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DETERMINANT OF FINANCING OPTIONS OF SMALL BUSINESS IN KWARA STATE, NIGERIA

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ABSTRACT

Nigeria is a country blessed with large numbers of small businesses especially in agriculture, craft and artisans, as such there is the need for small business enterprises to have access to efficient finance. The study is therefore aimed at investigating the determinant of financing options of small business in Kwara state, Nigeria. A structured questionnaire was randomly distributed among owners of 300 small business spread among the three senatorial district of the state. A logistic regression model was adopted for the study in the form of $Y = a + B_1X_1 + B_2X_2 + B_3X_3 + B_4X_4 + B_5X_5 + e$. Finding shows that 82 percent of respondents will rather go to the debt market rather than absorb equity holders. It was also discovered that majority of the respondents were aware of the existence of formal institution but they do not have assets that can be used as collateral. The study concludes that the inaccessibility of formal financial institutions is a major constrain to Finance. It was therefore recommended that more support should be given through micro finance institutions to support people with sound business ideals.

Keywords: Small Business, Financial Institution, Enterprises Determinant

Introduction

Evidences have shown that there is a place for small businesses in the economic advancement of any nation, be it a developed or developing economy. This is especially the case for newly industrialized countries that are moving from a command economy to a market economy in order to foster sustainable competitive advantage and economic development (Wu, Song and

Zeng, 2008). Countries like Malaysia, Indonesia and China, among others, were able to achieve economic growth partly through the activities of their vibrant Small and Medium Scale Enterprises (SMEs) which later transformed to Large-Scale enterprises. According to Schmidt (1945), Small business is the economic seed bed from which rise the majority of new ideas, new methods and the inventions of the nation even though they are frequently less efficient than the large business. Small firms in no small measure contribute to the goods and services available for consumption, capital formation and balance of payment.

Nigeria, however, is a country characterized by a large number of small-scale businesses, especially in the agriculture, craft and manufacturing sub-sector, hence, there is the need for the small-scale and medium-scale businesses in the country to have access to appropriate, reliable and efficient sources of finance to be able to operate effectively as a step towards building a vibrant and diversified economy. Successive governments in Nigeria, have not relented in their effort in launching several policy measures, program and institutions upon realizing that the development of SMEs is what is required to enable the country's industrial sector meet the contemporary changes of globalization, economic restructuring and poverty alleviation. Among these policy packages is the National Economic Empowerment Development Strategy (NEEDS) in which small and medium enterprises growth strategy is an integral part. Another institutional package is the Small and Medium Enterprise Development Agency of Nigeria (SMEDAN). The Central Bank of Nigeria is also making efforts aimed at complementing the government efforts like the launching of Small and Medium Industries Equity Investment Scheme (SMIEIS). Hence, Nigeria cannot be said to be short of policy program and institutions that could facilitate the development of the SMEs including direct participation, alone or jointly with the private sector, interest groups, assistance from external agencies, provision of industrial incentives and adequate finance.

New businesses require finance to purchase the goods and services, to build up the basic infrastructure and to provide working capital pending when turnover will be able to cover business costs more so that expenses may exceed income for long periods during start up (Rouse and Jayawarna, 2006). At this stage, most small businesses rely on informal finance source, majorly personal savings or money from relatives and friends, to fund the business. Some of the reasons for this include lack of business skills, track records and they may not initially be in the position to present an attractive investment avenue for finance providers. As the business starts growing, it is expected that such business should be able to raise funds from the formal sector to expand its operations, as personal savings will no longer be able to sustain the business more so that the company is now more experienced and transparent but this is not so in most

cases. Consistent empirical evidence has shown that small businesses continually complain about being competitively disadvantaged because of their inability to access fund from the formal sector. It is therefore difficult to say whether a particular financing pattern is just an issue of preference or desperation borne out of limited access or constraints to formal finance (Osei-Assibey, Bokpin and Twerefou, 2012).

