CFSI Center for Financial Services Innovation

Financial Health: A New Vision For Serving America's Small Businesses

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CFSI Center for Financial Services Innovation

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Introduction

Our country relies on entrepreneurs and small businesses to create economic growth and build strong communities. Small businesses were responsible for 63% of net new jobs between 1992 and 2013[1] and currently employ nearly 60 million Americans[2]. These businesses may be small—the majority do not have employees other than the owner—but with such a large, and growing, number of Americans owning or working for a small business, their financial health matters to all of us.

Unfortunately, small businesses, these engines of economic growth, are struggling financially in a myriad of ways. Consider these facts:

» Half of all small businesses hold a cash buffer of less than one month[3]

» 36% of small businesses struggle to meet basic operating expenses[4]

» 44% of small businesses struggle with access to credit or capital to expand[5]

» Even within the same credit-risk categories, small businesses with less than $1M in revenue are less likely to receive financing than larger firms[6]

» 49% of small businesses report finding it difficult to pay down their current debt[7]

» When faced with such financial challenges, small businesses are forced to use personal funds, take out additional debt, pay bills late, or downsize their business[8]

Looking at these struggles, CFSI—the national expert on consumer financial health—noticed striking parallels to the financial health challenges that many individuals face. We sought to understand the connections, similarities, and differences between consumer financial health and the financial health of small businesses.

CFSI has developed a framework for consumer financial health built upon in-depth consumer research, in-market tests, and collaboration with financial health providers and experts across the industry. We started with a simple definition—*financial health comes about when your daily systems help you build resilience and pursue opportunities*—and made it into an actionable business practice. As a result, more and more providers are launching products that address unmet challenges to attaining positive consumer financial health and are measuring their impact on consumers' lives. This a fundamental shift for some providers—yet also necessary given a competitive environment where consumers want more from their financial institutions.

To explore what a framework for small business financial health might look like, we conducted interviews with small business financial service providers, advocates, and experts, and completed a thorough literature review of existing research on U.S. small businesses, their owners, and the self-employed. Consequently, this report identifies three key financial health challenges that affect millions of small businesses, looks at the relationship between the individual entrepreneur and the small business's financial health, and spotlights providers who tackle challenges that are unique to small businesses and the self-employed.

We conclude our report by sharing nine key elements of small business financial health. We believe that by understanding these elements, providers can begin to identify obstacles to growth, create solutions that support small business success, and quantify the impact on small business outcomes in order to benchmark and measure small business financial health. While we are still at an early stage in this endeavor, this report presents what we have learned so far in this process and a vision for the way forward.

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Somewhere Between a Consumer and Big Company: The Financial Challenges Facing Small Businesses

Small businesses and the self-employed are a diverse group with a common experience: the U.S. financial system is not built for them. Financial products and services, and the regulatory and tax environment they exist in, tend to be designed either for consumers or larger businesses, but we see millions of Americans who need solutions that recognize the interconnected nature of the individual and the small business.

The focus of our research and resulting insights are small businesses managed by their owners, with little to no professional staff dedicated to accounting, finance, human resources, or other supporting functions. They may have employees or contract workers, or not, may incorporate or not, and may have growing revenues and profit, or not. These small businesses ultimately depend on an individual who is generating income, managing expenses, and navigating the complexity of a tax and financial system built for others.

What Stymies Small Business Financial Health?

Small Business Challenge 1: **Limited Access to Financial and Social Capital**

At the heart of the small business is the owner—the founder who takes the risk to set out on his or her own. With this lens, the personal and small business financial health connections are inextricable. The steepness of the road to success depends on the owner's financial health.

The personal connection to the small business is both a blessing and a curse. On the one hand, the top reason that small business owners report starting a business is to be their own boss[9], yet this self-reliance often leaves entrepreneurs with only the tools, support, and assets that they can rally. Personal funds are the primary source of funding for starting a small business[10], in addition to the cost of the owner's time, which often goes unpaid in the beginning. The need to self-fund the business is a barrier to entrepreneurship that cannot be overstated. The average small business starts with $40,000 from the founder.[11] Meanwhile, vast swaths of Americans have virtually no liquid assets or access to affordable credit. In fact, 46% of U.S. households cannot come up with $400 in the case of an emergency without borrowing or selling something.[12] For many, the opportunity to establish a small business that will serve as a wealth-generating asset is an investment they cannot afford to make.

