
AICEI PROCEEDINGS

“SPECIFICS OF CAPITAL BUDGETING OF SMALL ENTERPRISES IN THE CONTEMPORARY BUSINESS SETTING”

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Abstract

The academics and practitioners of the economic development are becoming more and more concerned with the issue of adjustment of the standard methodology of capital budgeting to the realities of small enterprise. This study refers to the general concepts for supporting the small and medium enterprises in the countries of the European Union and with us; and especially to the aspects of modern capital budgeting and the standard methodology, that may be employed successfully for the development of small business in Macedonia.

However, this, in no way means striving towards a rigid application of quantitative methodology, but a commitment for introduction of structured strategic planning and systems of support of the processes of capital budgeting. The allocated space for the quantitative methods and procedures will depend upon the nature of the industry and upon the intentions and actual capabilities of the specific company. With the purpose of introducing advanced practices of business planning based on the existing methodology, work needs to be done primarily with bank officials, managers of the network of centres for support of entrepreneurship, professors of management and planning in business high schools and universities, as well as, directly with the entrepreneurs in the sector of small business.

Keywords: *budget, small enterprises, business, Macedonia, European Union*

Introduction

Small business is, by many virtues, a phenomenon of the traditional Europe. The Italian concept of "family business" has been studied in the business schools around the world as an example of successful cooperation of small enterprises from a distinct geographic region. The successes of the United Kingdom and, lately that of the Republic of Ireland in the use of small business for restructuring the traditional economy, are also referent practices.

Furthermore, the phenomenon of small business and entrepreneurship was always inducing interest of various academics and business practitioners. "Psychologists are interested in what motivates the entrepreneurs. Pedagogues are interested in whether entrepreneurship, as a way of behaviour and collection of know-how and ability, may be built into the formal educational system and how to do it most efficiently. Economists find their interest in putting entrepreneurship in the function of economic development, the transfer of technology and export."¹

According to Markovski², the values related to small business are based on the fact that large companies arise from small entrepreneurship; small enterprises play significant role in transformation of the modern economies; they are vital, agile and have ability for fast adaptation to the changes in the business environment. They have maximum rationality in the use of the infrastructure, the human and material resources; most innovations are created in the sector of small business; small enterprises have always been, and still are generator of many jobs. Small enterprises often have family character; they sometimes provide employment for three generations of one or different families. It seems that woman entrepreneurship is more frequent with the small enterprises. In developed countries the number of small enterprises, which are owned by women, doubles every seventh year. Opposite of this, the number of members of boards of directors, women is still small, even in the most developed countries. Large companies are not able to function efficient and effective without interaction with small enterprises. Small enterprises are more efficient in many segments of the entire value chain. Finally, small enterprises provide jobs with flexible working-hours, and relatively high pays, facts significant for decision making of modern entrepreneurs.

However, besides the obvious advantages of the small enterprises, there are also many drawbacks noticed in their practice. Decision making process at small enterprises is not always led by objective business interest. Many small business entrepreneurs invest motivated by their wishes, guided by intuition or irrational motivation. The sudden bankrupting is very often seen at small enterprises. Up to 50% of the new small enterprises don't survive their first year, and more than 85% don't survive the third year of their work. So, here logically arises the question of the reason for the high number of

unsuccessful attempts in the sector of small business. "Tree kinds of most frequent weaknesses that burden the financial position and question the long term survival of the small enterprise are: the lack of capital, wrong sales policy and allowing high credits to the customers, and overinvestment in capital assets."³ Maybe the answer can be found in the common quick decision making for starting a small business. Without profound studies, application of capital budgeting methodology and careful business planning, the success of large number of the new small enterprises will remain to be doubtful.

Small business entrepreneurs rarely take initiatives for timely response to the global environmental challenges and turning them into opportunities for profit. Instead, they act reactively, when the change is already taking place. Other characteristic of the small business is the often bare and uncritical copying of business models. If we to this the fact that lack of capital and cash flow for financing of the on-going operations is also very frequent, than the picture of the realities of the small business is not as "pink" as it sometimes seems; and the need for a continuous and comprehensive social intervention in this field becomes more than an obvious.

