

CREDIT CARDS

AS A SOURCE OF START-UP CAPITAL



AND ONGOING
CAPITAL
MANAGEMENT

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ABSTRACT

This paper presents the results of a survey of businesses established between 2001 and 2005 in Rutherford County, Tennessee. Business owners or partners were asked about their sources of start-up capital, including personal and business credit cards, personal savings, home equity loans, bank financing (with or without collateral), venture capital, and funds from angel investors, friends, relatives, or other sources. In instances where credit cards were used as a source of start-up capital or to meet ongoing capital needs, additional questions were asked to explore the motives, attitudes, and other behaviors associated with entrepreneurs' use of credit cards. Findings portrayed a compelling picture of the use of credit cards by entrepreneurs. Credit cards are being used relatively frequently for starting businesses as well as managing ongoing operations in actual practice, and they should therefore be formally acknowledged as a mainstream business practice among entrepreneurs. Although members of the business press have already acknowledged the phenomenon, except to an extremely limited degree, scholars have not as yet demonstrated a reciprocal level of interest.

Introduction

Traditional sources of new venture financing tend to be emphasized in text books and constitute mainstream thought; however, bootstrapping (Roberts, 2003) and other non-traditional methods are commonly used by start-up entrepreneurs. Many start-ups report a lack of access to venture capital and bank financing, especially when that latter form of financing is labeled a business loan (line of credit, et al), as compared to a personal loan. Given the typical criteria of many banks for granting a business line of credit, which may include an already established positive cash flow, three or more years in business, and good business as well as personal credit (Parchois, 2000), the reasoning behind the adage "banks only lend money to those who don't

need it,” is easy to understand. It is also apparent that the terms “bank funding” and “start-up” go together about as well as oil and water: they simply do not mix.

U.S. Banker cited industry sponsored research commissioned by MasterCard, which reported that 57% of small business owners use personal credit cards for their business (de Paula, 2003), and added “credit cards of all kinds are quickly gaining in popularity as a method for small business owners.”

Further readings in the business press highlight numerous instances where business founders have used multiple cards for start-up funding. Indeed articles appear frequently in *Inc.*, *The Wall Street Journal*, and other non-academic journals, magazines, and newspapers. Hise (1998) in *Inc.* magazine concluded that despite the horror stories that result from the use of credit cards to finance new businesses, personal credit cards remain a fast, cheap, and easy way to obtain much needed start-up capital. In a *Wall Street Journal* article, author T. J. McCue (1999) reported that it was not unusual for people seeking money for new businesses to accumulate a “myriad of credit cards for this purpose—possibly 14 or 15!” (p. 6). In another *Wall Street Journal* article by Selz (1994), entrepreneurs were reported to use their credit cards for start-up capital and continue to use their cards to pay operating expenses.

Meanwhile, scholarly research into the use of credit cards as an initial source of capitalization by entrepreneurs has been too infrequent and insufficient to provide an understanding of this phenomenon. A search of databases used by *ProQuest* resulted in only three articles, which examined the behavior of credit card users published in scholarly peer-reviewed journals during the past four years. Research by Swift-King (2004) examined the use of credit cards to pay cash all at once and use the float, or to simply use credit cards as an easy form of borrowing. Yarett (2004) examined a new variant of structured financing called “whole-business” or “operating-asset” securitization. Credit cards were considered by Yarett to be passive assets like mortgages. The third article by Zopounidis and Doumpos (2002) used credit cards as a means to study multi-group discrimination using multi-criteria analysis.

Beyond the topic of usage itself, limited scholarly research has been conducted as it pertains to the motives of entrepreneurs and other factors that may drive their behaviors when opting in favor of personal credit cards for business financing. Hence, the purpose of this present research study was to identify and analyze the use of credit cards (both business and personal) as a source of business capital as well as owner motives and rationales. Given the aforementioned paucity of existing scholarly attention to the topic, despite the widespread use of credit cards for funding business start-ups and ongoing operations (as well as the apparent importance of the strategy from the point-of-view of actual practice), we anticipated that our study might serve as a pilot for additional research, and we began in the Rutherford County, Tennessee market area as a matter of convenience. This paper will present our review of the existing literature, research methods, findings, implications, and recommendations for further research.

