



SEAANZ White Paper

Growing and sustaining entrepreneurial ecosystems: The role of regulation, infrastructure and financing



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Growing and sustaining entrepreneurial ecosystems: The role of regulation, infrastructure and financing

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Abstract

Among the key elements in the development of entrepreneurial ecosystems are regulatory frameworks, infrastructure and the role of financing. This paper examines the role of these three elements in facilitating or impeding the growth and sustainability of entrepreneurial ecosystems. Australia and New Zealand generally rank well in comparison to OECD averages for ease of doing business. However, regional neighbours such as Singapore do even better. Government policy needs to consider the impact of regulation across the entire lifecycle of the firm, from start-up through growth and into maturity. Despite calls by some for the removal of all 'red tape' encumbrances on small businesses, evidence suggests that this is not likely to deliver the outcomes such advocates might desire. What is required are 'smart regulations' that help small firms deal with regulations and provide more efficient systems for compliance. A 'risk-based' model for regulators to deal with small businesses is what should be sought. In terms of financing there is a myth that what is required is more availability of venture capital. While such financing can play an important role, most small firms and entrepreneurial ventures rely on retained profits and debt to secure their funding. One of the most important is retained profits and the ability of the firm to manage cash flow and working capital. Government policy can assist by enabling small firms to get lower cost EFTPOS facilities from major banks and to encourage more non-bank financial institutions (NBFI) to play a role in the financing of small business. Enhanced matching services for business angels and the strengthening of financial management skills and systems within small firms can also play significant roles.

Introduction

This is the second of a series of White Papers issued by SEAANZ as part of its contribution to advancing research, education, policy and practice in relation to small enterprises. As the G20 Leaders' Summit moves from Australia to Turkey in 2015 it is appropriate to reflect on the broader economic goals that emerged from the G20 summit communique issued from the meeting in Brisbane on 15-16 November 2014. This communique called for enhanced economic growth that could be achieved by:

“...promoting competition, entrepreneurship and innovation, including by lowering barriers to new business entrants and investment” (G20 Leaders' Summit Communique, 2014 p. 2).

It also called for a reduction in unemployment, particularly amongst youth by “encouraging entrepreneurship”. SEAANZ supports this ambition and the fostering of more supportive environments for small to medium enterprises (SMEs) that comprise the majority of all firms around the OECD, and which form the foundation and incubator for entrepreneurial activity.

This White Paper series has been developed by the SEAANZ board and aims to build on the G20 SME Conference of 20 June 2014. That meeting was convened by the Australian Minister for Small Business, the Honourable Bruce Billson MP and organised by the Australian Treasury, Australian Chamber of Commerce and Industry (ACCI), ANZ Bank, Australian Bankers' Association, Organisation for Economic Co-operation and Development (OECD) and public policy think-tank Global Access Partners (GAP 2014). These White Papers address the challenge



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of how to meet the G20's target of 2% growth by 2018 and how this might be achieved through the enhancement of SMEs within entrepreneurial ecosystems.

What is SEAANZ?

The Small Enterprise Association of Australia and New Zealand Ltd (SEAANZ) is a not-for-profit public corporation limited by guarantee, registered under the Australian Corporation's Act 2001. Founded in 1987, SEAANZ is dedicated to the advancement, development and understanding of small enterprise and entrepreneurship within Australia, New Zealand and the world. SEAANZ is focused on providing thought leadership across the "four pillars" of research, education, policy and practice in the area of SMEs.

SEAANZ is affiliated with the International Council for Small Business (ICSB), which was established in 1955 and was the first international organisation dedicated to the promotion, growth and development of small businesses at the global level. The ICSB draws together a wide cross-section of academic researcher, educators, policy makers and practitioners, who specialise in the field of SMEs. SEAANZ is also a member of the Asia Council of Small Business (ACSB), a regional affiliate of the ICSB that includes Australia, Japan, China, New Zealand, South Korea, Taiwan, Singapore and Malaysia.

It should be noted that the opinions contained in this document are those of the SEAANZ Board of Directors and do not reflect the views of all its members. They are disseminated in this document with the aim of better informing those with an interest in this area, and to stimulate further discussion.

The G20 challenge for small enterprise and entrepreneurship

The G20 SME Conference held at the Parliament of Victoria on 20 June 2014 issued an outcome statement that made 12 recommendations for change in how G20 nations should support SMEs:

1. **Government procurement policies** – government agencies should streamline and reduce their tendering and insurance requirements for SMEs with a voluntary procurement target of 20% of goods and services to be sourced from local SMEs.
2. **Regulation and 'red tape' reduction** – smarter regulation and inter-departmental cooperation is required over the long term to reduce 'red tape', and SMEs and their industry organisations should identify specific instances of 'red tape' for immediate review by government.
3. **Labour market flexibility, tax reform and productivity** – governments should take steps to enhance labour market flexibility, reform taxation systems, harmonise regulation across local, state and national jurisdictions, free international trade and improve national productivity.
4. **Entrepreneurship education** – entrepreneurship should become a subject taught within the Australian school curriculum and encouraged as a post-education employment option.