The European Union policy for promoting small enterprises

Small enterprises are considered to be the principal driving force of the innovation, the employment and the social integration in the European Union countries, also. It is even thought "that precisely the small enterprises make the backbone of the modern national economies of European Union countries. They are the principal source of new jobs and the breeding ground for new business ideas."⁴ With the purpose of establishment a better environment for the small business and entrepreneurship, at their Lisbon Summit in 2000, the European countries introduced the "European Charter of Small Enterprises", depicting *ten global areas* of social intervention where continuous efforts should be made to influence the creation of positive environment for a development of entrepreneurship. According to this Charter, the policy of promotion of the entrepreneurship begins with the education measures and embraces the activities of changing the legislation and creation of systems for export promotion and financing the small business. Great attention is paid to the training of entrepreneurs and to the organized creation of a favourable climate for transfer of advanced technologies and application of technological advances, information systems and Internet in the small business sector.

Since the 2003, Thessalonica Summit, Macedonia is also a signatory to this Charter. Consequently, we are also obliged to follow and regularly inform the Union about the achievements on the field of development of entrepreneurship. Furthermore, the National Report on the situation regarding the application of the Charter in the Republic of Macedonia for 2003, states that "the development of small enterprises is of an extraordinary significance for the economic development of our country. The dynamic sector of small enterprises should provide the impetus for the restructuring and renewal of the entire national economy and is expected to

bring along higher living standard for the population. With the goal of reaching this ambitious mission, the small business sector should receive an intensive support through numerous of initiatives in this direction. Republic of Macedonia has genuine interest in accession to this European initiative due to the obvious need to enhance its efforts of development an efficient small enterprises sector.”⁵

Empirical study of the local practices in capital budgeting

There are not many empirical studies of the prevailing business practice regarding the issues of business planning and application of standard methodology of capital budgeting in Macedonia. Here we will present the results of a study conducted during the course of 2003 and 2004. The study had a purpose of providing the insights into the specifics of the small business in Macedonia, such as the average size of the companies, the invested capital, the number of employees, business activity, interests and problems the entrepreneurs face, in relation to the need for design of a more efficient and effective practice of capital budgeting in this sector. Therefore, the assessment of the size of the investment was made according to the statements of the entrepreneurs on how much money they actually invested in their business. According to these criteria, the companies surveyed were grouped into the following three categories:

	Type	Investment	%
1	Micro	0 - 75.000 EURO	40%
2	Small	75.000 - 500.000 EURO	50%
3	Medium	Above 500.000 EURO	10%

Table 1- The structure of the sample according to the amount of invested capital

The results have shown that the invested capital in establishment of a small business in Macedonia ranges up to 500.000 EURO.

The number of employees was observed based on the statements of the entrepreneurs, and not according to the number of registered employees. The companies were grouped into three categories:

	Type	Employees	%
1	Micro	1 to 5	35%
2	Small	6 to 25	50%
3	Medium	Above 25	15%

Table 2 - Structure of the surveyed businesses according to the number of employees

It can be seen that in Macedonia, we have many companies with only one employee; while the number of “real” small enterprises, with more than 25 employees, is in fact very small.

However, even such a small sample (20 companies) still mirrors very well the major social and economical trends and their influence on the type and the structure of the small businesses in Macedonia. In comparison with the developed EU countries where services prevail in the small business sector (for elderly people, health, travel, lifelong education and similar) in Macedonia the majority of the small business ventures is still around the production.⁶ This is fully understandable; these are developed post-industrial societies that are generally aging. In addition to this, the multicultural character of most European states is becoming increasingly more evident. This results in raised interest in different peoples and cultures, their products and cuisines. Small businesses that provide services of to satisfy the needs of the population strata with different ethnic background, such as national restaurants, interpretation services grow in an unprecedented rate. The transfer of the production, in pursue for cheap labour, to the countries of the Eastern Europe and Asia, closed down many production plants in the countries of the European Union, even in the small business. To compensate for this, when it comes to the traditional businesses and sectors, modern small businesses opt for the electronic alternatives, like Internet based job agencies, trade facilitators, supply concentrators, e-retail stores, and education and training organizations.

Unlike with the developed EU countries, the situation in Macedonia is entirely different. Having in mind that during the previous system there were often shortages of various goods, in the period of transition the small enterprises initially started to fill this gap. However, the majority of the ventures and investments are still in the production. A total of 14, out of the 20 interviewed businesses or 70 %, are into production or food processing, and only 30% were in the service sector. Construction is also in an upward trend as a result of a liberalization of this sector: five small enterprises out of these fourteen businesses were in the construction business or serve and supply this sector.