It is against this background and with the increasing importance of small businesses in nation building that this study intends to investigate the determining factors of financing options of small businesses in Kwara State, Nigeria, with a view of finding out if the financing options at start up stage is borne out of preference or limited access to formal finance. Most previous studies on SMEs dwelt more on the problems facing Small businesses in accessing finance (Ogboru 2007, Wu, Song and Zeng 2008) while little has been done on the factors influencing financing options among Small businesses

Conceptual Issues

There is no generally accepted definition of a small business because the classification of businesses into large-scale or small-scale is subjective and requires qualitative judgement (Ekpenyong and Nyong 1992). In Ketchum (1994) view, the concept has both qualitative and quantitative aspects in the sense that in trying to define the concept, there is no clear cut quantitative and qualitative distinction. However, the general consensus has been that the statistical definition of small or medium enterprise differs by country and mostly based on the number of employees or the value of assets (Ogboru, 2007).

Similarly in Nigeria, several institutions and agencies have attempted to define small and medium scale enterprises using different yardsticks (like total investment, turnover, number of employees) but still, there is no agreement on the figure which should be used as the dividing line of differentiating small from medium or large scale businesses. In fact, most of the definitions only differentiated small from large scale businesses while being silent about medium scale businesses. For instance, in the 1990 budget, the federal government of Nigeria defined small-scale enterprises for purposes of commercial bank loans as those with an annual turnover not exceeding 500,000 naira, and for Merchant Bank Loans, those enterprises with capital investments not exceeding 2 million naira (excluding cost of land) or a maximum of 5 million naira. A statistically different definition is the one given by the Company and Allied Matters Decree of 1990 that defined small company as one with annual turnover of not more than N2million and net assets value of not more than N1 million. Another statistical measure was given by the National Economic Reconstruction Fund (NERFUND) that put the maximum capital investment of small scale businesses at N10 million.

Definitions of small businesses continue to evolve according to particular scholars, environment and disciplinary backgrounds as well as their perceptions of present day realities as it is not practical to adopt a universal definition. However, while trying to avoid embracing all sectors in one definition, the Committee of Enquiry on Small Firms that was set up in UK in 1969 came up with three characteristics of small firms which makes them clearly distinguishable from other forms of business (Waite, 1973)). The first being smallness of market share corresponding to the theoretical concept of pure competition. The second is that management is not separated from ownership while the third characteristic is that the owner who doubles to be the manager is independent and free from outside control in taking principal decisions. Hence, even though there is no agreement in statistical definition of small firms, there is the consensus that these attributes are common to small firms.

Sources of Finance

A diverse range of finance mix is employed by small businesses. In Nigeria, however, the three main sources of financing to small scale businesses as categorised by Ekpenyong and Nyong (1992) are formal financial institution (commercial banks, merchant banks, savings banks, insurance companies and development banks), informal financial institutions (money lenders, co-operative societies, landlord friends and relations) and personal savings. For the purpose of this study, the three sources as identified by Ekpenyong and Nyong (1992) will be collapsed into two which is the formal financial institution and informal financial institution (personal savings will be taken together with this). This categorisation is informed on the basis that informal institutions and personal savings do not, most of the time, require collaterals.

Theories explaining SMEs financing pattern have its root from the work of Modigliani and Miller (MM) (1958), although it was developed for large firms but researchers have consistently apply its knowledge to small businesses too. Meanwhile, there are quite a number of theories explaining SMEs funding preferences like the Growth Cycle Theory, Static Trade off Theory, Agency Theory, Bootstrapping but the Pecking Order Hypothesis has a relatively dominant explanation for small business finance (Gebru, 2009). The Pecking Order Hypothesis asserts that small firms strive for external sources of finance only if the internal sources are found inadequate and they prefer to exhaust their borrowing capability before issuance of new equity due to reasons explained by Agency Theory, Information Asymmetry and Signaling Theory (Gebru, 2009). Also, Osel-Assibey, Bokpin and Twerefou (2012) supported the fact that SMEs are more faced with information asymmetry problem making financing decisions of SMEs to be better explained by the Pecking Order Hypothesis.

Hence, this paper sets out to investigate the determinant factors of financing preference at post start up of small enterprises in Ilorin, Kwara State of Nigeria.

Empirical Issues

The increasing important role of SMEs in a nation's economic development makes it one of the most interesting areas to study. Studies have been carried out both in the developed and in the developing economy ranging from the roles of SMEs, financing sources and preference, gender and SME financing and a host of other interesting issues.