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5. **E-Government** – single online entry points for the input of personal and business information and credentials should be developed as part of the Australian Government’s Digital Economy agenda.
6. **Prompt payment of SME invoices** –the 30-day limit for the settlement of government accounts should date from the issue of the initial invoice, with the burden of further requests falling on public officials, rather than the SME.
7. **SME take up of digital technologies** – SMEs must adopt new technology and embrace the digital economy in order to remain globally competitive. A stronger focus on design and brand quality can also underpin long-term domestic and export success.
8. **Alternative sources of SME financing** – alternative sources of SME finance should be encouraged, with appropriate protection for stakeholders involved. Most SME growth is funded by retained earnings, so firm profitability is a key to enhanced SME growth.
9. **Growing the existing stock of SMEs** – ‘Economic gardening’ of local SMEs by encouraging existing small firms to employ additional workers can incrementally increase employment. Medium-sized firms that have export potential have the greatest opportunity for growth and job creation, and policy should encourage their expansion.
10. **Elevate the OECD Working Party on SMEs** – consideration should be given to the elevation of the OECD Working Party on SMEs and Entrepreneurship to an OECD Level 1 Committee.
11. **G20 SME Conference 2015** – a follow-up international SME conference should be hosted in Istanbul, Turkey in March 2015 as part of the Turkish G20 Presidency program of activities.
12. **B20 to focus on SME issues** – the B20 should continue to focus on issues relevant to SMEs and international growth.

In the first paper of this series (Mazzarol 2014) we examined the nature of entrepreneurial ecosystems and the role that could be played by government policy in their formation and long term sustainability. Within the following document we examine the role played by regulatory frameworks, infrastructure and financing. We also provide a series of recommendations for policy and practice across these areas.

Regulatory Framework and Infrastructure

The roles of regulation and infrastructure within entrepreneurial ecosystems are significant due to their ability to be either impediments or enablers of small business creation and growth. There are many areas where government regulation and the provision of infrastructure can serve as facilitators or impediments to entrepreneurial ecosystems. The World Bank’s annual “Doing Business” survey benchmarks 11 areas of business regulation that are relevant to SMEs.



These are listed in Table 1. For the purpose of this analysis we have compared Australia and New Zealand against Singapore for their overall ease of doing business.

In the 2014 “doing business” survey Australia was ranked 11th out of 189 nations for its ease of doing business, with New Zealand ranked 3rd and Singapore ranked 1st overall (World Bank, 2013a). Table 1 compares the performance of these three countries on the 11 areas of business regulation. Also shown is the OECD average for high income countries.

Table 1: “Doing Business” 11 areas of business regulation

Indicator	Australia	New Zealand	Singapore	OECD
Complexity and cost of regulatory processes				
Starting a business	4	1	3	60
Dealing with construction permits	10	12	3	63
Getting electricity	34	45	6	53
Registering property	40	2	28	58
Paying taxes	44	23	5	55
Trading across borders	46	21	1	31
Strength of legal institutions				
Getting credit	3	3	3	47
Protecting investors	68	1	2	56
Enforcing contracts	14	18	12	36
Resolving insolvency	18	12	4	27
Employing workers	NA	NA	NA	NA

Source: World Bank (2013a,b,c,d)

As can be seen from Table 1 Singapore generally rates well across all areas. New Zealand is also well ranked in relation to most items, although its weakest area is getting electricity. According to the World Bank in the city of Auckland it takes 5 separate procedures to have electricity connected. This can take up to 75 days and cost around NZD \$45,721.50 for a full new electricity connection (World Bank 2013c). This compares to Singapore where a similar electricity connection takes around 38 days at a cost of SGD \$17,666 (World Bank 2013d).

Australia’s performance overall is worse than for both Singapore and New Zealand, although it is ranked above the OECD average for all items other than protection of investors. The main issue with Australia’s performance in protecting investors is the relatively lenient legal codes relating to company director’s liability.

Ease of starting a new business

The process of starting a new business is examined in the World Bank's annual "Doing Business" survey (World Bank 2013a). According to the survey, across 189 countries it takes on average 7 separate procedures, 25 days and costs 32% of income per capita to start-up a new business (World Bank 2013a). New Zealand was ranked as the country with the easiest start-up environment, taking only one step, half a day and costing little or nothing in fees. By contrast, in Surinam it takes 208 days to start up a new business.

The performances of Australia and New Zealand in terms of starting a new business are very good when compared to other high income countries in the OECD. For example, Japan ranks 120th place and requires eight procedures to start a new business taking around 22 days at a cost of 7.5% of per capita income. The positive global ranking of Singapore in terms of its ease of doing business was noted by the World Economic Forum in their study of entrepreneurial ecosystems (WEF 2013). In particular the country's regulatory framework and infrastructure, which were viewed as highly attractive to entrepreneurial firms:

"Moving HQ to Singapore: Singapore is becoming the Silicon Valley of Asia; start-ups are popping up all over, attracting substantial investment where there is potential in the technology and innovation space. Investors, shareholders and entrepreneurs are all realizing Singapore's advantages especially businesses looking to take advantage of the fast growth and untapped markets that the developing Asian markets have to offer. In addition, favourable regulations and extensive government support for start-ups made Singapore a very attractive choice for our new corporate HQ location in early 2012. (Capillary Technologies (India and Singapore) – cloud-based software for customer engagement." WEF 2013 p. 12)

How important is ease of business start-up to entrepreneurial activity?