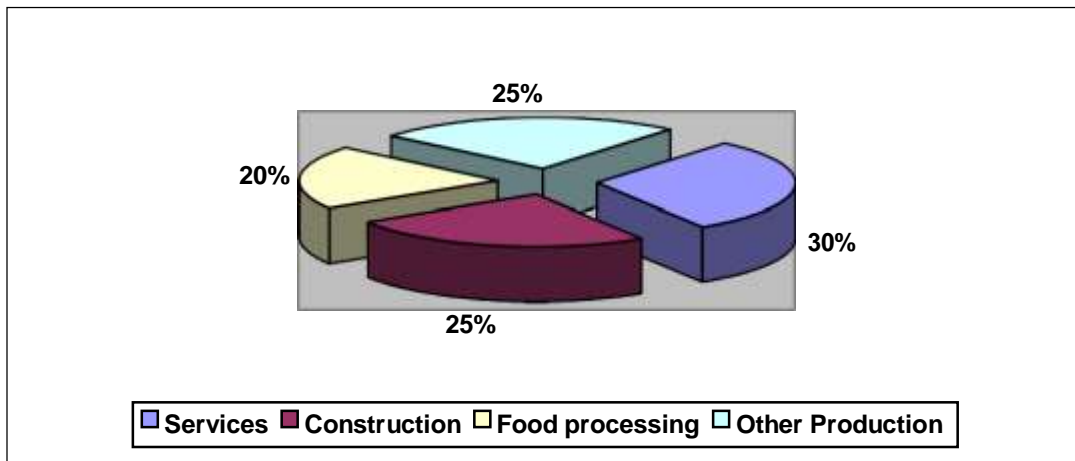


Chart 1 - Structure of Enterprises by Industry Sector

For the purposes of the analysis of the prevailing practice of business

planning and application of the standard methodology of capital budgeting during the investment decision process, the most indicative were the results of the Survey related to the type of assistance requested by the entrepreneurs and provided by appropriate business development centres in Tetovo, Skopje and Prilep. These results illustrate the major concerns of our entrepreneurs, but also their perception of the significance of various aspects of their endeavours.

Type of advice and assistance	
Marketing and sales	35%
Financial prognoses	70%
Franchising	5%
Choice of training	35%
Operation licenses	20%
Creation of business plan	60%
Improvement of management	15%
Legal form of business	5%
Procedure and technology	65%
Accounting	5%
Access to finances	60%

Table 3 - Type of requested assistance

While the entrepreneurs in developed countries request assistance concerning their marketing and sales, ours are much more concerned with the financial and technological aspects of their business. While entrepreneurs in developed countries seek various training programs to improve the work and the management, our entrepreneurs still struggle with the development of proper perception of the value of these services. The high occurrence of questions regarding procedure and technology matches the high number of production concerns, but also could indicate insufficient technical and technological development and underestimation of the sales and marketing related issues.

The analysis of the prevailing situation in the area of the access to the forms of entrepreneurship promotion shows that 40% of the enterprises have had access to some types of services or assistance in development of their business. Direct financial assistance in the form of grants was used by 30%, while technical assistance was available to 40% of the surveyed businesses.

Development loans were available for all companies and 25% of them already used such a loan. If we take into the consideration that farming and primary food processing are covered with micro-credits we can see that our entrepreneurs have relatively good offer of loan plans and that the efforts of the State and the NGO sector to improve the environment for small business in terms of the availability of capital are already turning recognizable results.

From the aspect of whether the entrepreneur had relevant experience in the specific field of his business, 55% of them responded affirmatively, while 35% of them even left their steady employment to start own business. This

data speak that the actual motives for starting a small business are not always and necessarily financial by their nature. They depend much more upon the character of the entrepreneur, her spirit of change and the readiness to take risks. It is indicative that only 5 of the 20 businesses were led by a woman entrepreneur; unlike in the developed countries where this number goes up to 50 percent and even.

The connection between the methodology of capital budgeting and business success

Although a statistically relevant association between the degree of applied methodology of capital budgeting and business success hasn't been proven⁷, it is believed that the application of methodologically sound procedures of capital budgeting and business planning can significantly improve the chances for success of a great number of newly formed businesses. Graham⁸ shows that the practice of application of Net Present Value and the Internal Rate of Return by the big companies is standard in more than 80% of the analyzed companies; the use of non-discounting methods such as Pay-off Year and even the Accounting Rate of Return) dominates in 57% of the analyzed small companies.

The high usage of the method Pay-off Year is a result, according to Graham, of the practicality and simplicity of this indicator for an average investor. Although the theory considers this method wrong because it ignores the time value of money and the cash flow in the years after the return of the initial investment, the owners of small enterprises still opt to this method due to the fact that it seems very logical to them. For small companies, with limited sources of financing, it is of greater relevance to quickly re-accumulate the investment, so they are much more interested in additional cash flows than in amount of profit. If a small company can not provide sufficient funds to finance the operations it will soon be belly up and thus the expected profits are becoming irrelevant.