Meanwhile, difficulties in accessing formal sector for finance have been relatively well researched even though there is no consensus concerning the reality and cause of the external finance gap. Farma (2004) in Rouse and Jayawarna (2006) even suggested that poor access to private external finance relates to lack of information about available sources rather than lack of available credit. It is therefore difficult to say whether a particular financing pattern is just an issue of preference or desperation borne out from limited access or constraints to formal finance (Osei-Assibey, Bokpin and Twerefou, 2012).

In view of the above, quite a number of researchers have carried out studies on the factors that could influence preference for a particular finance source among which is the age, size, location, educational background of the owner, type of ownership etc, although results have been mixed.

Ebben (2007) looked at the issue of financing preference of small business in United State of America from the angle of bootstrapping techniques. The study analyzed whether the financial status of small firms impacted their subsequent use of bootstrapping and whether that use of bootstrapping in turn affected their financial status. The results indicated that highly levered, illiquid, and underperforming firms were more likely to use certain bootstrapping methods than other firms, and that the methods they used may have been detrimental to future firm performance.

Gebru (2007) looks at the determinants of financing preference specifically in the light of Pecking Order Hypothesis in Tigray regional state of Ethiopia. Using a logistic regression model, he grouped his independent variables into respondent characteristics (that include educational background), business characteristics and the type of acquisition and found out that these variables significantly influenced financing preference. The findings of Wo, Song Zeng (2008) also confirm the hypothesis of Pecking Order.

Abor and Blekpe (2009) examined the determinants of capital structure of SMEs in Ghana. A regression model was used in estimating the relationship between the firm level characteristics and capital structure measured by long term debt and short term debt. The result showed that firm's age and size has a significant positive relationship with both short and long term debt. While growth and asset structure has a positive and significant relationship with long term debt but a significantly negative relationship with short term debt. Profitability has a significantly negative relationship with both long and short debt implying that SMEs that generate internal funds generally tend to avoid external debt finance.

Unlike Abor and Blekpe that examined the influence of firm level characteristics on financing pattern, Irwin and Scott (2010) examined the influence of personal characteristics of the owner of the enterprise on financing pattern. The purpose of the paper was to use univariate statistical analysis to investigate barriers to raising bank finance faced by UK small and medium-sized enterprises (SMEs), specifically the impact of personal characteristics (ethnicity, gender and education). It was found that education made little difference to sources of finance, however, graduates had the least difficulties raising finance. Though statistically insignificant, women respondents found it easier to raise finance than men. Ethnic minority businesses, particularly black owner-managers, had the greatest problem raising finance and hence relied upon "bootstrapping" as a financing strategy.

It is the aim of this paper to complement and contribute to literature in respect of determinants of financing pattern by specifically taking SMEs in Ilorin, Kwara state with a view to finding out if consistent result will be found.

Methodology

A survey research design was adopted for this study. The population of this study consisted of all SMEs in Kwara State whether registered or not while a random sampling technique was used in selecting the SMEs used in this study. The research instrument used for this study is a structured questionnaire. Copies of this close ended questionnaire were distributed to owners of 300 randomly selected small business owners in the three senatorial districts (North, South and Central) of Kwara State but only 275 copies of the questionnaire were returned and this formed the basis of analysis and discussion. All the questions in the survey instrument were close-ended in order to limit the respondents, a pre-test and a pilot study was conducted and the outcomes were carefully

considered in order to improve the final version of the questionnaire. Data obtained from the survey were subjected to descriptive and Inferential statistics

Model Definition

The dependent variables for the purpose of this study are categorised into two which are formal finance source and informal finance source. The independent variables are some entrepreneur personal traits and some firm demographics. The entrepreneur personal traits used are gender, educational background and previous working/training experience while the corporate characteristics used are age, size, location and profitability level.

If formal finance source is used, 1 is designated for the purpose of analysis while the use of informal source was designated 2. Sex has to do with male or female while educational background has to do with whether the entrepreneur has more than secondary school education or not. The duration of the previous training is not relevant for the purpose of this study. Age is the number of years in business, size is measured using the number of employee employed, Location is if the firm is located in a rural area or not and profitability is measured using return on capital employed.