In a study of 39 countries undertaken by Stel, Storey and Thurik (2007) the relationship between regulation and entrepreneurship activity was examined. This study found no significant impact on nascent or novice entrepreneurial activity in terms of the time, cost or number of procedures required to establish a business. However, the ability to raise the minimal capital required to start-up a new venture was found to be an impediment across all countries.

This research suggests that regulations associated with the establishment of business ventures may not impact on entrepreneurial activity in a particularly negative way despite some claims to the contrary (Djankov et al. 2002). However, it may influence the proportion of businesses that operate in the formal or informal economy with some enterprises operating in an unregistered manner where entry compliance costs or burdens are high. This appears to flow across into the nature of 'necessity' versus 'opportunity' entrepreneurship. While 'opportunity' entrepreneurs tend to be better educated and launch formally registered business ventures, their 'necessity' counterparts in developing economies tend to launch informal, unregistered ventures and thereby avoid regulation and compliance.

In developing countries excessive regulation creates a division between the formal and informal economies. A key finding from this study by Stel, Storey and Thurik (2007) was the impact of labour market regulation rather than start-up compliance on nascent and novice entrepreneurs.



Although the study has limitations caused by the nature of the data sources used (e.g. Global Entrepreneurship Monitor and World Bank Doing Business) the authors drew the following conclusions:

“Notwithstanding these limitations, we feel the current paper has re-opened an important debate on a key policy area. If administrative entry barriers play only a very modest role in explaining variations in enterprise creation rates, then the current ‘fashion’ for countries to compete by lowering these barriers needs to be reviewed.” (Stel, Storey and Thurnik 2007 p. 183)

Employing workers

Undoubtedly one of the areas of greatest interest from a policy perspective is how easy or hard is it for SMEs to employ workers. As noted earlier in this document, the level of interest in SMEs and entrepreneurship is their ability to serve as engines of growth for employment. Key areas that have emerged across countries for the “Doing Business” study are probationary periods for new employees, paid annual leave provisions and length of the working week (World Bank 2013a).

Most economies have probationary periods of 3 to 6 months, while the most common approach to paid annual leave is the 15 to 21 days. This is consistent with the International Labour Organization (ILO) conventions. In terms of the duration of the working week, 178 countries have six-day weeks, which complies with the ILO conventions. The World Bank (2013b) noted that reforms to Australia’s labour market employment laws were primarily undertaken in 2011. In that year Australia introduced severance payment obligations re-employment consideration in the case of redundancy dismissals. There was also an increase in annual leave and a decrease in the notice period applicable in cases of redundancy dismissals.

Best practices in regulation

There are a range of regulatory issues that impact a business throughout its lifecycle. There is a need for governments to set the macroeconomic policy settings that can help to foster a vibrant entrepreneurial ecosystem. Government must build the necessary infrastructure and make sure that legal and regulatory codes are clear and enforced consistently.

Best practices for start-up and employment

According to the World Bank’s analysis of its “Doing Business” survey there are several best practices for each of the five elements outlined in Figure 1 (World Bank 2013a). At start-up it is advisable to have all procedures take place online within a ‘one-stop-shop’ environment. There should also be no minimum capital requirement for start-up. In relation to employment there is a need to increase the flexibility of regulations relating to the hiring and firing of workers. Governments in high income OECD countries have been reforming and lengthening the tenure of fixed term contracts, but shortening the required notice period for severance payments in cases of redundancy dismissal (World Bank 2013a).

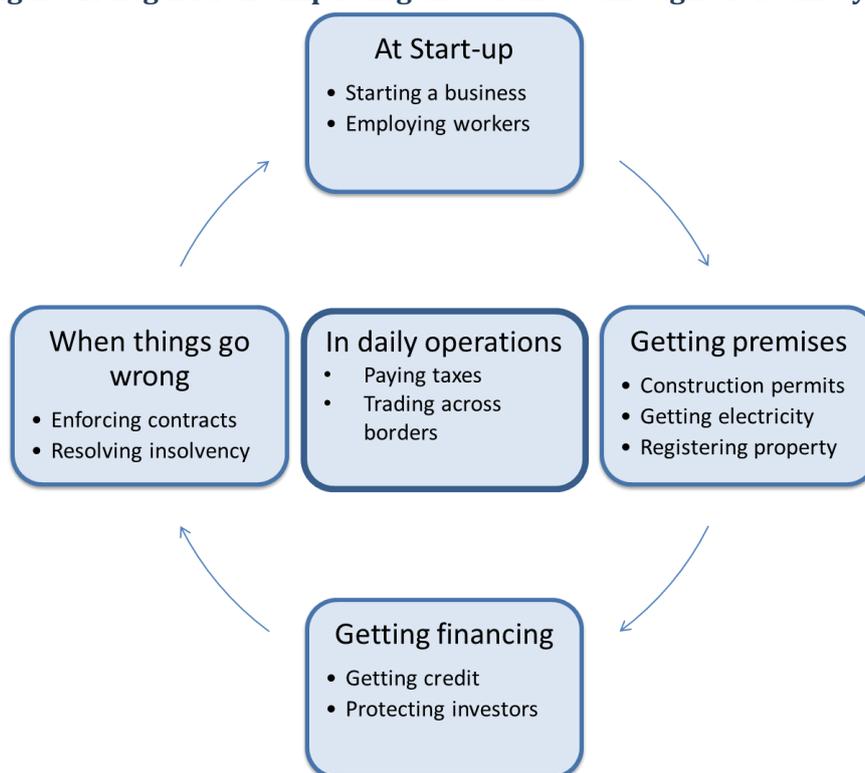
Best practices for getting premises

In relation to getting premises best practice has focused on assisting firms with construction permits by having comprehensive building rules, using online and ‘one-stop-shop’ entry points,



