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Cash: The King of Small Business

Introduction

The next financial disaster lurks right around the corner. Over the past 16 years, the US economy has experienced many downturns, including a housing crisis, a banking collapse, the Great Recession, devastating natural disasters, the Covid-19 pandemic, rising interest rates, and recent bank failures. Small businesses are especially vulnerable during a financial crisis. If they do not have enough cash on hand to weather the storm, they struggle to survive. Researchers agree that cash reserves are critical for small businesses, but few have looked at the source of that cash to determine if it came from bank loans or if it is "free and clear" cash. This matters during a crisis because as business income dries up, loans and other operating expenses must still be paid. Further, banks stop issuing loans to small businesses during a downturn, considering them "too risky." All this leaves small businesses shackled. Without enough cash, they are forced to close or file for bankruptcy.

Traditionally, three funding options have been used for small businesses: cash, loans, or bootstrapping, which is a combination of cash and loans. Starting and running a business on "free and clear" cash means that the owner has no debt and is in full control of the business. This results in slow but steady growth. Growing a business with loans often means faster growth and more income potential, but it can also mean having a bank controlling aspects of the business or the possibility of bankruptcy if those loans cannot be paid back. Bootstrapping attempts to leverage both types of funding, allowing a business to be flexible by taking small loans but also stable by storing enough cash to survive a financial crisis.

Every small business owner needs to understand the role the cash plays in a business, especially how “free and clear” cash helps a business survive a financial downturn. They also need to know that any bank loan carries risk and that most banks will not loan money to small businesses during a financial crisis. Finally, they need to know the additional benefits of using cash to grow their business at a slow, steady pace. <u>To accomplish these objectives, small business owners seeking a business license at the city or state level will be required to complete a training module to show them the value of cash in their business. The training will explore the following ideas: cash reserves are essential for small businesses; cash not obtained from loans allows small businesses to survive financial downturns; and cash-run businesses experience steady, solid growth.</u>

Claim 1: Cash reserves are essential for small businesses

Cash reserves are critical for small businesses. These cash funds help owners fund startup needs and pay for everyday business expenses. They are used to purchase equipment and supplies, rent, or payroll. Most researchers agree that cash reserves are essential for small businesses. They point out that businesses need to be able to accurately forecast their cash needs since small businesses are especially vulnerable to changes in cash flow. In the article “Small Business Cash Management Practices,” Dr. Philip L. Cooley, a professor of finance at the University of South Carolina, and Richard J. Pullen, of Confederation College, found that “cash [is] the lifeblood of a firm’s circulation system” (1), but only 30 percent of small business owners regularly prepare a cash forecast (7). Cash is vital for small businesses because it keeps all aspects of the business running smoothly. Surprisingly, many owners do not budget for the cash they will need for everyday operating expenses or financial downturns.

Another researcher, Nancy Opiela, agrees with Cooley and Pullen. In the article "Keeping Small-Business Cash Flow on Track," Opiela states, "If there's one thing that will make or break a small business, it's cash flow" (26). Both articles recognize that small businesses heavily rely on cash reserves and that owners must pay attention to cash flow often. If business is booming, cash is needed to expand and to capitalize on growth opportunities. If business is slow, cash is needed to cover expenses until income picks up again. Neither article pushes for a cash-only business model, but they both stress the important role cash plays in small businesses. They also show how important cash reserves are to succeed during any crisis.

Another researcher found that to be successful, small business owners must be able to accurately forecast their cash needs. In the article "Forecasting the Cash Budget in the Small Firm," Dr. Arthur R. DeThomas, a professor emeritus of finance from Valdosta State University, examines how a small business should budget cash to meet future needs. Like the articles by Cooley and Opiela, DeThomas does not push a cash-only business model but instead points out that things can go wrong rather quickly in business, so cash reserves are essential (9). Business owners should plan for the absolute worst when they budget their cash reserves. If they do this, the cash reserves would act like an insurance policy and could keep the business going during tough economic times. Business owners who know that they need cash reserves and who budget their cash with the worst possible events in mind will likely stay in business during any situation.

Researchers agree that cash reserves are critical for small businesses, but they do not specifically say where that cash should come from. Sources for funding a small business may include an owner's personal cash reserves or may come from credit sources, such as bank loans, credit cards, or crowdfunding. One recent trend in small business uses a combination of both personal cash and small loans, which is called "bootstrapping" (Neeley and Van Auken 401-06). When the economy is booming, the funding source that a small business owner uses probably does not matter much. However, when economic hardship hits, any use of credit is risky because loans cannot be repaid if income drops, and banks often refuse to loan more money to small businesses during a financial downturn. This can quickly lead to a business closing its doors or filing for bankruptcy.

