

# **Determinants of small & medium scale enterprises' financing: with special reference to small & medium scale Enterprises in Badulla District**

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## **Introduction**

Role of the Small and Medium sized enterprises (SMEs) is vital for economic development. Contribution to national income, job creation, poverty alleviation and exports promotion are some examples for their contributions. SMEs have become an important contributor to the Sri Lankan economy. In Sri Lankan context SMEs can be defined as enterprises that have employees between 10 and 99 (World Bank Definition for Sri Lanka). According to this definition around 90% of Sri Lankan businesses can be identified as SMEs. Their contribution to industrial value added is around 20% and it provides over 35% employment opportunities.

SMEs can fulfill their financial requirements with both formal and informal financial sources. Kushnirovich and Helibrunn (2008) identified own savings as a most significant financial source. Basu and Goswami (1999) revealed own savings and informal capital as major financial sources of SMEs. However, selection of financing sources depends on various factors in SMEs context (Gangata & Matavire; Kira & He, 2012). Moreover, Altinay and Altinay (2006) revealed variables such as ethnicity, age of owner, firm characteristics, owner's education and language skills are significant determinants of financing decision.

There is an immense potential to enhance SMEs contribution to economic development. However, despite of their major contributions, SMEs are facing a number of obstacles to develop. In developing countries, such as Sri Lanka, access to finance is the most important obstacle to SMEs and it creates entry and growth barriers for them.

Although there is an increase in supply of formal credit, Haugen (2006) identified informal lenders as dominant source of SME finance. Further, financial institutions are considering SMEs as high risk ventures. Hence, it is difficult for SMEs to access in to formal financing sources. Moreover, Titus and Huka identified flexibility, availability, less paper work and official requirements and accessibility as advantages of informal financing. In this end, this research intends to contribute to identify determinants of informal financing in the context of SME financing in Sri Lanka.

## **Methodology**

SMEs in Badulla district which registered under Chamber of Commerce in Sri Lanka have identified as the population of this research. A sample of 50 SMEs was considered based on systematic sampling method. A questionnaire was administered to collect primary data and published articles and journals were used in order to gather secondary data. Descriptive statistical techniques were used to discover and summarize the attributes of the sample. Furthermore, correlation coefficient analysis was also used to combine the contribution of each parts of the independent variable. The regression model can be expressed as follows.

$$FP = \beta_0 + \beta_1IA + \beta_2LF + \beta_3ME + \beta_4CR + \zeta$$

Where,  $\beta_0$  was the constant term and  $\beta_1$  to  $\beta_3$  Were Co-efficient to be estimated while IA, LF, ME, and CR were respectively Information asymmetry, Legal and regulatory framework, Economic environment and collateral requirement. Further, FP represent financing pattern and  $\zeta$  denotes the error term.

### Results and discussions

In this research, trade credit, money lender, retained earnings and friends and relatives were identified as informal financing sources while registered pawnshops, credit guarantee, bank loan, leasing, and venture capital were identified as formal financing sources. As illustrated in figure 1 retained earnings, trade credits, bank loans and friends & relatives are most popular financing sources among SMEs respectively. Hence, it is obvious that most of the SMEs are utilizing informal financing sources to finance their businesses.

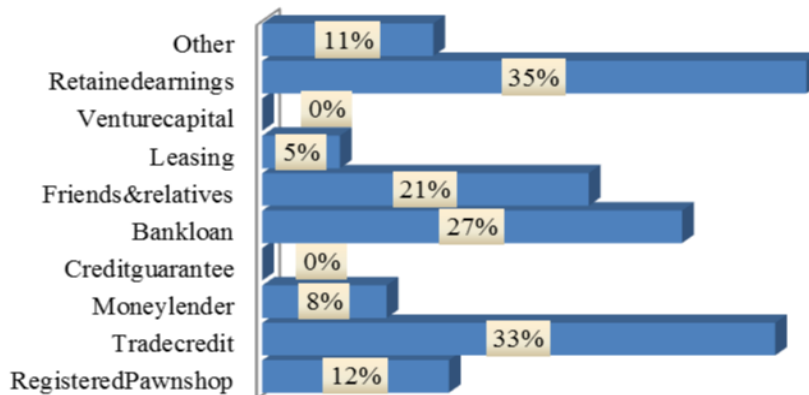


Figure 01: Financial Patterns of SMEs Source: Survey Data

According to the Table- 1, it can be identified that there is a statistically significant ( $P < 0.05$ ) strong positive relationships between IA, LF and CR with financing pattern of SMEs. Further, EE do not have statistical significant relationship with FP. This suggests that there is overwhelming evidence to say that IA, LF and CR affects to financing pattern of SMEs.

Table 01: Correlation between IA, LF, EE and CR with FP

Variable	Pearson correlation	P-value
Information asymmetry	.821	.000
Legal and regulatory frameworks	.859	.000
Macroeconomic environment	.155	.283
Collateral requirement	.675	.000

Source: SPSS output of surveyed data

The results of the multiple regression analysis can be summarized as follows.

$$FP = -2.409 + .533 IA + .555 LF + .127 EE + .478 CR + \delta$$

Hence, it is clear that legal and regulatory framework is the most prominent influencing factor to the financing pattern of SMEs among other selected variables. Information asymmetry and collateral requirement also influencing to SMEs financial pattern in considerable manner and the influence of economic environment is less than the other variables.

## Conclusions

This research was conducted to identifying the determinants of SME financing. Information asymmetry, Legal and regulatory framework, Economic environment and collateral requirement were identified as independent variables while financing pattern were taken as dependent variable. It was found that all independent variables positively affects to SMEs financing decision while legal and regulatory framework were identified as most prominent factor.

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