In the case that an entrepreneur is financially able to start a business, perhaps by entering an industry that is less capital intensive, or using a home equity line of credit to fund operations, the process to become financially independent of the business requires much more than incorporation. For example, a small business relies on the owner's credit profile well into the life of the business. If an owner has damaged credit, and is pursuing a small business to strengthen their financial position in the future, the door of opportunity may be shut simply based on their credit history. Even when a mature small business can access credit, it is often secured by the owner's personal guarantee.[13]

The personal connections to the small business do not start or end with finances. The owner's network is also fundamental to the success of the business. Nearly 83% of small business owners rely on friends and family for support.[14] A small business owner's network is primarily a function of their life experiences and community cohesion. This makes networks highly personal and variable. Social capital and access to soft resources, such as advisors and models of other successful small businesses, are arguably just as important to the success of the business as access to capital—and lower-income and minority populations often have systematically less access to key social networks.[15]

Industry Challenge: Personal Data is All That's Available

By definition, financial service providers have minimal business data to use in determining the credit risk of a relatively new business. In order to establish business credit history, the business must be extended credit, thus shutting out younger, less established firms from traditional lenders. Credit providers are understandably left to rely on other predictors of repayment, namely the personal credit score of the owner, and to minimize their risk with collateral, which requires the business or owner to already have assets.

A further barrier to extending small businesses credit is that it simply costs more to lend to small businesses. 70% of small businesses seek loans for under $250,000, yet many lenders perform similar amounts of due diligence whether making a small or large business loan.[16] In addition, given the lower revenue potential of most small business accounts, providers see less upside in serving as financial advisors or lenders to these businesses.

What is a CDFI?

Community Development Financial Institutions, or CDFIs, are mission-driven banks, credit unions loan funds, microloan funds, and venture capital providers that serves low-income communities. Many provide both capital and advisory services to small businesses in underserved communities, offering workshops on business planning and financial management, one-on-one coaching, and startups loans.

Solutions and Spotlights: Leveraging Data, Networks, and Partnerships to Increase Capital Access

Small businesses could benefit from providers considering a wider range of acceptable data points in order to bridge the divide between personal credit histories and the establishment of a business credit profile. Credit applications that provide small businesses with innovative ways to show how their plans and management characterize their risk can, in turn, help maximize the business's ability to sustain or grow their operations to generate value.

Efforts to advise and support the entrepreneur with mentors, networking, and guidance are often cited as the missing pillar to support small businesses and economic development. Pairing such capacity building and financial education with financial services so that lessons and skills are timely, relevant, and actionable continues to be necessary—especially when seeking to support underserved populations and communities.

Provider Spotlight

To promote the growth of promising small businesses, **Goldman Sachs 10,000 Small Businesses** combines business education, partnership with mission-driven lenders (CDFIs and SBA lenders) for capital, and business support services. The development of peer networks, hands-on business education culminating in a growth plan, and the business acumen of the owner, are considered fundamental to success and enable the receipt of growth capital.

Provider Spotlight

Intuit QuickBooks Financing helps small business customers solve their financing needs by introducing them to a variety of traditional and non-traditional lenders. QuickBooks Financing is a matchmaking platform that uses QuickBooks data to help match small businesses with participating lenders. Through the platform, borrowers are able to compare terms and conditions and much of the application can be pre-populated at the borrower's request. The loans are made by independent, third party lenders that meet Intuit's guiding principles for transparency, privacy, security, consumer protection, and overall cost of capital including rates and fees.

Provider Spotlight

Many mission-based lenders use philanthropic and government funds to subsidize the cost of lending and technical assistance to small business owners, working with them on personal financial management and credit building so that they are able to qualify for small business financing. **Mission Economic Development Agency (MEDA)** is a non-profit that offers asset-building and community development programs to the Mission neighborhood of San Francisco, CA. Recognizing that small businesses start with an individual, they offer a financial capability program: Strengthen Your Personal Finances for Successful Business Ownership. The program includes personal credit-building as well as business development programs for the self-employed and affordable credit in amounts up to $100,000 for low-to-moderate income entrepreneurs.