Claim 2: Cash not from loans allows small businesses to survive financial downturns

Financial disasters happen frequently in the United States. Over the past 16 years, the market has witnessed such devastating events as the 2007-2008 bank failure and housing collapse, the Great Recession, deadly natural disasters, the Covid-19 pandemic, high interest rates, and more bank failures in recent weeks. When a financial crisis hits, small businesses that have cash on hand that was not obtained from loans often survive the financial downturn, while businesses that borrowed money risk closing or going bankrupt.

Most small businesses are not prepared to endure a financial crisis. In the article "The Impact of Covid-19 on Small Business Outcomes and Expectations," a group of economists (Alexander W. Bartik, Marianne Bertrand, Zoe Cullen, Edward L. Glaeser, Michael Luca, and Christopher Stanton) found that most businesses do not have enough cash on hand to survive a financial downturn. During Covid-19, Bartik et. al noted that small businesses with monthly expenses over $10,000 only had enough cash to last two weeks, while those with expenses under $10,000 only had enough cash to last two months (17666). A financial downturn generally means fewer paying customers, but businesses have to purchase supplies, pay rent, and meet payroll. Therefore, the more cash that a business has on hand, the longer it can survive. Bartik et al. found that “firms with more cash on hand were more confident about their future” (17666). A large cash reserve helps during a downturn. Unfortunately, if that cash came from bank loans, those loans still need to be repaid, and new loans cannot easily be found because banks tend to stop lending to small businesses during bad financial times.

Economists Haifang Huang and Eric Stephens agree with Bartik et al. that cash reserves are needed for small businesses because bank credit dries up for them during difficult financial times. Huang and Stephens found that during the 2007 housing collapse, banks did not loan money to small businesses at a time they needed cash the most. This happened because banks had less money to lend, so they did not take risks on small businesses (854). If banks do not loan money to small businesses during a financial crisis, then those businesses must have cash on hand that was not obtained from loans to stay in business. Cash with no strings attached would enable a business to keep operating, rather than struggling to find a scarce bank loan or even facing bankruptcy.

Another researcher and professor, Dr. Rodney C. Runyan, agrees with both Bartik et al. and Huang and Stephens that financial disasters create many problems for small businesses. Runyan’s research found that cash reserves and a good disaster plan are key to business survival. Specifically, Runyan found that many small businesses in the New Orleans area were unprepared for Hurricane Katrina, despite living in an area known for hurricanes. The biggest vulnerabilities were not anticipating the worst events that could happen to their business and interruptions to cash flow (12). He explained, “Since many of these small business owners fund their operations from weekly cash flow, it is understandable that most do not have the ability to survive even a few weeks without revenue” (24). Small business owners in the area did not have enough cash set aside, and the hurricane hit suddenly. A small business can weather a financial disaster if the owner has planned for the worst and operates with cash reserves that are not connected to bank loans. Businesses that rely on credit or that do not have enough cash will probably go bankrupt.

Claim 3: Cash-only businesses experience steady, solid growth

Small businesses that reject bank loans and run on cash reap the benefits of solid, sustainable growth. This slower growth gives owners time to learn all the details of their industry and to gain experience managing problems while the business is small. Further, businesses that grow at a consistently slow rate experience quality, incremental growth. In the article “Pathways to Entrepreneurial Growth: The Influence of Management, Marketing, and Money,” Brush et al. explain the pitfalls of a company that attempts to grow too fast. “Fast-growing companies are cash hungry machines; the faster the growth, the greater the appetite for cash. Many struggle to find the essential cash to fuel this fortunate expansion . . . and must turn to external sources of cash flow: debt” (486). A business built on credit often grows rapidly but can easily overextend. If a business owner focuses on rapid growth, that business will carry loads of debt and will be at greater risk when a financial downturn occurs.

In contrast, Brush et al. explain what happens to businesses that choose slower growth. “The vast majority of business owners prefer to remain small, and of those that seek growth, most seek moderate rather than rapid growth. . . . Owners seeking modest growth might be better able to achieve their goals" (484). By growing at a slower rate, these businesses have quality, organic growth that is sustainable long-term. Doing this also allows the owner to fund the business with cash, which is a safer choice than credit. Such incremental growth is a "tortoise and the hare" method of running a small business, which leads to slow but steady success.

