Developing Country Studies
ISSN 2224-607X (Paper) ISSN 2225-0565 (Online)
Vol 2, No.11, 2012 www.iiste.org

Review of Financial Challenges of Nigerian Entrepreneurs in an Attempt to Reduce Financial Institutions Risk Perception Index of Small Firms: Evidence from Survey Data

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Abstract:

The success of an entrepreneur`s search for credit facility depends highly on his ability to reduce risk perception of fund providers of small firms. Three variables (financial management information skills, the prior banking relationships and the level and quality of collateral constitute risk reducing factors, which an owner-manager must package properly in a feasibility study to put his case for loan applications better. Also, access to credit facility is significantly affected by historic profit performance. Inability of the owner manager to face these challenges would force him to face up-hill tasks in accessing external financing. The paper recommends that small businesses should first; increase their level of knowledge in accounting/financial management skills, be assisted by way of public policy guarantees so as to reduce the stringency of conditionalities imposed on them for such facilities.

Key words: Financial challenges, Financial needs, entrepreneur, Risk perception, Investors action.

1.0 Introduction

Small enterprises are vital for economic development because they encourage entrepreneurship, generate employment, reduce poverty and provide suitable livelihood (Rogers, 2002; Okorie, 1982). They achieve such vital tasks through innovation and development of varieties of goods and services which empower the process of economic development. For small businesses to do that, they need adequate funds in terms of short and long term loans. Efforts to get adequate finances create financial challenges because investor's actions must meet with the financing needs of a firm. Thus, small business financial challenges entail skillful, extensive and consistent efforts on the part of owner managers to access adequate finances at affordable costs.

Small business principals promote this process of funding operations by engaging in various forms of investor-relations activities. Such relationships take various forms all geared towards reducing the risk perception of fund providers of small firms. Risk perception can also be reduced if qualitative accounting and financial management operating details and adequate collaterals are provided by fund seekers. Qualitative operating details/management information skills enable owner managers to provide required information about the quality of a firm. Variables which underscore firm quality include size of a firm, profitability and leverage levels (Merve and Niskanen, 2010). The researchers argue that small firms that excel in such variables enjoy easier access to credit at lower interest rate and lower collateral requirements. Other performance indices which could produce similar effects include such indices as asset base, sales volume, age of a firm and profit level (Okafor, 2008).

The objective of this paper is to ascertain the behavioural actions of entrepreneurs that could reduce investors` credit risk perception of their firms and thus facilitate loan accessibility of their firms to adequate and affordable finances for business operations and growth. In the rest of the paper, relevant literature on small business will be reviewed, the research hypotheses and methodology outlined and the findings discussed. The paper ends with a short summary and conclusion.

2.0 Related Literature

A variety of criteria have been used to define small businesses. All such criteria have generally been synthesized from the characteristics of a small business. For example, Cochran (1981) used total worth, relative size within an industry, number of employees, annual sales. Osteryoung and Newman (1993) and Aug (1991), define a business as small if it has no publicly traded securities, lacks limited liability, the owners are prone to high risk taking, the business experiences institutional imperfections and has no defined management team. Small business can be defined based on each country`s economic need. For instance, countries such as Britain and Canada use annual turnover and number of employees. The United States of America apply various characteristics such as market share, personalized management by owners and independence from the influence of any large enterprise in decision-making (Ganguly, 1985).

In Nigeria, institutions like the Central Bank of Nigeria (CBN), academic institutions of higher learning and the Bank of Industry (BOI) adopt other approaches to the definition of small and medium term enterprises. They normally define such enterprises in terms of capital base which ranges from N400,000 to N10,000,000 Naira excluding land. Small firms in this study comprise enterprises whose capital funds and working capital excluding land and building are up to N10,000,000 at the start of business in addition to the other defining characteristics already indicated above.

In articulating small business finance theory, reference must necessarily be made to the characteristics of small business. The characteristics of small business have an important impact on their ability to raise capital. Factors such as stage of product development, risk factor of the firm, and availability of capital, type of business, ownership structure and sales history affect the sources and amount of capital requirements (Auken, 2001; Aug, 1991 and 1992). The overall quality rating of a firm in terms of performance indicators like asset base, volume of sales, age of business and profit level (Okafor, 2008), size profitability index and leverage (Mervi and Niskanen, 2010) can affect accessibility.