Some managers of larger companies, even stipulate that in practice this method gives results sufficiently consistent with the results of the methodologically sound techniques.⁹ They point out that the value of their projects is determined more by the value of the real options in them and that their companies are faced with unpredictability of cash flows and act in an environment where the basic postulates of micro economy are of insignificant value. For them, the focus is thus again on the liquidity, and the soonest possible return of investments, so the Pay-off year method fits very well. The comparative indicators provided by Horngren¹⁰ on the use of the various methods in the practice of developed countries show a similar situation.

	US	AUS	CAN	Ireland	Japan	Scotland	Korea	UK
Pay-off year	59*	61	50	84	52	78	75	76
Internal rate of return	52	37	62	84	4	58	75	39
Net present value	28	45	41	84	6	48	60	38
Accountable rate of return	13	24	17	24	36	31	68	28
Other methods	44	7	8	-	5	-	-	7

The total by country exceed 100% because some of the methods are used combined

Table 4 Use of methods of capital budgeting according to Horngren

According to this study a large number of businesses still use the accounting rate of return method. There could be many reasons for this, but it is most often stated that entrepreneurs understand accounting indicators, and that managers of big companies are paid on bases of profit and not on the bases of cash flow.

The situation with the use of standard methodology in the Republic of Macedonia

The structure of the Macedonian economy is such that 96% of all business entities can be considered as small.¹¹The corporate world is limited to several direct foreign investments and to those domestic companies which have successfully undergone transition and have introduced western standards of operation. From the view point whether the entrepreneurs had prepared business plan, in up to 65% of the cases plan has not even been started in 25% there was a draft and only in 10% of the cases the entrepreneur had a previously prepared comprehensive business plan.

From the view point of the application of the standard methodology, all interviewed entrepreneurs stated that they knew nothing about the methods of Net Present Value and Internal Rate. The number of entrepreneurs who have checked their estimates with discount methods is small even in the case of the developed economies, but there the entrepreneurs, by rule, state that they know what this calculations really means.

When it comes to estimating the business environment it is much harder to do it here than in developed economies. Still, this fact should not question the value of business planning. On the contrary, under these circumstances, attempts to anticipate the future business environment for better estimates of the future investment effects are even more significant. What is minimal applicable practice in the developed world, today also applies in the case of the Republic of Macedonia. The time of improvisation and voluntarism is left to the past, here also. The practice shows that only serious and theoretically prepared entrepreneurs and managers have chances for prolonged business success.

However, the situation regarding the use of the methodologically correct estimates for long term business decisions is much less favourable. The investment activities in the years after the change the political system are primarily based on private funds of the entrepreneurs. So, formal business planning is not even practiced. The business plan, as the elementary instrument for planning and management, is prepared only when the entrepreneurs are applying for loan with some of the banks; and even then, it is done either vaguely or ostensibly-showing an idealized picture of the proposed investment to the credit board. The wrong association is created between a business plan and the loan application in the sense of their equalization. Entrepreneurs asked if they had a business plan, often respond fuzzy that they do not need one, because they are not applying for loan.

The examples of use of quantitative methodological framework of capital budgeting in one objective estimate of market and financial feasibility of the business idea and the development of a complete business study are very rare. To make the situation even worse, a proper comprehension of very important business concepts lacks, while some of them are incorrectly translated and thus understood. If the application of the Pay-off year method is still acceptable, since it is based on the cash flow, accounting categories that can still be found in certain methodologies are of no practical use in case of estimating the real investments and lead to underestimating of the value of capital intensive projects, that on the other hand, have much better marketing odds, domestically and abroad.

The second, clearly noticeable error is the over concern with the production function, and with the market issues. The lack of the marketing way of thinking of senior staff leaders can be partly explained with the fact that they never studied marketing. Their knowledge of business was accumulated in the previous system, when the marketing concept was suppressed from ideological reasons. Nevertheless, when such approach is traced with the current private investors, it turns in a really strange phenomenon. The lack thereof, erroneous and shallow understanding of marketing exists even with younger generations of entrepreneurs and is turning into a serious national problem.

