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PROBLEMATIC ASSESSMENT AND EVALUATION OF SMALL ENTERPRISES

Abstract

The philosophy of rating in Basel 2 principles is to evaluate the probability of default (PD) of the single enterprise; nevertheless it is attested that the assessment must exceed traditional quantitative approach based on the balance sheet analysis. The triangular approach posed by Basel 2 represents a significant progress in comparison with traditional quantitative methodologies, and it could be a good premise in order to appreciate the systemic value of enterprises - especially small ones.

Key words*: assessment, evaluation, small enterprise, banking system, Basel 2*

Life and development of SMEs are interesting fields of study and research for economists; in fact small and medium firms play a fundamental role in stability and growth of economic systems, instead of they are characterized by a lot of weakness and disadvantages:

➢ *limited possibility to take advantages by economies of scale, owing to the low level of production;*
➢ *limited possibilities of diversification, connected with the necessity to move in market niches;*
➢ *vulnerability to adverse market shocks, because of they generally operate in a single market;*
➢ *low contractual power towards public administration, owing to the few number of manpower resources;*
➢ *low financial sources and limited possibilities of giving collateral guarantees, with big effects of adverse conditions in relationships with banks.*

On the other hand, SMEs can take advantages by:

➢ *high motivation of owners and their family, because of the success of the business is directly connected with their well-being and social status;*
➢ *flexibility and adaptability to changes, thanks an essential organisation, low degree of bureaucracy, minimal problems in labour relations;*

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> ➢ *fidelity of customers especially in local markets, where small enterprises can offer special and personalized products and/or services;*
> ➢ *alternative and competitive offer in comparison with monopolistic tendencies of big companies.*

Looking for European Countries, we can observe that SMEs represent about 90% of business structure in all economic systems and they assure a relevant part of GDP and employment. In addition SMEs play a fundamental role in stabilization and reduction of cycle effects: like a colony of ants, each unity is not relevant as a single but as a member of the system, so that the failure of some units does not create big negative consequences[2]. The temporary falling down as in employment as in level of production and competition is easily compensated by the capacity of absorption of other units.

According to synergic principles, it is possible to assert that:
- *on one hand* small enterprise - individually considered - presents structural frailty, low stability and a lot of risky elements in comparison with their single contribution to economic system;
- *on the other hand* small enterprises - overall considered - can assure the foundations of economic and social system and their contribution is increasing in European Countries.

Life of SMEs is characterized by various connections – intangible and invisible often – more or less articulated, more or less complex. Joint ventures, groups of enterprises, consortia, clusters, outsourcing, exchange of services, inter-personal relationships: they represent some examples of links existing among SMEs.

This situation asks to re-examine traditional assessing and evaluating methodologies, and to analyse three fundamental questions:
➢ are Basel 2 rating principles adapt to recognize the added value generated by the systemic role of small enterprises?
➢ are bank methodologies and practices rightly organised in order to take in account the systemic-environmental context where small enterprises operate?
➢ how small enterprises can better their rating evaluation?

Are Basel 2 rules useful for evaluating small enterprises?

The philosophy of rating in Basel 2 principles is to evaluate the probability of default (PD) of the single enterprise; nevertheless it is attested that the assessment must exceed traditional quantitative approach based on the balance sheet analysis; it is asked that three categories of information are considered:

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[2] Not the same in case of failure of a big company.

- *Quantitative Information* about economical-financial aspects of the enterprise: they are found in balance-sheet and other accounting documents. Particular importance is given to:
  - capacity of self-financing;
  - estimation of net tangible capital;
  - entity and performance of working capital;
  - composition and impact of interests;
  - etc.
- *Performance Trend Information* about relationship with banks:
  - entity in limits of credit;
  - frequency in exceeding the limits of credit;
  - level of flow in bank accounts;
  - number of bank relationships;
  - quality of the bill portfolio;
  - etc.
- *Qualitative Information* about a lot of phenomena:
  - owners, governance, organization;
  - equity participations and links with other companies;
  - presence in informal groups;
  - typology of products/services, kind of markets, distribution channels;
  - characteristics of economic sector, competitive position, market quota;
  - trade marks, patents, know-how, special technologies;
  - production planning;
  - availability of economic-financial budgets and other forecast plans;
  - etc.

We can observe that the tri-angular approach posed by Basel 2 represents a significant progress in comparison with traditional quantitative methodologies, and it could be a good premise in order to appreciate the systemic value of enterprises - especially small ones. The big challenge for analysts - especially banks engaged in assessment and evaluation of enterprises - is to be able *to know* and *to evaluate* the various formal and informal relationships that enterprises manage with internal and external subjects, and to appreciate the capacity of enterprises to valorize their relationships in order to get good repercussions on the economic-financial results and on its market value.

According to Cantino-Devalle-Bava (2004), it is important to take in consideration a lot of actors and subjects:
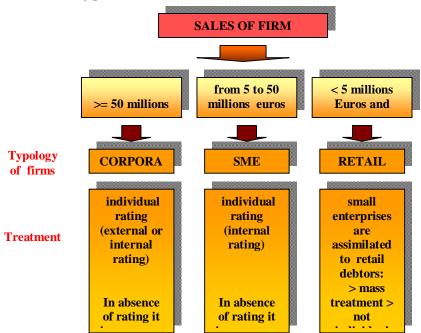
Actors directly involved *in firm:*
- Entrepreneur
- Shareholders and Partners
- Managers
- Financiers and banks
- Employees and self-employed workers
- Suppliers
- Customers
- Competitors
- etc.