Experience has shown that the success of an entrepreneur`s search for capital depends partly on the nature and mix of the operational and capital needs of the firm relative to the investment preferences of capital providers. The key considerations of capital providers often include level of investment, type of firm, tenor of the financing, expected return on the investment, growth potentials and risk tolerance (Auken, 2001). Different investors often have different motivations for and expectations from their investments. Equity investors are interested in return on investment, while debt investors are interested on the risk and collaterization of the loan (Brigham and Gapenski, 1997).

In Nigeria, funds for financing small businesses can be sourced from personal savings, loans and grants from relatives, friends and business associates. These sources entail little or no legal formalities. Nigerian banking industry (commercial, agricultural and investment banks) muster funds from government and international financing agencies, like World Bank, using Central Bank of Nigeria (CBN) as the arrow head. Such funds are normally geared towards development and establishment of small firms. Most often the funds are available to SMEs through equity participation and venture capital activities. Banks also lend money to businesses ranging from short-term overdraft facilities to medium and long-term loans and advances. The terms and conditions for accessing funds of this nature are spelt out against each credit type. There is an allegation that large firms dominate bank`s loan portfolio, because they often provide adequate and qualitative financial information about their past and current operations and can better articulate future plans of their business to support loan demands (Mumbula, 2002). Moreover, they provide better collateral than small firms (Okafor, 2008).

Since small businesses are perceived as risky borrowers, fund providers attempt to minimize credit risk exposure when dealing with them by offering small amount of loans rather than full financing, at very high cost. They would at the same time demand adequate and quality collateral that could easily off set the loan in case of default. In addition, they normally demand adequate qualitative and quantitative accounting system to be installed, financial reports, information on working capital management, fixed asset management, and managerial planning and control. These would enable them source adequate and qualitative financial information about the firms. These are the main financial challenges which owner-managers of small firms have to manage.

2.1 Financing Framework

Financing needs of small firms arise from operational fund requirements for fixed asset acquisition/replacement capital as well as working capital requirements. Small firms meet their financing needs by searching for funds both in the form of long-term and short-term facilities. Some small firms especially those in preferred sectors attract loans from development finance institutions, like the Bank of Industry (BOI), Agriculture and Co-operative Bank and the Export Import Bank. Many small firms do not extend their search for funds to the formal sector banking system i.e. commercial banks and micro finance banks because of fear of their limitations in operating characteristics such as poor banking relationship, limited information and management skills and low level and poor quality of collaterals to support loan applications. In other words, credit from a bank can be provided in the context of information asymmetry on the entrepreneur and the bank (Fisher, 1995), and this can be resolved if the entrepreneur can keep proper accounting records and demonstrate credit worthiness and project viability, which often are demanded by lending institutions (Cook and Nixton, 2000. Binks, Ennew and Read, 1992). Providers of fund for small businesses regard firms that cannot do that as high credit risk customers.

The process of financing involves the combination of financial needs and investors action to create financial challenges of small firms. The challenges entail access to adequate long-term and short-term financing facilities over suitable periods of time at affordable costs. Those firms that meet the challenges would successfully prosper. Small firms influence this process by engaging in investor's relations activity. The extent and quality of small firms' investor relations activity depend largely on their accounting/financial information management practices and banking relations skill. Excellent and frequent accounting/financial management practices ensure that relevant information about the activities and state of a business is recorded and communicated to the appropriate investor as demanded. There is no doubt to believe that significant progress has not been made by small owner managers to install and use accounting/financial management information systems as is the case in developed countries where the standard of financial reporting is vey high (De Thomas and Fredenberger, 1985, Thomas and Evanson, 1987).

Researchers reveal that good practice of financial reporting would yield adequate financial information in the areas of balance sheet, income statement, funds statement, bank reconciliation, cash flow information, debt/equity ratio and the value of other ratios to the firm (McMahon and Daies, 1994). Banking relations skill together with provision of adequate and perfect collateral can reduce risk perception of investors on small firms. Low risk perception influences investors' attitude/willingness to take positive action for loan decisions. This attitude would lead to the actual provision of funds (short and long term loans) provided the firm has a high quality rating.