and adopting a risk-based approach to building approvals. The securing of electricity connection has been enhanced through the streamlining of approval processes. Connection costs and processes should also be more transparent. Steps should also be taken to reduce the financial burden of payment of security deposits for new connections, and the electricity installers need to be adequately trained and accredited. For the registration of property there should be default use of electronic databases for encumbrances. Online information of cadastre data should also be used along with expedited procedures where requested, and the setting of fixed transfer fees.

Figure 1: Regulations impacting the business throughout its lifecycle



Source: World Bank (2013a)

Best practices for getting financing

Best practice in getting financing has been associated with enhancing the legal rights of those seeking to take on debt, as well as improving the distribution of credit information. The protection of investors can also be enhanced by having clearly defined duties for company directors. There should also be a requirement for detailed disclosure to shareholders who should be allowed to access all corporate documents before any trial.

Best practices for daily operations

For daily operations the best practice in taxation is to allow self-assessment and the completion of all tax registration and payments via online electronic systems. Tax should also be simplified to have one tax per tax base. Further, with regard to trading across borders online electronic submission and processing should also be the default and should be handled via a one-stop-shop or single entry point. Risk-based inspections should also be used.

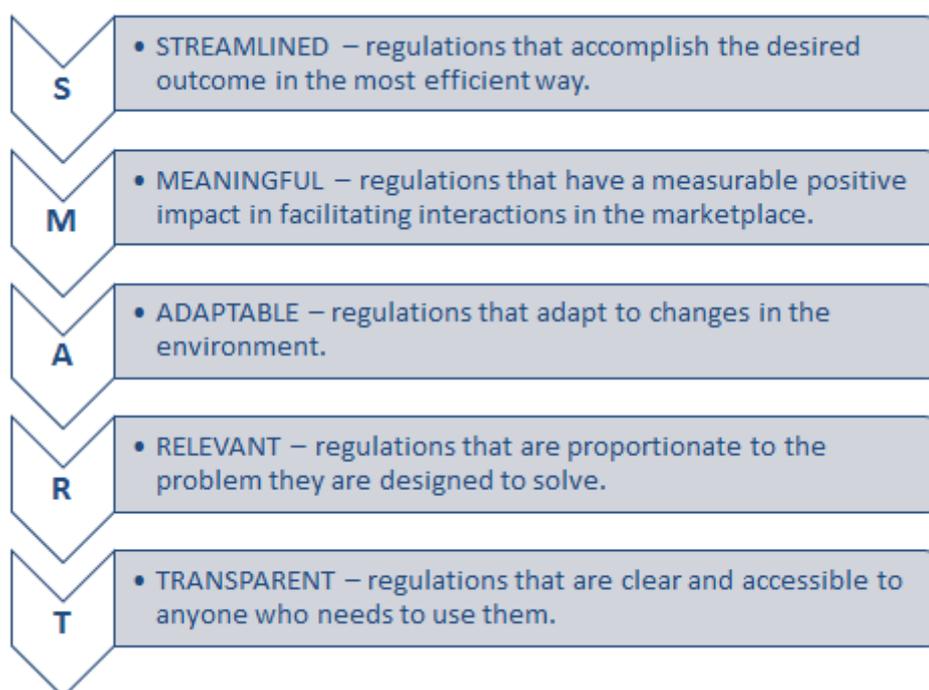
Best practices for when things go wrong

In situations where things go wrong the enforcement of contracts should be handled by specialised commercial courts and adjudicators. Dispute resolution processes should be used to avoid immediate recourse to court action and there should be electronic online filing of complaints. Where insolvency occurs best practice suggests that insolvency administrators should be regulated and qualified by law and provided with legal frameworks for out-of-court workouts. Creditors' committees should also be given a say in any insolvency proceeding decisions. Finally, there should be specified time limits for the majority of insolvency procedures (World Bank 2013a).

Smart regulations

While the cutting of 'red tape' is often used as a mantra by those seeking to lift the regulatory burden off the shoulders of SMEs, there are frequently few successful campaigns to cut red tape. This is because government regulation and compliance is typically put in place to protect the community, the workforce, consumers, the environment or other businesses. Some industries are more heavily regulated than others due to high potential for risk (e.g. air transport, construction, medical services and pharmaceuticals).

Figure 2: SMART Business Regulations



Source: World Bank (2013a)

The approach taken by the World Bank is to focus on “smart regulations” that are defined according to the issues illustrated in Figure 2. As shown the focus is on regulations that have been designed to be streamlined, meaningful, adaptable, relevant and transparent. As the “Doing Business” report of 2014 suggests:

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“The economies performing best in the Doing Business rankings therefore are not those with no regulation but those whose governments have managed to create rules that facilitate interactions in the marketplace without needlessly hindering the development of the private sector. Ultimately, Doing Business is about smart regulations, and these can be provided only by a well-functioning state.” (World Bank, 2013a p. 21)

An important aspect of how government regulation works is not the absence of regulations but how the various government agencies deal with the compliance issues. According to Mundy (2014) the first step for governments seeking to alleviate the impact of regulation on SMEs is to ensure that regulatory frameworks do not inhibit the ability of government agencies and regulatory authorities to adopt leading-edge engagement practices.