Provider Spotlight

PayPal Working Capital uses sales history to evaluate creditworthiness and has already originated over $3 billion to small businesses in just a few years,[17] including funding for women- and minority-owned businesses at a much higher rate than is typical for traditional lenders.[18] This is due in part to underwriting based on the transactions of the merchant—not the credit score of the business owner. Finding sources of underwriting data beyond the personal credit score may provide access to credit to entrepreneurs who are otherwise on their own.

Provider Spotlight

LexisNexis Small Business Credit Score uses several data sources, including vendor payments and public records, along with small business credit reporting from financial institutions, to build a credit file for small businesses. Many of these data sources would otherwise not be recognized by financial institutions without this third party validation.

Financial institutions have turned to technology to lower costs of service and to speed up the loan closing and funding process for borrowers. **Lending Club**, a marketplace lender to both consumer and small business customers, not only leverages technology to provide a quicker application and decisioning process, it has partnered with Opportunity Fund, a CDFI in California, to serve small business owners that do not qualify for Lending Club products. **Opportunity Fund** works with small business owners in a more holistic way to advise on their credit profile, business finances, and access to affordable credit.

Small Business Challenge 2: **Limited Options for Managing Cashflow**

Successful cashflow management depends on more than a small business's ability to make sales and budget in the short term. It also depends on understanding the variability of business income and expenses, minimizing delays in the collection of receivables, and addressing the volatility of seasonal or other forces beyond a small business owner's control.

A small business may find that short-term credit products, better payment terms to suppliers, or methods to speed conversion of sales to cash are necessary to manage cashflow. For example, a seasonal decorations business may need credit to purchase supplies and hire labor months before their annual peak sales at Christmas. This small business owner may find a credit card is the easiest option for financing the purchase of supplies, but what funds are available for paying the extra labor costs? She could forgo paying herself in order to have the cash to pay her helpers, but this can stress her personal household finances. While a larger business might be able to borrow funds to invest in inventory and labor based on past sales data or orders placed by others businesses, this small business owner sells directly to individuals and estimating demand is difficult for her and even harder to demonstrate to third parties.

Industry Challenge: Unique Needs Are Harder to Solve at Scale

The 28.8 million small businesses in the U.S. are anything but homogenous. They are diverse in terms of industry, size, sophistication, and overall needs, decreasing the market size for the highly tailored solutions they often require. Perhaps even more limiting from a provider perspective is the small scale that small businesses operates at, making their transactions, balances, and credit lines look more like consumer finances than commercial endeavors. Developing products and tools that are both customized enough to be useful but appeal to a broad market at an affordable price is often a tall order for financial services providers.

Solutions and Spotlights: Tailored Tools to Understand and Manage Cashflow

Deeply understanding a segment of the small business market can allow for product innovation and specialization to address the unique financial situations and goals of a category of small businesses. One useful categorization examines the spectrum of self-employed individuals and their relationship to their work. The self-employed segmentation diagram below shows that while individuals may occupy different segments over time, the self-employed do not necessarily move through the segments. Just as most babysitters do not go on to establish a daycare business, most individuals who are self-employed do not consider themselves to be small business owners, nor aspire to do so in the future. However, a daycare owner may also babysit to earn supplemental income. Intuit's On-Demand survey found that 37% of those earning supplemental income through on-demand platforms were small business owners[19], suggesting that many small business owners cannot support themselves with the earnings from their businesses alone.

The financial product needs of the self-employed segments above are influenced by tax regulations, the payment method of customers, the volatility and seasonality of the business, capital and asset needs, and stage of business development. By addressing the unique needs of these self-employed segments, small business solutions can differentiate themselves and improve financial health for these businesses.

Provider Spotlight

Square offers a dongle to open up point-of-sale card payment processing to small merchants and individuals, segments that did not have the option available in the past. The service now offers **Square Instant Deposits**, which allows for instant receipt of payments for a one-percent fee. By default, Square users receive payments in one to two business days, but timing can be everything when managing small business cashflows.