Studies on relationship lending have revealed that close bank-borrower relationships enhance credit availability. Thus, firms with close ties to financial institutions have a lower cost of capital, lower level of collateral requirements and better access to funds as opposed to firms without such ties (Harhoof and Korting, 1998; Berger and Udell, 1995; Petersen and Rajan, 1994; Boot and Thakor, 1994; Mayer, 1988). It has been noted that banks require collateral to hedge the perceived credit risk exposure. However, for collateral to be acceptable, its value must adequately cover the investor's perceived exposure to risk. Moreover, the provider of collateral must have perfect title. Unfortunately, few small owner-managed firms have landed property and real estate, which are the most common forms of collateral demanded for bank loans in Nigeria.

On the basis of the issues discussed above, three hypotheses were formulated and tested in this study.

Good accounting systems and adequate management information skills, good banking relationships and adequate and quality collateral do not reduce the risk perception index of small firms by fund providers. Therefore, three hypotheses are stated. There are:

Ho_1: There is no significant difference between the number of loan applications approved to the total number of application for both short-term and long-term facilities.

Ho_2: There is no significant relationship between access to credit and business performance variables as defined by (asset base, volume of sales, age of business and profit level).

Ho_3: There is no significant relationship between access to Bank credit and business performance of firms.

3.0 Methodology

Six small enterprises in Nigeria were explored. One enterprise was drawn from each of the following sectors – agricultural production, education and printing services, manufacturing and building material, hotel and medical services, motor vehicle and spare parts and mineral and production engineering.

Short Briefs on Sampled Enterprises

Animal and Agricultural Firm

This firm produces different types of birds, mammals, fish, fruits and vegetables and also renders medical services to all kinds of animals. It is a family business, founded by two university graduates; one specialized in animal sciences and the other in agricultural sciences. The wives of both partners have Masters in Business Administration specializing in accounting and financial management. Opportunity to extend production to plantain and pawpaw plantation and snail production arose but the owners could not provide private equity. They therefore sought for working capital and long-term loans from two commercial banks and an agricultural credit bank where they have banking relationships. The experience of the wives was utilized effectively to prepare project documents. The main assets of the business consisted of acres of land, equipment for production, as well as stock of goods which were mainly perishable. All the assets were regarded as being low loan quality collaterals. The banking relationships of the business had helped them to get short-term working capital at moderate interest rates.

Education and Printing Services Firm

The firm needed fund to extend its services to secondary education programme, replace some obsolete printing machines and upgrade the working capital. The owner sought for funds in one commercial bank. The assets of the firm were mainly human resources. The owners have no title to the collateral provided; therefore the collateral provided was rejected. The firm had quality management information skills and good banking relationship, but lacked necessary collateral to secure a long-term loan. The short-term loan which it had earlier secured was given at very high interest rate.

Building Material Production Firm

The firm manufactures various types of building materials. It needed funds for capital expenditure and working capital to exploit opportunities in the domestic and export markets. The owner could not provide equity capital. Based on his past banking relations, he approached three banks, and secured short-term loans at very high interest rates. The long-term loans he also applied for were rejected because the collateral demand was not met.

Hotel and Medical Services Firm

This service firm needed funds to replace obsolete equipment and to expand the working capital base. The owner approached three bankers for financing. Two banks offered some working capital at high interest rates but no long-term fund was secured to replace the obsolete equipment. The major problem was poor record-keeping and inability to provide adequate collateral. The firms traded in hi-tech equipment. Inability to raise enough funds to replace the obsolete assets, led to the loss of its customers.

The Motor Vehicle Firm

The firm deals on the importation of cars, motor spare parts and services. The educational level of the owner is basically the first school leaving certificate. However, he was highly experienced in motor-mechanical engineering, and had high personal ties and interactive abilities. He needed funds to maintain his market share, and expand to importation of motor tyres. He sought for low interest rate loan in a micro-finance bank. The bank demanded collateral, which he provided before the full fund at low interest rate was given.

The Mineral Production and Engineering Firm

The firm needed funds for capital assets and working capital to expand its local and foreign markets. The owner sought help internationally when he was unable to get fund from local banks, due to lack of collateral. Part of the loan applied for was given with moderate interest rate due to his affiliation with international financing agency and the quality of his management information skills.