Subjects inter-acting with firm:
- Market system
- Technological system
- Socio-cultural system
- Legislative system
- Banking system
- Local communities
- Consumer groups
- Environmental groups
- Political groups
- Ethnic groups
- Trade Unions organisations
- Public administration
- etc.

Another kind of "focused treatment" assured by Basel 2 consists in possibility for banks to assimilate small enterprises to retail debtors, as shown in following picture:

SALES OF FIRM		
>= 50 millions	**from 5 to 50 millions euros**	**< 5 millions Euros and**
Typology of firms: CORPORA	SME	RETAIL
Treatment: individual rating (external or internal rating) In absence of rating it	individual rating (internal rating) In absence of rating it	small enterprises are assimilated to retail debtors: > mass treatment > not

About the previous first question, it is possible to conclude that Basel 2 recognizes small enterprises as a special typology of firms, having not only an individual identity, but a collective identity also.

Are banks organized in order to assess and evaluate small enterprises?

At the moment it is difficult to estimate if automatized methodologies and procedures of rating that banks choose to adopt are useful for investigating on the various characteristics of small firms, in order to appreciate their role in social-economic system and their effective profile of risk. Banks might take in account that small and medium businesses are useful for diversifying and splitting up total credit risk.

Measuring credit risk and rating asks making use of complex methodologies: it is necessary to identify significant factors, to weight them with right coefficients, to use mathematic models able to synthetize all the variables in a single index of rating. In addition, it is preliminarily asked to collect a lot of information about enterprises.

A part some marginal cases of incompetence - especially in small banks - it is out of doubt that the general run of banks have specialized managers and white collars in assessment and evaluation of firms. Real problem is if top management of banks intends to invest necessary resources in investigating, assessing and evaluating small enterprises as in internal aspects as in context perspective.

Actually, taking account of bank organization, it is expensive and difficult to collect *Qualitative Information* especially, because of sources are not found in balance-sheet and other accounting documents, or in historical files of banks. *Qualitative Information* is available in the internal of enterprise, and it is considered as "confidential" by entrepreneurs. Generally, banks avoid investigating about qualitative aspects, and choose to compensate the insufficient knowledge and the uncertain evaluation of risks, on limiting the amount of credits and reducing typology of financial support.

Banks have to implement their informative systems for reducing problems of adverse selection; nevertheless in short time they will have serious difficulties and resistances in changing their approach towards small enterprises, especially under the point of view of a systemic assessment and evaluation.

In order to move this *impasse*, an important role must be played by small entrepreneurs, by adopting a pro-active style in pushing banks to implement and better their rating methodology.

How SMEs can better their rating evaluation?

Entrepreneurs must play an active role in relationships with banks, by opening a continuous dialogue, in order to reduce informative and operative asymmetries.

Small firms have to better their capacity of communication and negotiation in different ways:

1. *In looking the impact of strategic choices:* strategies have a significant impact on risk profile of enterprise and its capacity to be financed by external sources.
2. *In forecasting financial needs:* financial plans are very useful in relationships with banks, in order to show entity and reasons of needs; bank appreciates efforts of enterprise in controlling its financial sector.
3. *In playing an active role in evaluation process:* enterprise can organize procedures of self-diagnosis and self-evaluation; these procedures are really useful as early warning system and precocious correction of possible criticalities.
4. *In communicating to banks:* number and frequency of information is a practice well appreciated by banks; best entrepreneurs are able in explaining to banks what they are doing and how they are managing.
5. *In understanding what is the opinion of bank about enterprise and entrepreneur:* it is important to look for the criteria utilized by bank in order to estimate rating and what are the best key in order to improve it.
6. *In comparing criteria of different banks:* banks utilize different risk models, and it is very hard to compare them; enterprise might be able to self-estimate its probability of default and to utilize this index in order to negotiate with banks.

Actually it is asked a basic change in relationships between enterprises and banks; it needs time and strategic vision of both the parts, with the help of other external agents; particularly involved are:
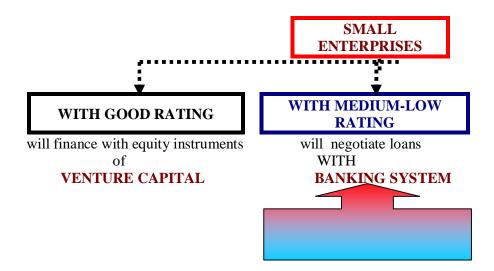
- *Associations of entereprises;*
- *Public and private Guarantee Organisations;*
- *Professional services.*

In addition it is necessary a structural change of small enterprises, according to following guide-lines:

- ***transparency and availability of balance-sheet:*** rating models are based on standardized ratios and mathematic formula; a lot of data are found in balance-sheet and other accounting documents: availability of these sources is considered a prerequisite of credibility;
- ***adequate capitalization:*** rating procedures take in big account financial equilibrium in enterprise; exorbitant leverage debts/own capital is considered a negative factor. Small business might increase own capital in different ways: self-financing, underwriting of fresh capital as by old and new partners as by private equity and venture capital organisations; best companies can be quoted in official markets (Stock Exchange and similar);
- ***size increasing:*** banks consider medium size as a benchmark; as consequence micro and small enterprises might increase their dimensional weight;
- ***innovative development:*** traditional manufacture is reducing its comparative weight; new economy is founding on knowledge-based enterprises, where intellectual capital is able to produce innovation in products, in processes, in organization, according to Schumpeter theory.

A long way to run

The way of full valorisation of SMEs in economic and financial system is long and difficult. A lot of constraints exist and running is slow and difficult. Nevertheless, it is possible to imagine that in future small enterprises can diversify their financial policy, as shown in following picture.

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