Review of Literature

As noted in our introductory remarks, academic research on the use of credit cards by entrepreneurs and small business owners is scarce. A search of several internet databases

indicates that the issue of credit card use by small business owners is a research stream that has not been tapped by academics.

Although commercial loans may enjoy a “hallowed reputation for respectability” (Rosenfeld, 1999, p. 1), “more and more small business owners are turning to credit cards for funding...because they are easy to come by and the credit limits are high” (Scully, 2002, p.1). In its *2002 Report to the Congress on the Availability of Credit to Small Businesses*, the Federal Reserve Board indicated that overall 46% of small businesses utilized personal credit cards in connection with their start-up or ongoing operational costs (Report to the Congress, 2002). Categories were reported under the headings of organizational form, years under current ownership, sic code, and number of employees. The most frequent users of personal credit cards among small businesses were: proprietorships; 0-4 years of age under current ownership; professional services firms; or those with 10-19 employees.

The aforementioned report further posited that personal credit cards may be used as a substitute for business credit cards. Publications in the popular business press such as *Entrepreneur* magazine seem to concur, suggesting that “good, old-fashioned plastic” is a source of capital that remains “plentiful even in tough times” (Prince, 2003, p. 1).

Financial advisors, who write regular commentaries in newspapers and magazines, have on occasion recommended the use of credit cards as one of several sources of start-up cash. Williams (2005) goes so far as to say that credit cards provide small business owners with an easy source of cash and are an option that allows entrepreneurs to avoid the controls that can be placed on a small business owner by banks, angels, relatives or other investors.

However, a writer for *Credit Control* magazine (2002) reports that the federal government is worried about a trend toward replacing traditional bank loans (for less than \$100,000) with the use of credit cards by small-business owners in the US. Hence, the federal government feels that credit cards are a riskier vehicle for financing the activity of a business, according to reports issued by the US Small Business Administration (SBA).

Additional observers would agree that the practice is riskier than other ways to finance a business (Hise, 1998). Despite the risks involved, Hise reported that according to the *Survey of Small and Mid-Size Businesses* by Arthur Andersen’s Enterprise Group and National Small Business United, the top two methods for financing small companies were bank loans and credit-cards, which were used by 38% and 34% of the respondents respectively. What is even more interesting is that the same survey reported that 25% of the companies that used credit cards were using them “often or routinely.” Shermach (2004) reported that “holders of cards for small businesses use their cards more often than consumers do, and their average transaction is bigger than the average consumer’s” (p. 24).

What makes the use of credit cards so risky? Primarily, it is the large bill that arrives each month, which cannot be juggled as easily as if there were several small bills coming in. Another risk is the violation of most personal consumer-cardholder agreements, which state that personal credit cards cannot be used to fund businesses. Hise (1998) reported that it is standard practice for thousands of entrepreneurs to use their personal credit cards to provide initial capitalization.

Additional observers note that minority and women entrepreneurs are at an even greater disadvantage with regard to having the means to acquire capital through traditionally accepted sources (Brush, Carter, Gatewood, Greene, and Hart, 2004). An article by Thomas (2001) stated that, as compared to men, many women entrepreneurs avoid the sale of equity in their businesses and “are more likely to rely on credit cards and personal loans” (p. B.2) to finance a business.

Research Methods

Population

The population in this study consisted of 830 businesses in Rutherford County, Tennessee. These businesses were listed on *Reference USA* as having been started between 2001 and 2005. In addition, the primary contact person was listed as “owner” or “partner.”