In addition, regulators need to be provided with the necessary tools to allow them to adopt flexible and appropriate compliance management practices. For example, at least 30% of regulators surveyed in Australia claimed to lack sufficient enforcement tools (Productivity Commission 2013). Regulators also need to be adequately resourced so that they can effectively adopt risk-based management approaches, which require more intensive engagement with SMEs. Regulators also need to change their cultures to be less risk averse and assess businesses on their risk on a case by case basis. Communication is critical with education rather than enforcement being a more appropriate default position (Mundy 2013).

According to the World Bank the economies that rank the highest on the ease of doing business are not those without regulation or with loose regulations and a “small government” approach, but those that have regulatory systems that protect the public interest without hindering private sector growth. As outlined in their report:

“*Doing Business* recognizes that the state plays a fundamental role in private sector development. Governments support economic activity by establishing and enforcing rules that clarify property rights and reduce the cost of resolving disputes, that increase the predictability of economic interactions and that provide contractual partners with core protections against abuse. So it is no surprise to find that there is no evidence suggesting that economies that do well on *Doing Business* indicators tend to have governments driven by a ‘smaller government’ philosophy. Indeed, the data suggest otherwise. It is generally the bigger governments (as measured by government consumption expenditure as a percentage of GDP), not the small ones, that tend to provide more of the protections and efficient rules promoted by *Doing Business*.” (World Bank 2013a p. 4)

A global study of entrepreneurial ecosystems undertaken by the World Economic Forum found that major inhibitors for enterprise growth were excessive complexity in government regulations compounded by overlapping and contradictory rules in local, state/provincial and national levels of jurisdiction. Inconsistency in enforcement regimes, lack of transparency and clarity, unreasonable time delays, uncertainty caused by constant changes to established rules, and a mindset within many government agencies that was non-growth focused and lacking in entrepreneurial orientation (WEF 2013).



Conclusions and recommendations for regulation and infrastructure

The G20 SME communique called for smarter regulation and greater inter-agency cooperation in the long-term reduction of red tape. It also sought to enhance labour market flexibility and the reform of taxation systems across jurisdictions. The adoption of 'e-government' initiatives using single online entry points for regulation and compliance were also key recommendations. All of these measures are consistent with the development of best practice in regulation and infrastructure. However, it should also be recognised that smaller government is not necessarily a recipe for enhanced performance in this area.

Regulation is required to ensure that the rights and best interests of suppliers, consumers, employees, shareholders, the environment and the broader community are protected. Smarter regulation rather than less or no regulation is the best course of action. In some cases this may require an increase in the resources and staffing made available to regulatory and compliance agencies. However, there must be greater use of technologies, in particular online systems to help reduce the compliance burden on SMEs.

It should also be acknowledged that firms of different sizes, levels of complexity and types of industry carry with them different levels of risk and different capacities to deal with regulations. Education, information and a risk-based approach to regulation should be the default policies for regulators. Flexibility and a culture that seeks to facilitate the growth of SMEs and entrepreneurial activities while protecting the community are key requirements for regulatory agencies.

Key Recommendations for Regulation and Infrastructure

- All government agencies and regulatory authorities should move towards a 'digital by default' online, single-entry-point and 'one-stop-shop' model for compliance issues.
- There should be a reduction in the compliance costs associated with securing regulatory approvals, reducing the number of steps in the process and increasing the duration of any licences and certifications where ever possible.
- Regulatory authorities should share common data and reduce the frequency and size of data collection where feasible.
- The regulation of SMEs should be undertaken on a risk-based model in which employees within regulatory authorities are empowered to adopt flexible and reasonable approaches based on an 'educate and inform' model.
- Regulatory authorities should be equipped with the necessary enforcement tools and provided with sufficient resources to effectively case-manage SME clients.
- Government authorities at local, state and federal level (where applicable), should collaborate to identify areas of regulation that can be streamlined to avoid unnecessary duplication of effort for businesses seeking to operate across multiple jurisdictions.
- The culture of government agencies should be shaped towards a service-based organisation that supports SMEs through effective communication and risk-based management.

Funding and Finance

There is no doubt that one of the most important elements for a business seeking to grow is the ability to fund growth via access to debt and equity financing. Financing SMEs from start-up through growth is an often complex mix of informal and formal funding. This typically commences with the founder's own savings, some personal credit card debt, and often loans or informal equity contributions from family and friends. Once the business becomes established the mix of funding will include debt financing, usually from banks, followed by informal equity financing from business angels, through to formal equity investment from venture capital firms and eventually initial public offering (IPO) on the stock exchange (WEF 2013).

