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# Financial Discipline is Necessary for Startup Firms – A Conceptual Approach

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## Introduction

For every startup, there comes a time when the shoebox full of receipts and excel spreadsheets no longer suffices as an accounting system. Having financial literacy, the knowledge that enables an individual to make critical and practical decisions with regards to finances, is extremely important for entrepreneurs and critical to successfully growing a business. According to Intuit, the main challenges early-stage startups have with regards to financial literacy is managing time and capacity. More than half (53%) of all new startups in India are run by part-time entrepreneurs. Working full-time and running businesses on the side is a lot of work and part-time entrepreneurs may not have the capacity to develop the financial literacy they need. Intuit believes boosting financial literacy capacity is the single most important thing it can do to help more entrepreneurs succeed. "Financial discipline is an important skill for entrepreneurs to acquire", says Andrew Tait, President of Vancouver-based Tait Labs. "Many founders get carried away with the aspects of developing a product or service so much so that they don't spend enough time beefing up their financial literacy. Without knowing financial basics like budgeting and reading a balance sheet, the entrepreneur may then have difficulty growing their business or even keeping it afloat." An accountant has the potential to play a large role in helping grow a startup. Analyzing the financial big picture, offering strategic advice, producing key financial documents and helping file company taxes are just some benefits of having an accountant. They also perform day-to-day hands-on tasks such as handling paperwork, paying bills and submitting invoices while also tracking company expenses to ensure every cost is recorded correctly for taxes.

## Financial Literacy

Financial literacy is more than just hiring an accountant. It includes building a knowledge base which enables an entrepreneur to make important decisions about company finances. There are tools and support structures that can help with this, making the life of an entrepreneur a little bit easier. "Quickbooks is now helping to automate some of these tasks, including generating invoices, balance sheets, P&L statements – all very important for a business," says Tait. Another way to increase financial literacy is to network.

Firms in developing countries are widely known to face many constraints, from lack of access to finance and physical capital to poor infrastructure. Recently, however, there has also been a growing focus among researchers on "managerial capital", or business skills, as an important determinant of entrepreneurship in developing countries. Policymakers have been equally interested in the perceived deficit of managerial capital, and have been pouring resources into financial and business literacy education programs around the world.

Financial discipline is central to a firm's business strategy and has important implications for firm behavior. In extensions of Modigliani-Miller (1958), theoretical analyses of large established firms have addressed how the degree of asset specificity (asset value at bankruptcy) and information opacity (aligning manager and share-holder interest) influences governance and financial discipline. Established-firm theory finds that, on the one hand, firms with highly specific assets (low liquidation value at bankruptcy) should have a higher proportion of equity relative to debt, since stockholders in principle can exercise greater control over the operations of the firm, whereas debt-holders cannot appropriate the highly specific assets. On the other hand, under conditions of information opacity about managers' activities, after internal resources, the firm should use bank debt, which disciplines management, and lastly equity, where ensuring the alignment of interests between managers and shareholders is more difficult.

Previous research points out that, in the case of startups, there are no ongoing operations and no track record by which to judge the firm. This information opacity makes external financing more difficult to obtain at the nascent stages. A startup's potential external equity investors (such as angel or venture capital) may have limited information about the founder (unless s/he is a serial entrepreneur) or the prospects for the enterprise and may therefore demand a high ownership stake for a given financial outlay. From the standpoint of the owner-founder, internal finance is preferred, followed by external debt such as bank financing, and only lastly would the founder use expensive external equity where s/he has to give up a large ownership stake.

However, these predictions based on information opacity are qualified by the characteristics of the assets of most startups. In small startups the entrepreneur not only supplies managerial expertise, but also provides financial, knowledge, and human capital to the firm. Such specific human capital may not be easily transferable to alternative uses, which compounds the information opacity problem. The 'inalienable' nature of human capital of the entrepreneur exacerbates the tension between debt holders and the owner because the owner can threaten to walk away. Therefore, firms with a high degree of asset specificity should be financed primarily by the entrepreneur's own resources, followed by external equity such as venture capital, and last by external debt.

