity. However, this “house of cards” collapsed when interest rates rose and the real estate market bubble burst. This also caused the collapse of the securitized investment market, which meant the end to easy liquidity for lenders that resulted in the credit crunch. Small business owners were hit hard when both home equity and securitization dried up as sources of financing.

Small Business: Home Mortgages and Home Equity Loans

A nationwide study of current small business owners indicated that 54.2 percent of those responding to the poll used their residence as collateral. The study was conducted by the Small Business Research Board (SBRB) and co-sponsored by Business Today Magazine (Jan 17, 2008). More than 450 small business owners and managers participated in the SBRB/Business Today study entitled, “Small Business Lending Relationship and Loan Requirements Study."

In 1996, bankers estimated that at least 90 percent of first-time small business owners used their homes as collateral on small business loans. This statistic is not so surprising if you consider that a new business often does not have a track record or sufficient assets to serve as collateral for the entire loan. Unfortunately, with the subprime mortgage crisis, the resulting credit crunch, and the slowing economy, these small business owners are experiencing financial distress due to lack of liquidity.

At one time, lenders would offer in excess of 95 percent of a home's value to borrowers with credit scores as low as 600. However, given the current credit crunch, lenders are demanding higher credit scores for home equity loans. This has restricted home equity as a source of capital for small businesses.

An August 2007, Middle Tennessee State University study found that 18.8 percent of small businesses in the state used home-equity loans for startup capital. An August 2007, Discover Small Business Watch survey found that 30 percent of small business owners had used home-based loans for funding. In the Tennessee study, home equity loans accounted for an average of 43.1 percent of startup funding for businesses that used them. Unfortunately, home-equity funding is becoming impossible to obtain.

Small Business: Credit Card Debt

Credit cards are now the No.1 source of small business financing. Credit cards facilitate easy access to capital, especially, at the inception of a business. In fact, banks and lending institutions are now targeting small businesses for credit card spending, seeing that small business owners are unable to have access to needed capital that was previously provided by borrowing against their main source of equity, their homes. With the nation suffering through the subprime mortgage meltdown and the resulting credit crunch, the small business owner has no choice but to access capital through credit cards.

Small businesses require access to capital especially for startups and existing businesses. Up until the early 1990s, only about 16 percent of small business owners used credit cards for capital. In the 2007 National Small Business Association (NSBA) Annual Survey, more than 44 percent said they had used credit cards for financing over the preceding year. Of those, 13 percent are carrying more than $25,000 in credit card debt, and 36 percent are carrying more than $10,000.

The easy availability of credit cards has been beneficial. Without them, many small businesses would have no line of credit at all to finance purchases or cover cash flow shortfalls. Most surveys of entrepreneurs show that credit cards are among the most popular sources of startup financing.

But there is a downside. More than 70 percent of business owners carry a month-to-month balance, up from 64 percent in 2000. This poses a dangerous situation when small business owners resort to making the "minimum payment" on their credit card debt, without realizing that this belies the fact that their debt is rising and may be leading them into insolvency and bankruptcy.

Bankruptcy studies show that small business owners in the bankruptcy admitted that credit card debt was the source of as much as one-third of their business financing at the time of business formation. Although, credit card usage can be an effective means by which to acquire capital, managing this type of debt requires careful planning. There are risks involved which the small business owners are not prepared nor financially knowledgeable to handle.

Too Much Debt: The Major Cause of Small Business Bankruptcy

Debt can overwhelm a small business and lead to financial distress. According to a study of the bankruptcy filings of small business owners conducted by Professor Rafael Efrat (2007), the data suggests that small business owners in bankruptcy had overburdened their businesses with debt. The study found that the total outstanding debt (including mortgage, home equity, credit cards, etc.) for the small business owners averaged $259,134, while wage earners in the bankruptcy sample reported average outstanding debt of $58,250. The approximately $200,000 of additional debt may have been acquired from mortgages and home equity loans.

Since credit card debt was becoming a growing credit source for small business owners since the 1990s, the study sought to evaluate the level of credit card debt for small businesses in bankruptcy. The results were striking. The average outstanding credit card debt exceeded $55,000, while for small business owners not in bankruptcy, it was only $17,000. The study also indicated that small business owners had more than double the amount of credit card debt as compared to the wage earners. Thus, this study illustrated that there was a greater reliance by small business owners on credit card debt to finance their business operations.

One-in-Five People in Bankruptcy Is A Failed Entrepreneur.

A landmark study uncovered evidence of the high rate of small business failure as contributing to the bankruptcy of individuals. The bankruptcy filings for individuals make no distinction between wage earners and small business entrepreneurs. It is difficult to distinguish between the

two groups. This study was entitled, "As We Forgive Our Debtors: Bankruptcy and Consumer Credit in America," by Teresa A. Sullivan, Elizabeth Warren, and Jay Lawrence Westbrook. It took six years to conduct and was the most extensive empirical study of consumer bankruptcy ever undertaken and gave insight into small business failure.

The study concluded that small business failure was the cause of personal bankruptcy of one-in-five individuals. Small business entrepreneurs were nearly three times more likely to go into bankruptcy. Considering that small business entrepreneurs failed at a rate of one-in-five of the bankrupts, they accounted for more than half of all debts.