Sources of finance and the SME financing gap

A business typically secures its financing from three sources comprising retained profits, debt and equity. Each of these plays a role and the overall mix within the firm's balance sheet will depend on the nature of its business model. How an SME finances its growth will depend on the pace of its growth cycle and the strategic intent that its management team has for the business. High growth entrepreneurial firms typically seek equity financing because growth requires high levels of working capital and they are not able to sustain growth from debt or retained profits. The following example is a case of this type of financing:

"We bootstrapped the business from inception until the end of 2008. At that time, we were awarded a US\$ 250,000 grant from Facebook, which was enough for us to hire a couple more developers, launch the product out of beta and achieve profitability without raising money. As a profitable company, there were all kinds of funding available to us and we raised series A funding through a venture capital firm in the area. We felt great about the team the venture capital firm had and it seemed like a good fit. When we changed the business model, we raised insider series B funding." [Wildfire (USA) – social media marketing platform] (WEF 2013, p. 12)

However, only a relatively small proportion of SMEs secure venture capital funding either because they cannot offer a suitable business case to attract this type of investment, or they don't need or want such financing. For example, in a study of 567 innovative SMEs from 11 OECD countries the importance of different sources of financing was examined. All firms were engaged in the development of an innovation such as a new product or service. They were asked to rate the importance of equity, debt or retained profits to their future plans for the commercialisation of this innovation. Only 46% considered equity financing to be of importance to their plans to successfully commercialise their innovation and only 23% felt that this was very important. By comparison 82% of respondents rated retained profits as important and 56% rated it as very important. Debt financing was rated as important by 43% of respondent firms (Mazzarol and Reboud 2011 p. 95).

The SME financing gap – is it a myth or a reality?

When the financing of entrepreneurial and small firms is discussed it is common to hear claims about the existence of a 'financing gap' for SMEs (Harris 1995). This argues that a major impediment for the future growth of such businesses is their lack of access to funding. In a

review of this SME funding gap the OECD examined whether it was a myth or a reality (OECD 2006).

The findings from the OECD (2006) report of a survey of over 100 economies found that the advanced economies did not report any generalised financing gap for SMEs. Most small firms were able to secure necessary debt financing from banks and other financial institutions. In some cases this financing was supplemented by government loan guarantees. Within the less developed economies the situation was different. In these countries the level of access to formal debt financing was low and a largely informal debt market was operating. However, where the gap was perceived to lie within the advanced economies was in the financing of innovative SMEs, particularly those engaged in technology intensive sectors.

This study pointed to the gap – where it did exist – as being in the area of “risk capital” such as informal (e.g. business angels) and formal (e.g. venture capital funds). The more innovative and growth focused SMEs, which by nature are a more risk prone business, often find it difficult to fund growth organically from retained profits, and cannot secure sufficient debt due to a lack of collateral assets. Much of the ‘gap’ was found at the early-stage of the funding cycle, typically when the venture or its technology were still new and unproven (OECD 2006). Research undertaken in the United Kingdom found an ‘equity gap’ of between £150,000 and £1.5 million (approx. AUD \$270,990 to AUD \$2.7 million) (Harding and Cowling 2006).

Debt financing – lessons from the GFC

Since the report by the OECD (2006) was published the Global Financial Crisis (GFC) of 2008-2009 has occurred and this has had a significant impact on SME financing. A post-GFC review of SME financing found that most small firms sourced external funding from debt rather than equity sources. This included lines of credit and overdrafts, bank loans, factoring and leasing plus trade credit. However, the years immediately following the crisis saw a drying up of bank financing for SMEs although this varied from country to country (OECD 2012).

A similar pattern occurred within the Asia-Pacific region where the main external source of funding for SMEs is bank credit. The non-bank financial institution (NBFI) sector remains under developed in the Asia-Pacific region (ADB-OECD 2014). Within Australia the main sources of external financing for SMEs are: banks (65%); followed by owner’s personal savings (28%); family and friends (13%) and NBFIs (10%) (IPA 2014).

One of the key lessons from the GFC was that financial crises of this kind impact more negatively on SMEs than on large firms. For example, analysis by the OECD (2012) found that large firms found external finance outside the banks such in the bond markets. SMEs also experienced much higher rates of interest on credit than did large firms and also found access to credit more difficult. This was also at a time when revenues were falling and cash flow was slowing. This was a pattern found not only in Europe and North America, but also across the Asia-Pacific region (ADB-OECD 2014).