Finally, Freek Vermeulen, professor of strategy and entrepreneurship at the London Business School, agrees with Brush et al. that slower growth is better than rapid expansion. He explains, "Organizations need rest and time in between growth spurts to recuperate and digest the effort. . . . There are limits to how fast [businesses] can grow, without starting to suffer from it" (lines 37-40). Small business owners need to learn from the growth they experience. Doing this allows them to adjust strategies or fix any problems. Interestingly, slower-growth businesses are more profitable than fast-growth businesses—almost twice as profitable (Vermeulen lines 47-49). When a business compresses rapid growth into a short timeframe, the business cannot learn from the growth and adjust the business as needed. Rather, they are strapped to a rocket engine and merely going along for the ride. Small businesses would be more effective and profitable if they chose a slow- or moderate-growth pattern. Doing this would allow them to finance the business with cash and avoid debt.

Counterargument

Some business professionals and researchers disagree that a cash-based business is best. Instead, they believe that loans give small businesses a boost when starting or growing. Loans lead to faster growth, more income, and greater innovation. In the article "The State of Small Business Lending: Credit Access During the Recovery and How Technology May Change the

Game," Karen Gordon Mills, a senior fellow at Harvard Business School, and Brayden McCarthy argue that "bank credit, particularly through term loans, is one of the primary sources of external financing for small businesses . . . and is key to helping small firms maintain cash flow, hire new employees, purchase new inventory or equipment, and grow their business. Bank loans have historically been critical for small businesses" (4). Loans, they say, are an essential part of funding every aspect of a small business, from start-up to expansion. By having loan money available, small businesses are positioned to succeed in the marketplace by innovating quickly and expanding as needed. Also, loan money allows small business owners to purchase new equipment, meet payroll, and fund other essential parts of the business.

Further, Mills and McCarthy argue that technology has made applying for and receiving loans easier than ever with online applications, quick loan decisions, and data-driven algorithms to help banks evaluate risk (3, 7, 12). With just a few clicks or swipes, most small business owners can easily obtain some form of a loan. Further, most business owners take loans, and many business professionals assume that every business would be better if it used credit.

While loans do offer a quick funding solution for small businesses, the better and safer option is to always have actual cash on hand. A crisis can happen suddenly, and when it does, credit sources dry up, interest rates rise, and customers stop buying. However, loan repayments still have to be made. This leaves small businesses vulnerable to bankruptcy.

The Mills and McCarthy article shows bias by not even considering that a small business could operate without loans. Further, Karen Gordon Mills served as the administrator of the Small Business Administration (SBA) from 2009 to 2013. The SBA pushes government loans for small businesses, and Brayden McCarthy is a vice president of Fundera, which acts as an online loan broker for small businesses. It is not surprising that these authors would pressure small businesses to take loans.

Summary and future research questions

As research shows, cash is the best funding source for small businesses, allowing businesses to weather financial disasters, ensuring incremental growth, and allowing owners to learn critical management skills while the business is small. Small business owners need to better understand the role that cash plays in a business. They should know that cash reserves are critical for small businesses to start and operate. They should realize that another financial crisis waits right around the corner and that businesses with "free and clear" cash will be more likely to survive that downturn than businesses operating on borrowed money. Also, business owners need to know that banks stop lending to them during a crisis, so the business needs to have enough cash on hand to get through the disaster on their own. Finally, small business owners need to realize that slow to moderate growth is a safer, surer bet than explosive, out-of-control expansion. Plus, slower growth is twice as profitable in the long run! For all of these reasons, anyone seeking a business license at the city or state level will undergo a training module to teach them the value of cash in starting and running a small business.

More research still needs to be done. Perhaps the most important area left to explore is how much cash a small business should hold to cover day-to-day expenses as well as market uncertainties. Should this amount be a percentage of monthly operating costs, or should it be 6 to 12 months' worth of operating expenses? Additional research questions are: How often do financial downturns hit the US market? Are downturns becoming more frequent? Is credit a thing of the past even in a good market? What is the absolute best way to educate current business owners on the advantages of cash? As small businesses close or go bankrupt, does that discourage other people from starting a business? Finding the answers to these questions will give small business owners a clearer picture of how important cash is to their business. They will better understand that cash is the one item that makes or breaks a small business.

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