Why is the marketing approach important in capital budgeting? The close monitoring of the market and the regular checking of the changing preferences of the buyers is key, also to a successful capital budgeting. The ultimate quality of the capital budgeting is hence not determined by the methods and calculations but by the quality and the scope of the data in the analysis of the market environment. Therefore, ignoring the marketing would mean continuation with the practice of throwing away otherwise, modest capital resources, although this time not because of ideological reasons but because of ignorance. The banks are submitted loan requests completely lacking a marketing part, while the estimates of expected returns are simple projections of the capacity, instead of being objective estimates of the expected sales as the most important input in the process of financial

forecasting. It is clear that there can not be a justification for this situation. The efficiency of capital investments will not increase on its own with the change of the political system and the character of ownership. The banks have at their disposal a series of examples proving that private investors today are making the same mistakes as the managers of yesterday.¹²

Suggestions for improvement and advancement of the practices in capital budgeting in Macedonia

Small enterprise, not only in Macedonia, but also in most developed economies in European Union for instance is becoming a predominant model of business. Therefore, it is understandable why the specifics of investing in them are imposed as dominant in the design of a practical system of support of capital budgeting.

In a situation of extreme changes to the conditions of business and the rapid introduction of a large number of technical and technological innovations and changes, the traditional methodological procedure seems to be losing on its relevance. The time dimension of money ceases to be a relevant factor when a life cycle of a product is no longer than two to three years. Today companies operate in an environment where knowledge is the main business asset. The flexibility in making optimal decisions in situations of existence of strong real options, as well as in other situations, may play a key role for the final quality of the managerial decisions. Among the particular circumstances that should be studied is the rivalry within the industry, the behaviour of the investors in situations of crises in the economy, uncertainty of the market success, the readiness for cannibalization of existing products etc.

From the view point of the Macedonian situation, we should first strive towards greater use of quantitative methodology and only then to start to contemplate possible introduction of subjective methods and procedures.

Our greatest limitation is the insufficient understanding of the basic concepts of capital budgeting and strategic management. However, this, in no way means striving towards a rigid application of quantitative methodology, but a commitment for introduction of structured strategic planning and systems of support of the processes of capital budgeting. The allocated space for the quantitative methods and procedures will depend upon the nature of the industry and upon the intentions and actual capabilities of the specific company.

With the purpose of introducing advanced practices of business planning based on the existing methodology, work needs to be done primarily with bank officials, managers of the network of centres for support of entrepreneurship, professors of management and planning in business high schools and universities, as well as, directly with the entrepreneurs in the sector of small business.

Naturally, the rigid adherence to the form will not turn a viable solution. We experienced such a practice in the previous system when the methodology, otherwise quite correct, was naively enforced by law, while nobody seriously respected it or even understood it. It is clear that quantitative methodology is not a purpose all for itself. The uncertainty of the business environment has really made quantitative estimates to be very relative. Still, the understanding of the concepts is even more important. Only the entrepreneurs who fully understand the concepts of strategic management and capital budgeting will be able to make correct investment decision regardless of whether he shall rely on objective techniques or subjective procedures and estimation.

Quantitative estimates have not been a dogma for quite a long time even in the developed countries but there, the cash flow concepts are clearly prevalent over the accounting average profit. Nobody puts in question the necessity for discounting the results from different years and the price of capital as the factor for discounting. On the contrary, these concepts are underlying principles behind any business decision.

If technology is no longer an obstacle for introduction of advanced systems and procedures of capital budgeting, than we have the naturally imposed fact that to improve the process of business decision making and to increase the efficiency of investments we need to turn towards concepts such as permanent education and on the job training. We should constantly act upon educating investors, but also banking personnel employed in loan departments. That is how we can achieve realistic comprehension of methodology and concepts by all key subjects. Entrepreneurs will learn why the adherence to a generally accepted methodology is their genuine interest and will understand the connection between the marketing, capital budgeting and the future cash flow. This will gradually lead towards a much higher quality of business planning and raising the all-out efficiency of domestic investments.

Finally, for standard methodology to be applicable in practice, cheap and easy to use software packages for the support of the processes of business decision making should be made available. This should be perceived as a unique chance for software and consulting companies in Macedonia since the direct application of imported software is practically impossible due to the incompatibility of the content of various concepts and the language barrier. Such solutions should contain an educational dimension (explanations of concepts and practical examples) side by side with the calculations. Banks in Macedonia should adjust their procedures in accordance with these solutions and reject plans prepared by consultants instead of the entrepreneurs themselves. If there are still dilemmas with regards to the usefulness of the application of various advanced methods of capital budgeting for business success, among the academics and practitioners of capital budgeting, a consensus has been achieved a long time ago stating that for the business

success the perfection of the plan is not important, but the ability of the entrepreneur to conceptualize and undertake his original business idea.

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