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Small and Medium-Sized Enterprises Financing: A Review of Literature

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Abstract: There is no doubt that access to finance is of crucial importance for the ongoing and sustainable growth and profitability of small and medium enterprises sector (SMEs) through its role in facilitating the creation of new businesses and nurturing the innovation process as well as promoting the growth and development of existing businesses, which in turn, boost national economic growth. The main motive of this paper is that SMEs significantly differ from large firms in terms of their financial decisions and behavior. Hence, the purpose of this paper is to review the literature on the various financing sources of SMEs taking into account the effects of both SME characteristics and those of the owner–managers on SME financial behavior.

Keywords: Small And Medium Sized Enterprises SMES, Financing.

I. INTRODUCTION

The availability of finance has been highlighted as a major factor in the development, growth and successfulness of SMEs (Ou& Haynes, 2006; Cook, 2001). Financing methods employed by SMEs vary from initial internal sources, such as owner–manager's personal savings and retained profits (Wu,Song, &Zeng, 2008) to informal outside sources, including financial assistance from family and friends (Abouzeedan, 2003), trade credit, venture capital and angel financiers (He & baker, 2007), and thence to formal external sources represented by financial intermediaries such as banks, financial institutions and securities markets (Chittenden, Hall, & Hutchinson, 1996). According to the financial growth cycle paradigm proposed by Berger and Udell (1998) financial needs and the financing options available for SMEs change throughout the various phases of a firm's lifecycle. In other words, at different stages of the firm's growth cycle, different financing strategies are required. In general, because of the unique features that characterize SMEs during the start- up phase, such as informational opacity (Berger & Udell,1998), a lack of trading history (Cassar, 2004) and the high risk of failure (Huyghebaert& Van de Gucht, 2007), SMEs in this stage depend heavily on insider funding sources.

II. SMES CHARACTERISTICS

In general, the characteristics of SMEs affect their financial decisions and behavior and ultimately the firm's performance and growth. In this context, the literature has identified several characteristics peculiarly related to the SMEs sector as factors influencing the financial behavior of firms in this sector. These include firm size and age, ownership type and legal form, geographical location, industry sector and asset structure (reflecting the ability to provide collateral).

A. Size and Age

Even though there is no consensus amongst researchers about the criteria that should be employed to measure the size of the firm (typically total assets, sales or the number of employees), the notion that firm size has an effect on SME's activities and its potential to expand appears to receive general agreement. A firm's size is usually coupled with its age as they tend to have similar influence on the firm's life cycle. This influence can be strongly observed in the decision making process in the firm about whether one particular sort or another of finance should be chosen and utilized (Cassar, 2004). Studying firms financing and capital structure using a sample consisted of 292 Australian firms, Cassar (2004) concluded that the "larger" small firms are, the more they rely on long-term debt and external financing, including bank loans. This is consistent with Story (1994) who found that in the case of SMEs, the owner–manager's personal savings are more important as a source of funds during the start-up stage than outside finance such as loans and overdrafts from banks. From another angle, the extent to which firm size can impact the availability of finance to the firm was measured by Petersen and Rajan (1994). They argued that as firms grow, they develop a greater ability to enlarge the circle of banks from which they can borrow. They then provided evidence that firms dealing with multiple banks and credit institutions are nearly twice as large as those with only one bank.

B. Ownership Type and Legal Form

There is a positive relation between SME leverage and the type of organisational structure (Coleman & Cohn, 2000). This is in line with Abor (2008) who identified the form of business as one of the factors explaining the capital structure decisions of Ghanaian SMEs. In addition, ownership structure and the type of firm were found to have a significant impact on the use of bootstrap financing. Van Auken and Neeley (1996, p. 247) state that:

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C. Location

The geographical area where a firm is located in the proximity of banks is also believed to have an influence on the firm's ability to gain external finance. For example, SMEs located outside major cities face greater difficulties in acquiring external finance, especially long-term debt, compared with their counterparts operating in cities (Abor, 2008). In the same regard, Fatoki and Asah (2011) added that the geographical location of SMEs close to their banks advantages them in that they can better cement relationship lending with those banks. As a result, SMEs are better able to access bank loans using no more than soft qualitative information.