Four Segments of Self-Employment[20]

On the Side

- Provides supplemental income
- Common for gig workers and those using a platform intermediary

Making a Living

- Provides piecemeal income from several sources to earn a living
- Often combined with W-2 income

Making a Career

- Constitutes control of job and career path
- May still include W-2 income secondarily

Small Business Owner

- Represents a change in mindset to ownership
- May hire employees or subcontractors

Provider Spotlight

While the self-employed have long existed, financial products that are built for their needs are just emerging. QuickBooks has long been the accounting and financial management tool of choice for small businesses. Recognizing the personal and business financial management needs of the self-employed individual, Intuit developed **QuickBooks Self-Employed**, a mobile-first app for individuals to track their income, expenses, and tax obligations. It pulls in financial data and automatically categorizes it, only requiring the user to review and verify transactions. Without such an app, the self-employed may find they are unaware of their current financial situation, including quarterly tax liabilities, unless they hire professional assistance. Bringing together the transactions from multiple accounts into one platform allows the user to view cashflow in real time and anticipate upcoming expenses.

Provider Spotlight

StreetShares is a marketplace lender specifically targeting U.S. military veterans. By specializing in veterans, investors and borrowers have a shared connection that may promote lower credit risk and allow for a lower cost of capital than the borrower could receive elsewhere.

Provider Spotlight

The **Wells Fargo FastFlex(SM) Small Business Loan** is an installment loan available online and in-branch to existing small business clients of Wells Fargo. By leveraging technology to provide next-business-day funding of amounts between $10,000 and $35,000 with a one-year term, the product offers small business owners a financing option to meet a wide of range of needs, including smoothing out cashflows.

Small Business Challenge 3: **Limited Time for Financial Management**

By and large, the self-employed are responsible for juggling multiple streams of volatile income, obtaining their own insurance coverage, estimating and paying quarterly income taxes, and paying for tools and equipment out of pocket. Many do not even recognize the tax payment and reporting requirements they may have. They often struggle to pay bills on time, to save, and to plan for the future on top of the challenges they face in establishing, sustaining, and potentially growing a small business.

The lack of benefits and tax-advantaged savings programs can also be felt by the employees of small businesses. The financial and administrative costs of employee benefit programs can be nearly insurmountable for a small business with financial health challenges. Yet those that cannot shoulder this burden are the small businesses that are also more likely to employ individuals within underserved communities, where high-quality jobs are most needed.

Many small businesses begin with only rudimentary financial management tools. Any budget or plan that may exist is usually contained within a static document. One study showed that even after receiving a microloan, only 46% of entrepreneurs use financial management software.[21] The same study found 65% of entrepreneurs work over 40 hours a week. This all adds up to small business owners who are stretched thin and may rightly prioritize the work of the business over the finances of the business. When they do have a financial need, whether it is cash to make payroll or disaster insurance coverage, it can be overwhelming to shop for a solution. Often, they do not receive the support they need.

Industry Challenge: Providing High-Touch Service at Low Cost

As we have seen in consumer financial services, providing affordable service for customers who need high-touch support to help plan and manage their finances is difficult for providers to sustain. Time is money both for the financial institution and the small business owner. Yet when a small business owner is shopping for a financial product, or wondering if there is a solution out there, having a trusted advisor may be the only path they are comfortable with.

Solutions and Spotlights: Linking Multiple Services Together and Reducing Costs Via Technology

Gathering all the threads of small business financial management into one platform provides a comprehensive financial picture and, in the ideal case, insights that a small business can use to maximize success. Advances in data-sharing between financial institutions and user-friendly analytics tools hold the promise of robo-advising for small businesses and the self-employed. Leveraging data analytics across customers may allow such platforms to anticipate product needs for the user and make personalized recommendations. Several web-based accounting software solutions also exist for small businesses, bypassing manual data entry by offering integration with banking, credit card, and other transaction accounts. Through add-on services, the small business can disperse payroll, pay vendors and contractors, and accept payments from customer invoices, all through one portal. Bringing together services in one spot, and providing analytics on-demand, can decrease the need for professional services that small business owners may not be able to afford. When they do need professional guidance, online options like those below are available at no cost and from any location.