This study adopted a regression model used by Abor and Biekpe (2009) with some modification. The model is presented below:

$$Y = a + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \beta_6 X_6 + \beta_7 X_7 + e$$

Y = formal or informal finance source

a = intercept

β_1 = coefficient

X1 = gender

X2 = educational background

X3 = previous training

X4 = age

X5 = size

Result and Discussion

Preliminary Result

More than 75 percent of the respondents are between the ages of 30 and 55 implying that majority of the respondents are still within the active working group,

although, the respondents were male dominating. A larger proportion of the respondents operate wholesale and retail companies employing less than 20 employees.

The respondents were asked the most serious challenge that they had at start up and it was discovered that finance was the most significant out of the many challenges listed (while government regulation was the least) but gave different impacts that this constraint has on their business but the major impact is that they had to start with fewer amount than expected.

Consequently, majority (80 percent) of the respondents' source of finance at start up comes from purely informal source (personal savings, loan from family and friends and loan from cooperative societies) while only 15 percent used fund from both the formal source (specifically loan from banks) and the informal source and the remaining 5 percent used purely formal source of finance. The fact that the informal source carried a larger share is consistent with previous findings (Irwin and Scott 2010; Abor and Biekpe 2009; Gebru 2009).

An interesting revelation in this study is that majority of the respondents are aware of the existence of formal institutions that can give credits but they don't have household tangible assets that can be used and that are usually requested as collateral by the formal institutions. In fact, a reasonable number of the respondents already have deposit/savings account with the bank prior to setting up the firm. It is also interesting to reveal that out of these few that approached the formal institutions, majority are female.

However, responses to question with respect to financial preference of owners/managers during growth stage shows that they (82 percent) will rather go to the debt market (in particular, short term and less secured debt) rather than absorb equity holders. This scenario could be explained in tune with the hypothesis of Pecking Order that small firms have preference for informal finance source at start up and will opt for the formal source as the business starts growing. More so that at the post start up stage, the informal sources become inadequate, hence they strive for external sources of finance and they prefer to exhaust their borrowing capability before issuance of new equity. In fact, literature on SMEs suggests that owner/managers of small firms are reluctant to give up their independence and control (Wo, Song and Zeng, 2008).

With respect to previous working experience or training, result shows that many of the respondents had no previous experience in business before embarking on their current business activity. They were tempted to start a small firm majorly because they could not get employment probably because of their low level of education and the least reason given for setting up a small firm is for the purpose of complementing existing income.

Table 1: Categorical Variables Coding and Frequency

		Frequency	Parameter coding
		(1)	(1)
other businesses	0 no	184	.000
	1 yes	94	1.000
educational background	0 below and up to secondary level	203	.000
	1 above secondary level	75	1.000
Household tangible asset	0 no household asset	212	.000
	1 has household asset	66	1.000
location	0 rural	186	.000
	1 urban	92	1.000
gender	0 male	233	.000
	1 female	45	1.000

Source: Survey (2012)

Regression Result

Direct logistic regression was performed to assess the impact of some selected owner/manager attribute on the likelihood that respondents would prefer to use informal finance sources at start up stage than formal finance sources. The model contained six independent variable (gender, educational background, previous training, ownership of household assets, location and ownership of other businesses). The full model containing all predictors was statistically significant, $X^2(5, N = 278) = 263.35, p < .001$, indicating that the model was able to distinguish between respondents that used formal finance source and the informal source. The model as whole explained between 61.2% (Cox and Snell R square) and 94.5% (Nagelkerke R Squared) of the variance in finance preference and correctly classified 97.5% of cases.