D. Industry Sector

A number of studies evidenced that factors related to the industry sector in which a firm operates also explain capital structure and financial decisions (Mackay & Phillips, 2005; Michaelas, Chittenden & Poutziouris, 1999). Firms in the services sector, for example, can differ from those operating in manufacturing or construction in terms of financial needs and choices. Michaelas et al. (1999) empirically analysed the different capital structure determinants across time and industries utilizing a sample of 3,500 randomly selected SMEs across ten industries in the UK. They summarised that the impact of industry on short-term and long-term debt varies greatly across industries.

E. Assets Structure

As the provision of collateral plays an indispensable role in easing SME access to debt finance. SMEs that have more fixed assets tend to utilise higher financial leverage (Bradley, Jarrell, & Kim, 1984). The reason for this is that these firms can borrow at lower interest rates as their loans are secured with these assets serving as collateral. This explains why Coco (2000) describes collateral as the lender's second line of defence.

II. OWNER-MANAGER CHARACTERISTICS

The personal characteristics of the owner-manager also make a difference to the firm's ability and likelihood of accessing external finance (Irwin & Scott, 2010; Cassar, 2004). The reason is that the owner–manager in SME has the dominant position in the firm in their role as the primary decision maker. For example, Berggren, Olofsson and Silver (2000) reasoned that most owner–managers in SMEs do not prefer to finance firm operations using external finance, particularly as it entails changes in ownership structure whereby such financing may lead to control aversion. In the same vein, it has been shown that SME owner–managers themselves exert a noticeable influence on their firms' financing decisions and subsequently performance and growth (Vos, Yeh, Carter, &Tagg, 2007; Coleman, 2007).

A. Owner-Manager Gender

Female and male entrepreneurs generally differ in the way they finance their businesses (Verhuel&Thurik, 2001; Carter & Rosa, 1998). As reported in the enterprise literature, the issue of differences in financing sources related to gender among SMEs is more highlighted during the introductory (start-up) stage. For example, Verhuel and Thurik (2001) found that although men and women do not significantly differ with regard to the type of capital, women SMEs owners appear to have a smaller amount of start-up capital. In addition, women-owned SMEs begin in business with less than half of capital amount used by men and face more credibility issues when dealing with bankers (Badulescu, 2011). In parallel, Mijid (2009) found higher loan denial rates and lower loan application rates among female entrepreneurs. Coleman (2007) also provided evidence of credit discrimination against female entrepreneurs as they were more frequently charged higher interest rates and asked to pledge additional collateral in order for loans to be granted.

B. Owner-Manager Age

It is often found that the personal financing preferences of entrepreneurs appear to change according to age. According to Romano, Tanewski and Smyrnios (2001), the effect of the owner–manager's age on the financial behaviour of SMEs can be noted in that unlike younger entrepreneurs, older entrepreneurs are less likely to invest additional finance into their firms. This finding is in line with that of Van der wijst (1989) who suggests that older SME owner–mangers are more reluctant when it comes to accepting external ownership in the firm. Further, Vos et al., (2007) examined SME financial behaviour utilizing two data sets from the UK and the US consisting of 15 750 and 3 239 SMEs, respectively. The results show that younger owner–managers tend to use more bank overdrafts and loans, credit cards, own savings, and family sources than older owners who appear to be more dependent on retained profits.

C. Owner-Manager's Education and Experience

Employed by institutional financiers as a proxy for human capital, the educational background of the SME owner–manager is often positively related to the firm's usage of leverage(Coleman,2007). A study by Bates (1990) examining the impact of owner–manager's personal characteristics on SME longevity across a wide sample of SMEs owned–managed by men across the US between 1976 and 1986 concluded that owner–managers who had higher levels of education were more likely to retain their firms operating throughout the period of study. He further emphasised that the level of education of entrepreneurs is a major determinant of banking loans amounts offered to SMEs. As for the demand side, Storey (1994) asserts that higher levels of education provide entrepreneurs with greater confidence in dealing with bankers and other funders when applying for loans.

IV. SOURCES OF SMES FINANCE

A. Equity Financing

Due to moral hazard and problems with information opacity typically being more severe during the initial stages of SME development, internal equity financing, as best represented by owner–manager personal savings, is a critical source of funding for SMEs in these early stages (seed financing and start-up). Subsequently, in later stages, in order to develop

and grow SMEs tend to reduce their dependence on these sources and start seeking alternative channels for raising capital. Internally generated profits and venture capital exemplify just two of the other equity options SMEs seek to expand as they grow. In general, "…equity capital is that capital invested in the firm without a specific repayment date, where the supplier of the equity capital is effectively investing in the business" (Ou& Haynes, 2006, p. 156). Equity capital can be raised either internally or externally. Internal equity is funds obtained from the current owner–manager(s), family, and friends or from the retained earnings within the firm. External equity, however, is capital acquired from external channels other than the existing partners and their relatives.