Insights gleaned from theory suggest that startups would use internal funds first, followed by external resources, with the predictions on the external debt-equity mix unclear and dependent on the relative importance of asset specificity and information opacity. However, despite this theoretical preference for internal finance, Berger and Udell reveals the importance of debt financing for young firms in the United States, including high-growth startups.3

Outside the issues of asset specificity, information opacity, and financial constraints, substantial empirical work focuses on the relationship between financial structure and entrepreneur characteristics such as their education, race and ethnic ties, strategic alliances and networks, and experience of the founding team. Using the KFS allows us to examine these entrepreneur characteristics in conjunction with financial structure. With regard to race and gender, the KFS allows us to examine whether the financial structure of African-American and women-owned firms differs from that of other startups, and specifically to examine whether they have less external funding.

## Financial Discipline Variables

• Business knowledge: the number of businesses owned by all the entrepreneurs (who are also managers of the business)

• Industry experience: total years of work experience of the entrepreneurs (who are also managers of the business) in the same industry as this current venture. in the same industry as this current venture. A majority of the entrepreneurs do not own other businesses in the

same industry, although there is a wide dispersion, with some entrepreneurs owning up to six businesses in the same industry. This variable measures knowledge of the business sector (human capital), but it may also proxy for the availability of other business assets that could be used as collateral (tangible capital).

• Tangible assets: cash on hand, and the value of buildings, machinery, and other property owned by the firm. Tangible assets can serve as collateral for obtaining loans from external sources and can have relatively high liquidation value compared with intangibles. The total work experience of all the entrepreneurs is between zero and 150 years, the larger number being for startups with a large number of owners. On average, entrepreneurs in firms have 14 to 17 years of work experience in the same industry.

• Intellectual property: Total units of intellectual property (IP) owned by the venture: patents, copyrights, and trademarks. The distribution of IP varies between 0 and 103, with an average firm holding about 1.5 units.

• R&D personnel: the share of employees engaged in research and development (R&D). In 2004, the average startup had 38 percent of employees engaged in R&D.

**Conclusion**

Startups are likely to suffer from greater information opacity and higher asset specificity than large established firms, or even small ongoing firms. For startups, the existence of human capital-specific assets, coupled with small levels of traditional tangible assets that can serve as collateral, and the lack of information and reputation suggest constraints on borrowing from external sources. Therefore, we should expect to observe a higher overall dependence on internal sources of funds in the financial disciplineof startups. However, because startups may face financial constraints, the entrepreneur will look to augment personal resources. Using the Kauffman Firm Survey of new businesses, we investigate how information opacity and asset specificity are related to the initial financial disciplineof startups, controlling for owner's attributes, and firm, sector, and spatial characteristics.

Consistent with theoretical underpinnings based on asset specificity, we find that startups with more tangible assets as potential collateral are more likely to use external debt in the financial structure, since these assets have a high liquidation value. Entrepreneurs with other businesses as collateral are less likely to give up control to external equity investors. On the other hand, all else equal, startups with higher human capital embodied in the entrepreneur or more intellectual property assets have a lower probability of using debt than other startups, consistent with the higher asset specificity and lower collateral value of these assets.

In terms of information opacity, startups located in the entrepreneur's home are the most opaque and their financial discipline is dominated by credit card debt. Team-run startups are less likely to use debt finance, particularly credit cards and other external loans and, consistent with their greater personal resources and available information, more likely to have internal and external equity in their financial structure. Serial entrepreneurs are equally likely to finance their businesses using their own resources, bank loans, or external equity, since more information is available about these entrepreneurs, which mitigates the information opacity problem.

In terms of owner attributes, some, but importantly not all, of our findings mirror the research on ongoing small businesses. Educated entrepreneurs are more likely to use debt financing. African-American entrepreneurs are more likely to use their own resources to finance their business and less likely to use credit card or nonbank debt. An important finding is that the financial discipline of women-owned startups does not differ from that of male-owned startups, controlling for many other attributes.

Regional factors and local conditions relate to the financial discipline of startups. Areas with better-educated resident populations may have greater personal resources to finance startups using internal debt. Startups in innovative states and states with higher venture capital activity have a greater probability of having external equity in their financial structure. Startups in larger states have a higher probability of having bank loans in their financial structure.

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