Instrument

A survey was developed that identified sources of start-up capital typically associated with the creation of new businesses. Respondents were asked to identify sources of start-up capital in relative percentages of total capital. The instrument also probed the manner in which credit cards were used in two separate sections, usage related to the start-up phase of respondents’ businesses, and usage related to the ongoing capital needs of businesses. Additional demographics were also identified.

Data Collection

An invitation to participate in the study was sent to all members of the population by mail, utilizing a post card. Respondents were asked to go to an online survey, or to make other arrangements to participate by mail, fax, or telephone. Of the 830 cards that were mailed, 70 (11.86%) were returned as undeliverable. 32 completed instruments were collected, inclusive of both paper and online surveys. At the time of this writing, surveys are still being received.

Results

Demographics for survey respondents showed that the breakdown in terms of legal entity of the responding businesses were 56.3% proprietorships, 15.6% S-corporations, 15.6% C-corporations, and 12.5% as limited liability corporations. Franchises made up 6.25% of the respondents with the remainder independently-owned businesses. Gender breakdown was 37.5% female and 59.4% male – the remaining 3.1% representing individuals who chose not to identify their gender. Of the businesses that did respond, 38.5% had been in business about four years, 15.4% for 3 years, 15.4% for 2 years, with 30.8% in business for one year or less. Approximately 87.1% of the businesses currently had one to four employees, 9.4% had five to nine employees, and 6.3% had ten to nineteen employees. No business had more than nineteen employees.

Responses from the survey portrayed a compelling picture of the use of credit cards by entrepreneurs. Entrepreneurs tend to use credit cards extensively in the funding of start-up capital, ranking second only to personal savings among the most commonly used forms (Table 1). Among respondents to the survey, 37.5% indicated that credit cards played a role in the collection of start-up capital, and provided 26.2% of the capital needed to those individuals.

Table 1 about here

Personal savings was mentioned less than twice as often (68.8%), but it provided more than twice the capital (56.0%). Overall, personal savings provided an average of 39.8% of the funding needed by entrepreneurs to start-up a business – the clear leading source based on average percentage of funding overall. Interestingly, although credit cards and personal savings were most commonly used, the funds provided were less as a percentage of total capital generated than would be expected based on the frequency of their usage. In fact, credit cards provided less funding (based on average percentage of funding if used) than any other source besides loans from friends. Based on this information, it may follow that credit cards are seen as a necessary source of funds in terms of access but not in terms of magnitude of funds. Another additional important finding from Table 1 is the lack of identification of venture capitalists and angel investors as sources for start-up capital – not a single respondent acknowledged either as a source for start-up capital.

External sources such as banks were relied upon heavily by those that tapped into those sources. Based on the survey, 46.9% of the respondents specifically identified a bank or some other formal arrangement such as a home equity loan as a source for start-up capital. A full two-thirds of the respondents indicated some sort of collateral usage when formal external sources were engaged. Moreover, banks (with and without collateral) provided some of the highest percentages of capital funding when those sources were utilized.

In analyzing our data, we also observed that start-up capital obtained from sources based on personal wherewithal was utilized by 84.4% of the respondents and accounted for 82.4% of total start-up funding on average. For purposes of our analysis we defined personal wherewithal as the aggregate total of credit cards, borrowing from relatives and friends, personal savings, and home equity loans. Our logic in doing so was to glean a view of the data in such a way that we might discern the value of social capital, personal assets, and borrowing power.

Of those that used credit cards for start-up capital, 25% of the respondents indicated that one or more business credit cards were utilized compared to 91% who identified personal credit cards as the source. Those using personal credit cards borrowed over a quarter of all startup capital from their personal credit cards on an average of 2.55 personal credit cards per person.

Table 2 shows the association between users of personal savings and credit cards for start-up capital. Based on those that identified either source as a basis for funding, the table indicates that it is relatively rare for someone to tap into credit cards when personal savings are not used (or non-existent as the case may be). The preference appears to be for the use of personal savings alone, with the secondary choice of credit cards to complete the funding, although the exact nature of this relationship could not be confirmed within the survey. Additionally, it appears that

those that use personal savings are more likely to utilize credit cards than those that do not use personal savings.