1.Venture Capital: Venture capitalists are financial intermediaries. Venture capital is that form of financing in which funds are raised from investors and redeployed by investing in high-risk information ally opaque firms which for the most part are young or start-up firms (Potter & Porto, 2007). Further, venture capitalists decide the timing and type of investment in addition to their role in monitoring, screening and contracting (Gorman &Sahlman, 1989). Moreover, by performing these functions, venture capitalists virtually participate in strategic planning and decision making in the firm. The venture capital market includes a variety of organizations, including public corporations, small business investment corporations and private limited partnerships.

2.Business Angels: Unlike other external sources of financing, business angel finance is not intermediated. It is instead an informal market for direct finance (Berger &Udell, 1998). Angels are highly-selective wealthy individuals with long business experience who invest directly in high growth SMEs with which they have had no previous relationship (Madill, Haines, & Riding, 2005). This form of investment is usually based on an equity contract, typically common stock. Though angels by definition are individuals, they sometimes coordinate their investment in small investment groups. According to Harrison and Mason (1992), there are three features that make angel financing an appropriate option for SMEs. First, angels are more active in the early stages of enterprises (seed and start-up) closing the so-called 'equity gap' by forming a 'bridge' between internal financing sources and outside investors. Second, by having lower rates of rejection and being a more patient form of capital with longer exit horizons, angel financiers tend to be more obliging to the needs of SME owner–managers. For example, German entrepreneurs have ranked business angels as the most desirable funding providers (Brettel, 2003). Finally, unlike venture capitalists, angel investors prefer to invest in their local economies where the majority of SMEs operate.

B. Debt Financing

It is well known that capital structure decisions, in SMEs as in large firms, relate to the use of either equity or debt or both. However, Berger and Udell (1998) believe that in the case of SMEs, this is partly incorrect because information opacity is more severe in SMEs. Issuing additional equity to satisfy the firm's financial needs would then lead to a dilution in ownership and control. Therefore, in order to keep full ownership and control of their businesses, SMEs owner–managers may prefer to seek debt financing rather than external equity. Three significant differences between debt financing for SMEs and that of large firms have been identified in the literature (Wu et al., 2008). First, unlike managers of large firms who usually have the choice of broader range of debt financing resources, SMEs tend to be more attached to commercial lenders, especially institutional lenders, as a source of short-term debt financing that can be renewed for long-term debt. Second, as information asymmetry problems are more acute in SMEs than in large firms, long-term lending relationships are important for SMEs in order to deal with the resultant agency problems along with the other three conventional mechanisms; signaling, monitoring and bonding (the provision of guarantee or collateral). Third, in concentrated owner–managed SMEs, and contrary to what the agency theory suggests, it is not clear whether debt can lower the agency costs that result from information asymmetry arising due to different motives of owners and managers.

1. Trade Credit: One of the most important sources of external financing for SMEs is trade credit. For instance, Berger and Udell (2006) estimated that one-third of the total debt of SMEs in the US in 1998 was represented by trade credit. According to García-Teruel&Martínez-Solano (2010) trade credit is a delay in the payment for goods or services after they have been delivered or provided as a result of an agreement between the supplier and the firm. Therefore, for the firm this is a source of financing appears in the balance sheet under current liabilities, whereas for the supplier it is an investment in accounts receivable.

2.Nonbank Financial Institution Debt: As finance institutions tend to differ from banks in their lending policies possibly in part because of regulatory differences (Berger &Udell, 1998) and following Ayyagari, Demirgüç-Kunt and Maksimovic (2010) who separate bank finance from other nonbank financial institutions funding, the focus in this section is on nonbank financial institutions as the role of banks will be discussed in the later section.

C. Bank Finance for SMEs

A large body of the existing literature has documented that banks are the main external capital provider for SMEs sector in both developed and developing countries (Vera &Onji, 2010; Ono &Uesugi, 2009; Zhou, 2009; Wu et al., 2008; Carey & Flynn, 2005; Cole &Wolken 1995). De Bettignies and Brander (2007) assume that bank loans are available for SMEs on competitive and fair basis.