Provider Spotlight

Fundera is an online marketplace for small business credit products that allows users to complete one application in order to receive multiple offers—ideally cutting down on the time an applicant spends finding and comparing options. Fundera provides customer assistance by phone, email, or online chat to help applicants understand their options, and pledges to remain lender-neutral while assisting potential borrowers in choosing the best credit option for their needs.

Provider Spotlight

BusinessAdvising.org is a website developed by Pacific Community Ventures (PCV), to help match volunteer advisors and mentors with entrepreneurs across the country. As a nonprofit, PCV has identified advisors with specific skill sets as a vital support to helping small businesses grow and contribute to their communities.

Provider Spotlight

In order to bring together financial information in one place, online accounting and financial management services are working together with large financial institutions to find safer ways to access bank transaction data. **Xero** and **Capital One** recently announced a data-sharing agreement employing an application programming interface (API). A similar partnership exists between **Intuit** and **JPMorgan Chase**. **Wells Fargo** has agreements in place with both Xero and Intuit.

Small Business Financial Health

Even the smallest businesses have numerous relationships with financial service providers. But are the needs of the small business being met? Are the products and services they use supporting the financial health of the small business? CFSI has asked these questions of consumer financial service providers, recognizing that a customer impact focus requires a major shift for some providers. However, we posit that aligning the success of the customer with the success of the provider is a necessary move to compete in the U.S. financial services industry.[22]

Our review of existing small business financial health definitions and frameworks found many different ways to evaluate a business enterprise but each had its own narrow lens to define success. From evaluating growth potential, to free cashflow available to service debt, existing frameworks are not holistic enough. Just as blood pressure alone is not an adequate measure of physical health, an individual's FICO score is not an adequate measure of her financial health. We need a wider lens to understand a small business's financial health, and where it may be struggling.

Our definition of financial health for a small business is the same as for an individual consumer: Financial health comes about when your daily systems help you build resilience and pursue opportunities. But what a small business needs in order to maximize financial health differs from a consumer's needs. The key elements for small business financial health listed below can be applied to any business, large or small. However, as the challenges identified earlier illustrate, small businesses have fewer resources to devote to ensuring their needs are met and fewer tools and supports from providers.

These nine elements provide a starting place to examine the entirety of a small business's financial health needs and identify where there are gaps in products, services, and support. When looking across the customer base, they can also be used to identify common pain points and potentially diagnose where product innovation is needed. With further research, we also hope to translate these elements into indicators of small business financial health that can be used to measure impact and outcomes.

Small Businesses are Financially Healthy When They...

Manage Cashflow

1. Meet obligations (bills, taxes, payroll) on time and in full
2. Maximize collectability of sales
3. Have a financial management system and budget
4. Have access to funds to weather financial shocks

Sustain and Grow the Business

5. Have a sustainable debt load
6. Generate earnings to cover expenses and replace assets
7. Have appropriate insurance and risk mitigation plans
8. Have access to capital sufficient to pursue opportunities
9. Have a business plan that includes cashflow cycle, future expenses, and investment opportunities

Conclusion

In setting out to understand where a consumer's financial health is intertwined with their ability to establish, sustain, and grow a small business, we found the two are greatly linked given the personal and structural connections. In addition, small businesses have financial service needs that go unmet as small businesses fall in between consumer and business product offerings.

We believe that the vision for financial health put forth in this paper, adapted to the unique needs of small businesses, can help providers see where small businesses need more support and how to better serve them. Of course, financial services will never solve all the challenges faced by small businesses. Nevertheless, we believe that this approach—of orienting products and services to positive financial health outcomes for small businesses—can point the industry in a new and promising direction.

This brief represents only the beginning of CFSI's exploration into small business financial health. Providers will need tools and instruments for measuring and assessing small business financial health in ways that are both comprehensive and practical. In-market use and benchmarking to relevant research can allow for testing and refinement of insights into how the key elements outlined in this report can serve as indicators of small business financial health. And ultimately, new products will need to be developed to fill in the gaps that this approach identifies and improve financial health for millions of small businesses.

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