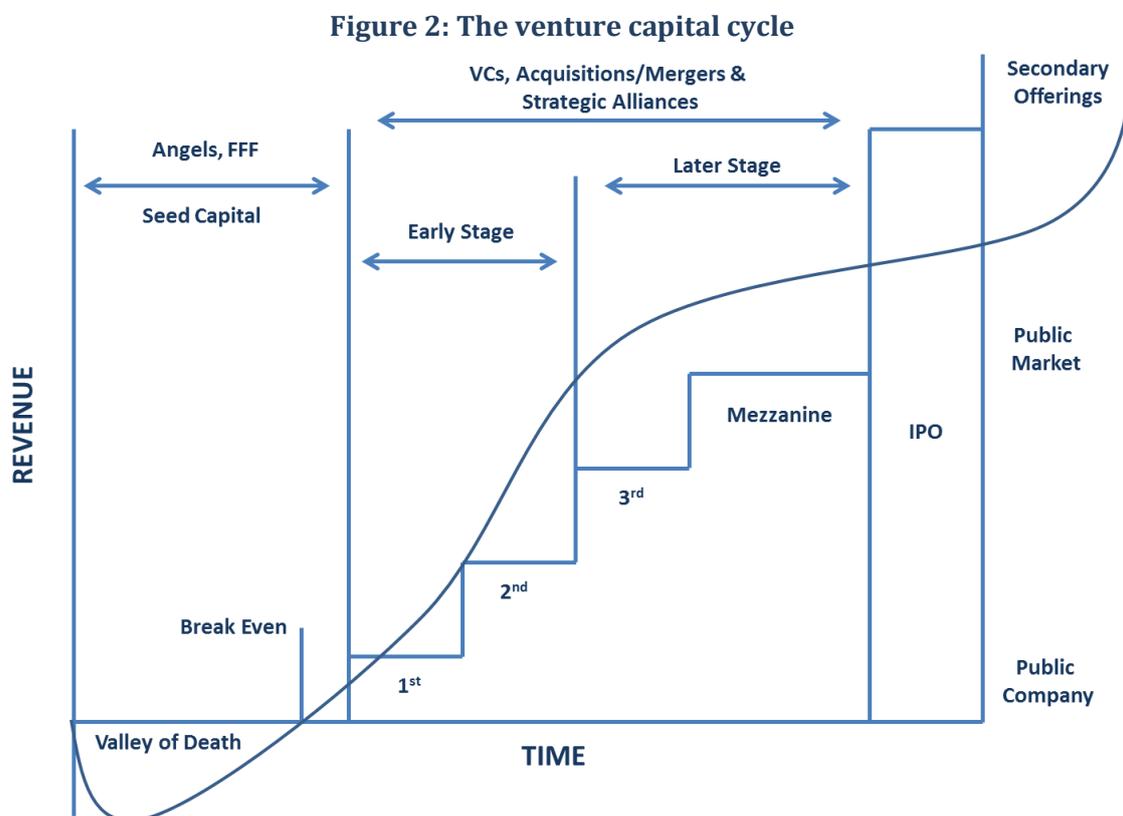
Access to credit and debit financing by start-up and early stage firms can be even more difficult due to the need for any collateral to be derived from the owners’ personal assets. This is



typically the family home and is likely to take the form of a credit card debt or personal loan, which might carry high interest rates. Many SMEs, in particular micro-enterprises, find it difficult to access online payment systems such as EFTPOS and online credit card payments. These generally carry high costs and have complex establishment and maintenance (IPA 2014).

Equity financing

Although equity financing is required by and available to only a relatively small proportion of SMEs it is typically the higher growth firms that require it. Such firms have high levels of innovation, often involving a technology platform, and this imposes a requirement to expand quickly in order to take advantage of a market window of opportunity. The cycle of funding that these firms need flows through a series of distinct stages as illustrated in Figure 2. The first of these is at start-up and this is generally informal in nature. It is typically sourced from the founders' savings, family, friends and "fools" (FFF), and business angels, who are high net worth private investors.



Source: Cardullo 1999 cited in OECD (2013a)

If the business survives the initial start-up stage it will move through a series of stages through which the funding requirements increase along with the formality of the investment. While some ventures might move from private equity financing to initial public offer (IPO) through listing on the stock market, many will be sold (trade sales) via acquisition or merger, or they might form a joint venture with a major customer, supplier or third party firm that might have complementary technologies or services. Access to 'seed capital' and early stage equity

financing is often the most difficult for young, fast growing firms (OECD 2004). However, as noted above, many innovative SMEs do not seek to access equity financing and only a small proportion of all firms actively seek to do so beyond the very early and informal stage of their growth (OECD 2010b).

Retained profits are the key to growth

Although debt and equity financing remain important to SMEs the most significant source of financing for any business, in particular those seeking growth are retained profits. The value of retained profits as a key source of future funding for innovation was highlighted by OECD (2010b) research, which is consistent with other studies of innovative SMEs where retained profits were the most important source of future funding for commercialisation (Mazzarol and Reboud 2011).

The ability to grow a business in a sustainable way depends on the firm's underlying ability to generate above average profits (Glancey 1998; Suttapong and Tian 2012; Lee, Kelly, Lee and Lee 2012). For an SME to do this it must be able to generate high gross margins and this requires that the firm be in a position to charge premium prices while maintaining control over costs. Price premiums can only be charged where the business has the ability to secure control over assets that enable it to offer superior value through innovation in products or processes (Alvarez and Barney 2004).

Growth places pressure on the firm's working capital requirement and this is why many firms that seek to grow without adequate working capital experience cash flow and liquidity problems. The ability for a small firm to grow is dependent on its ability to effectively manage its cash conversion cycle and this requires the business to shorten the time it takes to collect its accounts receivable (Gill, Biger and Mathur 2010; Baños-Caballero, García-Teruel and Martínez-Solano 2012).

Cash flow management is critical

What this means for SMEs, in particular growth oriented ones, is that cash flow management and the ability to retain profits and maintain adequate working capital requirements are critical factors for success (Ebben and Johnson 2011). The ability for SMEs to secure payments from customers in a timely manner is therefore very important. As noted above, there is a need for SMEs, in particular micros, to gain access to lower-cost EFTPOS and online credit card and other payment systems.