D. Government Assistance and Initiatives

In both developed and developing countries, governments have recognized that the SME sector faces constrained access to external financing which may negatively affect its crucial role in achieving national development goals. As such, many governmental initiatives programs have been implemented to

ensure SMEs have easier access to financing, of which credit guarantee loans, factoring programs and subsidized fees are typical examples. According to Mensah (2004, p. 3), government official schemes are those introduced by government either alone or with the support of donor agencies to increase the flow of financing to SMEs. It has been argued that such programs and schemes have the capability to ease the access of SMEs to additional credit (Boocock&Shariff, 2005). However, Riding, Madill and Haines (2007) maintain that government schemes aim at assisting access to finance for SMEs can be effective only under well-specified conditions. In addition, as SMEs are subjected to credit rationing due to their small size and information asymmetry Zecchini and Ventura (2009) suggested that in order to be effective such schemes should aim at lowering the degree of discrimination against SMEs borrowers in terms of lending costs and unmet demand for fund. Moreover, as for SMEs operating in the export sector, Albaum (1983) recommended that it should be taken into account that not all firms are at the same phase of export development, thus a set of programs targeting firms at different stages of export development is essential.

1. Musharakah: Musharakah as a mode of Islamic finance can be defined as "form of partnership where two or more persons combine either their capital or labour together, to share the profits, enjoying similar rights and liabilities" (Al-Harran, 1993, p. 47). In this form, the profits are shared according to a pre-determined agreed ratio, however, in the case of loss it will be shared based on capital contribution ratio. Additionally, In Musharakah contract all partners are entitled to have a role in the management of the project. According to Lewis and Algaoud (2001) Musharakah contract can be either permanent or diminishing contract. In the former contract, which may last to limited or unlimited period depending on the original agreement, annual equal shares of the profit/loss are ensured for both parties based on pre-agreed deal. In the latter, however, capital is not permanent since the financier receives profits on a regular basis diminishing his/her equity. Consequently, this will gradually increase the total capital of the client till he/she becomes the only owner of the project.

2.Murabahah: Among all Islamic financing modes Murabahah is the most distinct and the most popular. Under Murabahah contract the financier (often Islamic bank) purchases or imports certain goods or commodities (assets or raw materials) ordered by the client and then resells them to the entrepreneur after adding a negotiated profit margin (Dhumale&Sapcanin, 1999). Under this contract the payment is due in installments. It can be inferred that Murabahah transaction entails two contracts. The first contract is that one between the financier (usually the bank) and the supplier of the goods/commodities. The second is between the financier and the client who applied for the goods/commodities. The fundamental principles that characterize Murabahah contract are summarized in (Gait & Worthington, 2007). First, the goods/commodities must be clearly classified and identified on the base of accepted standards and must be provided by the time of sale. Second, at the time of sale goods/commodities must be completely owned by the financier. Third, the entrepreneur must be informed of the cost price at the sale point. Finally, both the time of goods/commodities delivery and the due date of payment must be clearly specified.

3. Mudarabah: Gafoor (2006) described Mudarabah contract as a profit sharing and loss absorbing rather than profit and loss sharing contract. Mudarabah is a contract between two parties; a capital owner and an investment manager, under which profit is distributed in accordance to a ratio that is pre-agreed between the two parties at the time of the contract, whereas, financial loss is borne solely by the capital provider and the manager losses his/her effort and the expected profit. In other words, Mudarabah refers to two parties involve together to establish a project whereby one party (individual or bank) provides the capital needed and plays no further role in the project while the other (entrepreneur) offers his/her skills, experience and effort. Profits are then divided between the two parties on the base of pre-determined ratio. In the case of loss, however, the financier entirely bears the financial loss and the entrepreneur bears the operating losses and receives no reward for his/her effort. One exception that the entrepreneur becomes liable for the amount of capital invested is in the case of negligence and breach of the terms of the contract (Abdulrahman, 2007).

V. CONCLUSION

The increasing importance of economic contributions made by SMEs sector necessitates better understanding of financial behavior and practices of SMEs. Taking into consideration that the financial behavior of large firms cannot be applied to SMEs as large firms significantly differ from SMEs, this paper surveys the literature on the various financing sources available for SMEs including Islamic financing methods. In order to attain more in-depth understanding of the financing decisions of SMEs the paper also explores the effects of the characteristics of both SMEs and their owner-managers on the financing methods chosen and employed by SMEs.

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