Table 2 about here

Fifty percent of respondents using credit cards indicated that the associated debt from start-up had yet to be paid off. This is not surprising in that 75% of those utilizing credit cards for startup capital named “Ease of acquiring un-secured capital” as their primary purpose for their use; another 17% indicated it was their only source of capital. Indeed, the results of the survey identified instances of entrepreneurs “floating” their borrowing using one credit card to pay off another. Table 3 shows the satisfaction and recommendations of that group concerning the use of credit cards for start-up capital. Clearly, those that had somewhat or more satisfaction with their use tended to recommend their use to emerging entrepreneurs as a source of start-up capital whereas individuals that were neutral or less satisfied tended to not recommend their use. Overall, 46.2% of individuals who used credit cards would recommend their use while 53.8% would not.

Table 3 about here

Table 4 shows the relative uses of credit cards in terms of purchases made during the start-up phase and on-going business. Not surprisingly, purchases during the start-up of the business tended to include more goods and equipment, whereas ongoing purchases tended to favor operational needs. Conferences/Seminars/Workshops/Training and Business Travel, Meals, and Entertainment became integral on-going credit card expenses, while small pieces of equipment and major equipment went to zero. An interesting yet clarifying view can be seen in the shift from “cash for survival” in start-up to “office rent” and “advertising” when the business is ongoing.

Table 4 about here

Discussion and Implications

This study examined approaches to initial capitalization of start-up businesses as well as the use of personal and business credit cards to meet ongoing capital needs. We were interested in exploring the use of capital sources beyond those that are often emphasized in entrepreneurship text books, such as investment bankers, venture capitalists, and angel investors. Given the dearth of existing scholarly research related to the use of credit cards for the above purposes, our efforts were envisioned as a pilot study to guide future inquiry to be undertaken by both ourselves and other scholars.

Moreover, since credit cards are being used relatively frequently for starting businesses as well as managing ongoing operations in actual practice, they should be formally acknowledged as worthy of additional study. Although members of the business press have already acknowledged the phenomenon, except to an extremely limited degree, scholars have not as yet demonstrated a reciprocal level of interest.

Some of the more interesting implications of our study became visible after we began to combine sources under other logical typologies, such as “personal wherewithal,” discussed above. According to our findings, approximately eight out of ten start-ups, and eight out of ten start-up dollars, can be linked to personal wherewithal. This finding suggests important implications for the classroom, for scholars, for practitioners, including the lending community. In particular, additional emphasis should be placed upon educating would-be business founders on the role, risks, and rewards of using personal savings, credit cards, social capital, family and friends, home equity loans, and other personally leveraged strategies to capitalize business start-ups. We would also note some irony as it relates to bankers’ reputations for being reluctant to become involved with unsecured transactions for new businesses: in some cases, they are funding unsecured loans for start-ups through credit cards, anyway!

Limitations and Future Research

The results of this study must be interpreted in light of several limitations. First, the response rate to the survey was low. The methodology used to collect the data directed participants to go to an online site to complete the survey, or to make other arrangements that would require additional efforts on the part of respondents to participate by mail, fax, or telephone. It could not be determined how many nonrespondents did not have online response capability (i.e., a computer, time, or both); respondents who lacked a fax capability would have faced analogous impediments. Second, because of the exploratory nature of this study, the survey instrument was the first to gather data used in this kind of research. Further refinements of the instrument will lead to improvements in the quality and clarity of responses. Third, this study was not designed to identify the reasons why entrepreneurs use credit cards for initial capitalization in place of other sources (e.g., personal savings, relatives, venture capitalists). Fourth, entrepreneurs and small business owners subject to the same set of circumstances may decide differently on the use of credit cards. This study was not designed to examine how individual entrepreneurs and small business owners would behave under similar (and dissimilar) circumstances. Fifth, the current study was primarily designed to examine the use of credit cards as a source for initial funds for start-up businesses; thus, the study did not attempt to examine the impact which personal savings, investment bankers, venture capitalists, angel investors, and other sources of capital have on the use of credit cards.