Correlation between Small Business Failures and Bank Failures

Small business failure has the potential to exert a devastating effect on our economic system by contributing to the surge in bankruptcies, the high level of credit card debt and delinquencies, and bank failures.

According to a research study (September 1990) commissioned by The Federal Reserve Bank of Cleveland entitled: "Underlying Causes of Commercial Bank Failure in the 1980s," the report concluded that banks that failed between 1982 and 1989 tended to be located in states with higher small business failure rates than those of the nonfailed banks. This is the most recent study of its kind.

Credit Alone Does Not Guarantee Small Business Success

With the availability of credit, there is an urgent need for financial literacy education. This topic was addressed by Federal Reserve Chairman Bernanke in his speech at the Community Affairs Research Conference, Washington, D.C., on March 30, 2007, entitled, "The Community Reinvestment Act: Its Evolution and New Challenges."

Chairman Bernanke referred to the need for financial education as it related to the Community Reinvestment Act (CRA). He recommended that counseling and financial education should be given more weight in CRA examinations as services complementary to lending.

Chairman Bernanke stated that the CRA has enabled lower-income communities to have access to credit, which has resulted in an increase in homeownership rates, (Joint Center for Housing Studies, 2006). However, the subprime mortgage crisis illustrated the fact that, "more lending equals better outcomes for local communities, may not always hold."

Financial Literacy for Small Business: You can't manage if you can't measure

Small business owners require an understanding of debt management and the tools and techniques that will help them monitor their liquidity, solvency, and profitability. This does not imply that all borrowing is bad, but it does imply that there is a need to be able to measure and monitor the level of debt so as to avoid going down the slippery slope towards insolvency and bankruptcy.

The antidote to small business failure is knowledge and understanding of practical accounting and its analytical tools and techniques, which provide the business owner indications of where the

business has been, where it is, and where it is going. The small business owner can and should be taught to analyze accounting and financial data, which could mean the difference between success and failure. Practical accounting can help diagnose small business health. Failures can be predicted and businesses can be saved when their problems are detected in time.

The leading cause of small business failure is a lack of financial literacy. This apparent weakness was highlighted in a National Federation of Independent Business (NFIB) National Small Business Poll (2006) conducted by Mr. William J. Dennis, Jr. The survey concluded that small business owners were lacking in the basic concepts of accounting and may not be using all the management tools available to them. This lack of accounting knowledge may cause "unpleasant surprises" that can force small firms to close their doors.

Various studies of the reasons for small business failure inevitably show poor or careless financial management to be the most important cause:

• A nationwide survey of approximately 1,000 small business owners and managers, whose businesses failed, conducted at the University of Texas found that more than half of the individuals interviewed said "lack of financial management expertise" was the primary cause of their small business failure.

• According to testimony offered before the Securities & Exchange Commission's Government-Business Forum, "One primary cause of the high failure rate for small businesses is a lack of knowledge on the part of owners and managers about accounting – particularly management accounting and internal control."

• The Dun & Bradstreet Business Failure Record indicated that "incompetence, unbalanced experience, and lack of managerial experience creates problems in areas such as operating expenses, receivables, and inventories."

Small business owners lack internal financial expertise because of the size of their enterprises. The owner is wearing five hats. He doesn't have a CFO, and the operations manager tends to be an outside accountant.

Nearly everyone who has any experience with small business recognizes that the average small business borrower often needs improved management skills just as much as he or she needs access to credit. Most small business owners know how to produce the product or deliver the service they're offering, but they may not know how to run their business and manage their cash flow.

According to Dun & Bradstreet, businesses with fewer than 20 employees have only a 37 percent chance of surviving four years and only a 9 percent chance of surviving 10 years. Restaurants have only a 20 percent chance of surviving two years. The failure rate for new businesses seems to be around 70 to 80 percent in the first year, and only about half of those that survive the first year will remain in business the next five years.

There currently is an inadequate appreciation of the manner in which accounting functions – or at least could function – in the control, conduct, and understanding of small business management, and how it can be used to lower the small business failure rate. The small business owner often lacks an adequate appreciation of accounting, which leads to misunderstanding and lost opportunities. The difficulty lies not in the failure to understand accounting processes as in the

failure to appreciate how accounting gives small business the management tools they need to successfully handle daily operations and long term growth.

Conclusion

Subprime mortgages have significantly impacted small businesses by facilitating the access to capital. The demise of subprime mortgages has caused a liquidity crisis for lending institutions and the resulting credit crunch. The subprime mortgage crisis has forced many small businesses to seek liquidity through the use of credit cards, which have the least restrictions and documentation. The high level of debt has been a contributing factor to small business bankruptcies, and small business failure has been the cause of bankruptcy for one in five petitioners.

Small business plays a significant role in our economy. Easy access to credit is a major requirement for small business success. In this time of tight credit and economic downturn, it is important not only to facilitate access to capital, but financial literacy education should also be recognized as vital to the survival of small business.

The Small Business Administration is in a good position to consider new and innovative approaches to deliver effective financial literacy education to small business. With the proper understanding and knowledge of accounting and its tools and techniques, small businesses will avoid the greatest threat to their survival -- insolvency and bankruptcy.