Data Collection

Interview and questionnaire methods were used to collect primary information about the firms and their principal owners(s). The questionnaire contained close ended questions, each of which categorized specific responses. The interview questions were open ended. The questions centered on the need for the firms to seek for additional funds, sought information on current bank relationships of respondents, accounting/management information skills of the respondents as well as the level and quality of collateral they could pledge for loans. Performance indicators like asset base, total sales, and age of business and profit levels of the six firms were ascertained from their financial records to supplement the primary data. Included in the investigations are the sources of external funding, type and terms of the loan previously obtained, strategies for coping with various challenges facing the firms? Banks were interviewed to get their views in the credit and other operational relationships with the study firms.

Dependent and Independent Variables

The nature of data collected helped in identifying both the dependent and the independent variables applied in this study. Risk perception of investors is the dependent variable while accounting/financial management information skills, bank relationship, level and quality of collateral provided are the independent variables, which are expected to impact on the level of risk perception of fund providers. Willingness of investors to approve loan application is another dependent variable while the number of short-term and long-term loans applied for are the independent variables. Finally total credit (TC) sourced by the six firms is another dependent variable which is hypothesized to have relationship with sales volume, asset base, age of business and profit level. The test relationships are presented in equations I to III below.

RPI + (MIS + BR + LQC)……………………………………………………………………………(i)

RIP = f(MIS,BR,LCQ)……………………………………………………………………………….(ia) and in linear form

RIP = b_iMis + b_2BR + b_3LCQ + e……………………………………………………………………(ib)

Where:

RPI = Risk perception of fund providers (investors)

MIS = Management information skills

BR = Banking Relationship

LCQ = Loan Collateral Quality

e = error term

LAR = f(TSTL, TLTL) ………………………………………………………………………………..(iia)

and in linear form

LAR = a + biTSTL + b2TLTL + e ………………………………………………………………..(iib)

Where:

AR = Loan approval Rate (i.e loan approved to loan applied for)

TSTL = Total short term loans applied for

TLTL = Total long term loans applied for

TC = f(S,A,T,P) ……………………………………………………………………………………….(iiia)

and consequently

TC = a + b1S + b2A +b3T + b4P + e……………………………………………………………….(iiib)

Where:

TC = Total credits accessed by the firms for the year 2009TC =

A = Total asset base for 2009 = Total value of sales/turnover for 2009

T = Number of years the firm were in existence

P = Total profit (PBIT) for 2009

error term

4.0 Hypotheses Testing

Since it was not feasible to quantify the interview responses which constituted the variables for the functional relationships specified in equations I and ii, the chi-square (x^2) test statistics was applied in testing the hypothesized relationships in equations I and ii. The hypotheses postulate that management information skills, past banking relationships, quality and level of collateral have no potency in reducing investors` risk perception; and that there is no significant difference between short and long term loans approved relative to the number of applications received for such loans. The objective of the test is therefore to determine whether these expectations are supported or rejected by the tests (information) derived from the field survey. The assumed level of significance for both tests was 5% and 1%.

Table 1, represents responses to questions posed in the opinion survey, regarding factors which influence the risk perception of fund providers.

Table 1: Impact of Selected Variables on the Risk Perception of Fund Providers

S/N	Variables	Important	Not Important
1	Management Information skills	4	2
2	Banking Relationships	5	1
3	Collateral (level & quality)	2	4

Source: From survey data

Based on the relative responses in Table 1, the relevant chi-square test result is derived as follows:

$$X^2 = \sum \frac{(O-E)}{E} = 3.98$$

The critical value for this test is also derived as follows:

Critical value = $(.05)x^2(1) = 3.84$

Since the test statistics (3.98) is greater than the critical value (3.84) the null hypothesis is rejected. Therefore, management information skills, banking relationships and quality of collateral provided have significant potency in influencing the risk perception of fund providers for small firms. A lower risk perception of course leads to greater willingness to give favourable consideration in loan decisions. Such willingness would manifest in an enhanced number of approved loan applications for short and long-term durations as well as on the rate of interest charged.

Table 2 gives a summary of the number and distribution of loans applied for and approved for the businesses covered in the survey over the period 2009. On the whole, the total number of bank loans applied for by the six companies covered in the study was 16.