Despite the above limitations, the study provides some of the first evidence that connects entrepreneurial credit card usage with founders’ motives. The study’s measures included credit card usage in the context of competing choices (including “no other choice”). Further, the study probed entrepreneurs’ satisfaction, or lack thereof, with the use of credit cards for start-up purposes or ongoing capital needs.

Future research opportunities abound because of the scant amount of research in the area of credit card use for initial capitalization or ongoing capital needs. The impact that alternative sources of capital for start-up (e.g., personal savings, investment bankers, venture capitalists, and angel investors) have on each other is an interesting question that can be answered by future research. The study’s findings have provoked additional questions about entrepreneurs’ attitudes toward the use of credit cards, by suggesting other possible attitudinal variables to examine, such as: “sensible in moderation” or “never” a good idea. Another opportunity for further research

lies in examining the relationship between perceptions of credit card use and behavioral characteristics such as risk aversion, personality, performance, and gender. Thomas (2001) identified women entrepreneurs as showing a preference for credit cards and personal loans for financing purposes compared to the use of equity funding for the same purpose. Thomas' results suggest behavioral variables may exist which may explain why credit cards may be used before (or after) other alternative financing devices.

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TABLES

Table 1. Start-Up Capital Sources and Percentage Frequency (n=32)

	Percentage Used ^A	Average % Funding Overall _B	Average % of Capital Funding if Used ^C
Credit Cards	37.5%	10.1%	26.2%
Relatives	28.1%	12.7%	43.8%
Friends	3.1%	0.8%	25.0%
Bank w/ Collateral	18.8%	11.8%	60.8%
Bank w/o Collateral	18.8%	10.9%	56.1%
Venture Capitalist	0.0%	0.0%	N/A
Angel Investor	0.0%	0.0%	N/A
Home Equity Loan	18.8%	8.3%	43.1%
Personal Savings	68.8%	39.8%	56.0%
Other Sources	6.3%	5.6%	87.0%
		100%	

^A - Percentage used will not sum to 100% as multiple sources are used by most respondents.

^B - Average of percentage of funding reported by all respondents.

^C - Average of the reported percentage of funding for those who utilized that source.

Table 2. Frequency of Credit Card Use and Personal Savings for Start-Up Capital (n=26)

		Personal Savings		Total
		Yes	No	
Credit Cards	Yes	28.1%	9.4%	37.5%
	No	40.6%	21.9%	62.5%
Total		68.8%	31.3%	100.0%

Table 3. Satisfaction with and Recommended Use of Credit Cards for Start-up Capital (n=13)

Satisfaction ^A	Recommend Use ^B	
	Yes	No
Extremely Satisfied	15.4%	0.0%
Somewhat Satisfied	15.4%	7.7%
Neutral	15.4%	23.1%
Somewhat Dissatisfied	0.0%	23.1%
Extremely Dissatisfied	0.0%	0.0%

^A - Satisfaction with use of credit cards for start-up capital.

^B - Whether respondent would recommend the use of credit cards for start-up capital to emerging entrepreneurs.

Table 4. Primary Uses of Credit Cards during and after Start-Up Phase (n=32)

Use	Purchases during Start-Up Phase	On-going Purchases
Business Supplies	69.2%	81.3%
Small pieces of equipment	61.5%	0.0%
Business travel, meals, and entertainment	38.5%	81.3%
Inventory	15.4%	12.5%
Major equipment	15.4%	0.0%
Insurance	7.7%	6.3%
Cash advance for survival	7.7%	0.0%
Maintenance contracts	7.7%	0.0%
Conferences/Seminars/Workshops/Training	0.0%	50.0%
Memberships	0.0%	18.8%
Publications	0.0%	12.5%
Advertising	0.0%	6.3%
Office Rent	0.0%	6.3%