Academic research into the relationship between good cash flow management and the financial performance among SMEs highlights these relationships. For example, a longitudinal analysis of panel data from 13,797 Swedish SMEs found that firms that managed their cash flow and their working capital cycles efficiently were able to boost their profitability (Yazdanfar and Ohman 2014). A similar study from Finland of 1,136 small firms produced the same broad findings, which highlighted the importance of efficient management of the cash conversion cycle (Enqvist, Graham and Nikkinen 2014).



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In their *Australian Small Business White Paper*, the Institute of Public Accountants (IPA 2014) proposed that the Australian government introduce a world best practice payment system, and that they also take steps to reduce the cost of establishing and operating EFTPOS systems for SMEs. Relatively few SMEs have EFTPOS facilities and most have to wait weeks or even months to secure payment from customers. The cost of collecting accounts receivable for the small firm is also a major compliance burden (Ekanem 2010).

Getting paid on time

It is encouraging to see that one of the recommendations from the G20 SME Conference was the prompt payment of invoices from SMEs by government agencies. This recommendation calls for a 30 day limit for the settlement of government accounts that should be dated from the issuing of the invoice (GAP 2014). However, there is a need to ensure that large firms also pay SMEs in a timely manner. Large companies also benefit from efficient management of working capital and the cash flow cycle (Lifland 2011), yet they should not use their relative size and power to delay payment to SMEs.

The ability to receive payments from customers in a timely manner is a critically important factor in the survival and growth of small firms. As noted above, the efficiency of the firm's cash conversion cycle (e.g. how quickly it can collect its accounts receivable once an invoice is raised) makes a significant difference to its profitability. A study of 133 SMEs in the United Kingdom that tracked their trading activity over a five-year period, found that the ability to manage their accounts receivable and payable was crucial to the firm's profitability (Tauringana and Afrifa 2013). This appears to be a consistent trend across all types of economies. For example a study of 55 SMEs in Pakistan found similar results suggesting that profitability was closely linked to the firm's ability to quickly collect its accounts receivable and maintain the efficiency of its inventory turnover (Gul, et al. 2013).

Alternative sources of financing for SMEs

In addition to the traditional sources of debt and equity financing there are now some emerging alternative funding sources. Among these is 'crowd funding', which is typically facilitated by online platforms where entrepreneurs with business ideas or existing projects seek to raise small amounts of money from the general public. Investors typically commit small individual contributions usually as micro-loans rather than as equity investments.

An example of this is the United States program "Kickstarter" (see: www.kickstarter.com) that has provided funding for a range of projects such as a films, online games, books and new products (OECD 2014). Another example from Australia is "Pozible" (see: www.pozible.com). This crowd funding platform launched in 2010 under the name "Fundbreak" as a solution to helping raise money for creative arts projects. However, it has been used to successfully raise money for small firms engaged in social enterprise.

Although still a relatively new tool in the SME funding process the ability for such systems to play a bigger role is likely to depend on the development of regulations to ensure that investors are protected. As with any investment or credit relationship the critical factors are the openness



and transparency of information to allow participants the ability to make informed decisions. As the OECD (2014) observed:

“Legislators also need to keep up with developments in crowd funding to ensure that the regulatory environment is favourable and provides sufficient investor protection. One of the problems that can arise with crowd funding platforms is low control by platform managers on the viability of business proposals put forward for investment and low monitoring of their progress. Similarly, information on business projects is limited to what entrepreneurs are willing to disclose, whereas more structured and homogenous information requirements would help investors make a better choice. Finally, the support of equity-based crowd funding should also encourage the parallel development of senior investors (e.g. business angels) and secondary markets to secure exit options for people investing in equity through crowd funding platforms.” (OECD 2014 p. 148)

Conclusions and recommendations for funding and finance

The G20 SME communique called for prompt payment of SME invoices by government agencies and the adoption of alternative sources of funding. While such initiatives are important there is also a need for government policy to focus on ways to help SMEs increase their working capital cycle and this can be achieved through enhanced access to cost effective online payments systems for EFTPOS.

Broadening the debt financing system is another opportunity. This would include increasing the level of SME debt and credit funding that is provided by NBFIs, in particular credit unions and mutual financial organisations as well as finance companies and crowd funding. Helping all SMEs gain access to factoring services at competitive rates would also assist cash flow and working capital management.

In the area of equity financing there is a need for greater transparency of information on SMEs for investors and enhanced matching services that can make it easier for entrepreneurs to find business angels and other informal investors in the early stage of the funding lifecycle. However, the provision of more information on small companies on the stock exchange will also assist in lowering the risk premium on such firms and this will help to reduce the cost of capital raising by SMEs on the public market (Frino 2014).

Key Recommendations for Funding and Finance

- Reduce the cost of establishing and operating online EFTPOS systems for SMEs.
- Widen the base of debt funding sources by encouraging NBFIs to play a more active role in the financing of SMEs.
- Assist SMEs with cash flow management and working capital requirements by ensuring that government agencies and large companies pay SME invoices promptly (e.g. within 30 days).
- Enable SMEs to secure funding via crowd sourcing, but ensure that such systems are adequately regulated and that lenders and investors have access to appropriate information to permit well informed decisions.
- Enhance matching services to help entrepreneurial firms find 'business angels' and other informal investors.
- Improve the overall financial knowledge and skills of SMEs and their advisors through education and training.
- Assist SMEs to raise capital on the stock exchange through improving the flow of information on small companies and make such information free.

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