Table 2: Loan Applications and Approvals

Type of loans	Total Applications	# Approved	# Not Approved
Long-term	6	2	4
Short-term	10	10	-
Total	16	12	4

Source: From survey data

Based on the responses in table 2, the chi-square statistics is 8.89 while the critical value is calculated as $(.05)x^2(1) = 3.84$

Based on the test result, the null hypothesis is again rejected. There is therefore significant difference between the numbers of loan applications approved for short-term relative to that for long-term loans. The relative ratio of loan approvals shows that investors are more willing to take a chance on short-term loans than on long-term loans.

Accessibility to funding ultimately depends on the quality/performance of a firm. A multiple regression test was conducted, to explore the relationship between the dependent variable access to credit [total credit (TC)] and a number of independent variables identified as business performance related variables which include sales volume, asset base, age of a firm and profit level. The equation for the multiple regressions was defined in the previous section is reproduced hereunder for ease of reference

TC = a + biS + b2A + b3T + b4P + e ………………….(iiib)

The normal log transform was applied and the overall test results are as follows:

$R^2 = 0.914$

R = 0.905

SE =14827738

df = 4

F-Cal = 96.14

F – sig. = .000 at $p < .01$

The test results for hypothesis 3 suggest that there is very strong evidence to reject the null hypothesis. The alternate hypothesis, which states that significant relationship between access to credit and business performance variables of firms is accepted. The high level of F-calculated = (96.14) underscore the significance and relevance of the relationship.

The detailed analysis of the test result is presented in table 3

Table 3: Analysis of Coefficients of Regression

	Unstandardized Coefficients B	Unstandardized Coefficients Std. Error	Beta	T	Sig.
Constants	-391450.4	5263329.2	-	-.074	.941
Total Sale	53E-02	.047	.029	-.586	.561
Total Asset	439	.023	.955	19483	000
Age	-1527010	279849.43	.027	-.546	.589
TPBIT	-.320	.363	.044	-.881	.384

Source: SPSS Results

The high level of the beta coefficient of asset (0.96) suggests that the asset base is not only significant but clearly has the strongest positive impact on total credit accessed by small firms. The implication is that credit institutions, particularly banks, attach more consideration to collateral requirements than to other business performance indices of firms.

5.0 Summary and Conclusion

The issue of access to external financing, by small and medium scale enterprises, has been on the front burner of small business management for ages. The topic continues, to attract immense interest because the small business subsector is a key driver of national economic growth and development and lack of access to financing is a major constrain to the successful operations of the sub-sector. Small firms require external financing both in the form of short-term funds for working capital and long-term facilities for investment capital. Traditional providers of funds for such business particularly banks, generally regard them as high risk loan customers. The high risk perception is re-enforced by operating characteristics of small firms such as limited banking relationships, limited information on accounting and financial management skills and low level and poor quality of collaterals available to support loan applications.

The experience of six small businesses in Nigeria in securing short as well as long-term external financing provided information for testing three hypotheses formulated for the study. The statistical analyses indicated that the risk assessment of small businesses by fund providers was highly correlated with the accounting and financial management information skills of the small business operations, the prior banking relationships of the businesses and the level and quality of collaterals they can provide. It was also found that access to credit by the small firms was significantly affected by the previous turnover, current asset base, age of the firm and its historic profit performance.

The paper recommends that small businesses should make use of the following:

1. Install *accounting systems* - the types of systems in use, systems perceived as useful to particular type of business, computer utilization and applications.
2. F*inancial reports* - which incorporate utilization of financial statements and associated information to facilitate managerial decisions, techniques of financial analysis used.
3. W*orking capital management techniques* - for the management of cash, accounts receivable, inventory, and accounts payable, useful quantitative management models, computer-based working capital management system.
4. *Fixed asset management techniques* - for the evaluation of capital expenditure projects, determination of accept/reject standards, administrative procedures for capital budgeting and post-acquisition management of fixed assets.
5. *Management planning and control* – which permeates almost every aspect of budgetary planning and control ranging from strategic planning practice, through the setting of financial objectives, to the method and frequency of preparation and use of the major budget components (sales, expenses, profit, capital, cash, etc), the use of cost-volume profit analysis, pricing practices, performance evaluation.
6. The paper also recommends that small businesses should be assisted, by way of public policy guarantee, to reduce the risk perception index of their operations so as to improve their access to credit and reduce the stringency of conditionalities imposed on them for such facilities.

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