As shown in Table 2 below, only two of the independent variables made a unique statistically significant contribution to the model (ownership of household asset and location). Ownership of household tangible assets has consistently been reported in the literature as a major determinant of securing a loan from financial institutions (Ebben 2009, Wu Song and Zeng 2008, Irwin and Scott 2010). As such, it is not surprising to see a significantly negative relationship in this study. The OR reported by the logistic regression is .056. this shows that respondents

who doesn't have household tangible assets are .56 times less likely to use formal finance source. Hence, the informal preference exhibited by the respondents is probably better explained in line with the fact that since majority of the respondents do not have assets that can be used as collateral, they are therefore confined to the use of informal finance source

With respect to location as a determinant variable, the result shows a significant negative relationship. Out of the few that used formal finance source at start up stage, majority of them are from the urban areas where these financial institutions are majorly concentrated. The OR from the logistic regression shows that respondents in the urban area are .057 times likely to use formal finance

Educational background, although not significant but shows a negative relationship to informal finance source. This means that an increase in the level of educational attainment reduces the chances of using informal finance source. meanwhile, it is not surprising that not having a degree appears to correlate with a greater frequency of financial constraints at start up. This is consistent with the argument that the decision on the choice of credit source is partly determined by the financial market knowledge available to the potential borrower on the available source in which education plays a significant role. Also, it was possible that the level of education was a major factor in coming to a lending decision, either because bankers valued a higher education or because a higher education means that owner-managers were more articulate and more likely, therefore, to persuade the banks that they had a viable proposition (Irwin and Scott 2010). This is consistent with findings of Irwin and Scott (2010) and Gebru (2009).

For Gender, the result shows an insignificant negative relationship with informal finance source. This means that the female have a higher probability of using formal source compared to their male counterpart. This is not surprising because literature has suggested that women have better track record of repaying their loans. Also this result is acknowledging the fact that women are becoming more enterprising unlike in the previous years when they lack the required level of flexibility and mobility and were more engrossed in their domestic chores (Boohene, Sheridan and Kotey (2008). Empirical evidence also supported the fact that there is no discrimination of what so ever by financial institutions against female SME owners (Watson and Newby, 2009). The only positive explanatory variable is the existence of other businesses, although insignificant. The explanation probably backing this is that the more a manager/owner has other businesses, the more he will continue the use of informal finance source in support of bootstrapping concept, a methods for

obtaining resources that collectively reduce the need for outside financing. In order to cope with their capital constraints and to preserve ownership and control, small business owners devise methods to acquire essential resources that minimize the amount of outside debt and equity financing needed from banks and investors. One of these bootstrapping techniques is joint utilisation of resources with other firm. Hence, the positive relationship could be explained in line with the fact owners of other businesses used bootstrapping technique of joint utilisation of resources to minimize their financial needs, hence could still do with informal financing source as costs has been kept to the bearest minimum. Although, few (94) of the respondents have other businesses, but most of these that had other businesses preferred informal finance source.

Table 1: Categorical Variables Coding and Frequency

		Frequency	Parameter coding
		(1)	(1)
other businesses	0 no	184	.000
	1 yes	94	1.000
educational background	0 below and up to secondary level	203	.000
	1 above secondary level	75	1.000
Household tangible asset	0 no household asset	212	.000
	1 has household asset	66	1.000
location	0 rural	186	.000
	1 urban	92	1.000
gender	0 male	233	.000
	1 female	45	1.000

Source: Survey (2012)

Conclusion

This study examined the determinants of informal financing preference specifically in Ilorin, Kwara State of Nigeria. The result reveals that owner/manager of small and medium scale enterprises have a strong

preference for using informal finance source especially personal savings at start up and the use of formal finance (bank loan) source is preferred when the business is growing as confirmed from the responses given.

Although this result is consistent with the Hypothesis of Pecking Order, but empirical evidence has shown that everything still boils down to inaccessibility to formal financial institutions rather than own preferences. For majority to have reveal their future financing preference for formal source is a clear indication that the use of internal finance at start up is not because of preference but as a consequence of constraints they face in accessing formal finance. To further buttress this fact, the study revealed that those that had tangible assets went for formal source, so also those in the urban areas also used formal source.

Hence, despite the various policy measures, packages and institutions aimed at empowering the SMEs by government of Nigeria, SMEs, especially those in the rural areas, still face financial constraints. Majority of SMEs were starting up with personal savings and many people with sound business ideas are giving up simply because of the difficulties of raising the finance, it is therefore recommended that more support should be made available through micro finance institutions to support people with a proposition that looks viable but who lack sufficient resources to start up and cannot attract bank finance.

Also, with the increasing advocate for more women in nation building, SMEs can be an avenue for developing women entrepreneurs as this is among the important targets of the millennium development goals.

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