



DOES FIRM PROFILE INFLUENCE FINANCIAL ACCESS AMONG SMALL AND MEDIUM ENTERPRISES IN KENYA?

Martin M. Musamali

School of Business and Economics, Moi University, Eldoret, Kenya

Daniel Kipkirong Tarus

Department of Accounting and Finance, Moi University, Eldoret Kenya

ABSTRACT

The purpose of this research is to determine whether firm-specific factors influence Small and Medium Enterprises' (SMEs) ability to access finance. To address the study objectives, data from a sample of 103 SMEs was used in the study. Using multiple regression analysis, we found that, firm profile such as ownership structure; size of the firm; business type; and age of the business indeed influence SMEs' access to finance.

Keywords: Financial Access, Firm Profile, Small and Medium Enterprises; Kenya.

JEL Classification Code: D 92; D 26.

INTRODUCTION

Small and Medium Enterprises (SMEs) have been defined differently by many scholars owing to differences arising out of contexts. However, what is frequently used include characteristics such as the number of employees, annual turnover and the enterprise's net worth. For the purposes of this study and consistent with the Sessional Paper No. 2 of 2005, we defined an SME as an enterprise with less than hundred employees; and with annual turnover of less than four million shillings (GOK., 2005). As in most developing countries, the indigenous private sector in Kenya is dominated by SMEs engaged in various business activities. The 1999 Baseline Survey by the Central Bureau of Statistics (CBS) shows that there are 1.3 Million Micro and Small-Scale enterprises and employs approximately, 2.3 million workers which accounts for 26 % of the total workforce. It contributes an estimated 13.8% of the country's Gross Domestic Product (GDP).

The Kenyan Government is aware of the significant role this sector play in economic development thus during the first half of the 1990s it developed a policy document dubbed "Sessional Paper No.



2 of 1992 on Small Enterprises and Jua Kali Development in Kenya” which is intended to direct government efforts to reenergize the sector. The policy document highlighted the critical role of access to finance as an important ingredient in growing the sectors. Therefore, the government established various financing schemes for the sector, however, these schemes have not benefited majority of the enterprises (GOK., 2005). The reason why the financing schemes did not realize the intended objective was because of the disconnect between the financiers and the SMEs.

Extant literature indicates that access to finance is a life blood for business enterprises not only in Kenya but all over the world. Traditional long-term bank finance is generally inaccessible to small businesses because they lack the requisite collateral and have no business records (Girabi, 2013; Olusola and Olusola, 2013). Atieno (2009) found out that lack of access to finance is a major constraint facing SMEs thus is one of the reasons for the slow growth SME firms in Kenya. Thus we believe that SME firms face varying financing needs depending on firm specific characteristics. This study therefore sought to determine the effect of firm profile on access to finance.

LITERATURE REVIEW

Access to finance refers to the possibility that individuals or enterprises access financial services, including credit, insurance, and other risk management services (Beck and Demurguc, 2006). It is the ability of a firm to get and use financial services that are affordable, usable and meet their financial needs Claessens (2006). Access has four key dimensions: physical access, affordability, appropriate features that meet the users’ particular needs and appropriate terms that do not effectively exclude any category of potential user.

Measures of access fall into two broad categories, those based on the providers’ information, such as banks and other service providers, and those based on users’ information – individuals, households or firms (Beck *et al.*, 2009). More specifically, access to finance can be measured in terms of access to certain institutions, such as banks, insurance services, or microfinance institutions, or the services that these institutions provide, such as payments services, savings or loans and credits. Another approach would be to look at details on the uses of specific financial products, such as debit cards, credit cards, life insurance, home mortgages, among others.

Theoretically, there are good reasons to suggest why access to finance is more adverse for SMEs. First, the fixed costs associated with loan appraisal, supervision, and collection is prohibitive to lenders. This implies that lenders prefer to provide larger amounts of credit to large enterprises than small amounts of credit to many smaller enterprises. Second, SMEs are less able to provide collateral against their loans. From the lender’s perspective, the cost implications associated with the possible bankruptcy of the borrower rise accordingly, further diminishing incentives to lend to



smaller enterprises. Thus, SMEs frequently report financing as a major obstacle compared to large firms (Ayyagari *et al.*, 2006).

Firms Profile Characteristics as Predictors of Financial Access

Effect of Firm Size on Access to Finance

Extant literature associate firm size to the ability of firms to access finance. For example, Honhyan (2009) found that larger firms tend to be more diversified and fail less often, so size can be an inverse proxy for the probability of bankruptcy. Cassar (2004) argues that it may be relatively more costly for smaller firms to resolve information asymmetries with debt providers. Consequently, smaller firms may be offered less debt capital. In addition, transaction costs are typically a function of scale and may be higher for smaller firms. It is also possible that small firms have fewer opportunities to raise capital because capital markets are out of reach due to their size.

In the presence of non-trivial fixed costs of raising external funds large firms have cheaper access to outside financing per dollar borrowed. Size may also proxy for the volatility of firm assets, for small firms are more likely to be growing firms in rapidly developing and thus intrinsically volatile industries. Yet another explanation is the extent of the wedge in the degree of information asymmetry between insiders and the capital markets which may be lower for larger firms, for example because they face more scrutiny by ever-suspicious investors.

While economic theories have been preoccupied with the determinants of firm size and its optimality since Coase (1937), existing theories are silent on the effect of firm size on external financing. Demsetz (1973) offers an alternative explanation for the relationship between firm size and profitability, arguing that the greater profits of large firms have little or nothing to do with conventional scale economies. Rather large firms are inherently more efficient than small firms due to superior management. Consequently, overtime, the more efficient firms are rewarded with both growth and elevated profit. Again profitable firms have higher access to finance given the assurance it gives to the lenders on financial sustainability. More recently, Dun and Girma (2012) using firm level data from China spanning the period 1998-2005 found that bigger firms source capital from the bank while smaller firms use self raised finance. Thus we hypothesize that:

H1: Larger firms have more access to finance

Firm Age and Access to Finance

Firm age appears in several studies in the empirical finance literature as control variable especially in corporate strategy research (Villalonga, 2004). However, we believe that the age of the firm has implications on financial access. The relation between age of the firm and growth or profitability has been given attention in the industrial organization literature. For example, Evans (1987) and Cooley and Quadrini (2001) are of the view that firm growth decreases with firm age. Age of the



firm can affect performance by inducing organizational inertia (Leonard-Barton, 1992) and by impairing firms' ability to perceive valuable signals. According to this hypothesis, the problem is the tendency of firms to codify their success with organizational measures, rules of conduct, and processes (Adizes, 2004). The organizational inertia restricts them from recognizing, accepting, and implementing change.

Another perspective is given by Chandler (2009) that the longer a firm exists; the more it signals that it can weather tough economic conditions. Furthermore, by staying in business, a firm can signal that it does not adopt opportunistic behavior. It also signifies that the firm and in particular the owners or managers are mature enough to deal with business challenges. Older firms provide a resume in which lenders can use to gauge their credit worthiness. Ngoc *et al.* (2009) found that it is often difficult and expensive for young SMEs to access bank financing, due in large part to information asymmetry between the banks and firms. Bougheas *et al.* (2005) argue that young firms are more prone to failure than older ones. Therefore, we hypothesize that:

H2: There is a positive relationship between the age of the firm and access to finance

Effect of Ownership Structure on Firms' Access to Finance

There are several types of firm ownership. For example sole proprietorship, partnership and companies. Dietmar *et al.* (1998) demonstrate that incorporated firms under limited liability, have higher growth than unincorporated firms. Several factors could explain the association between incorporated firms and growth. First, corporations have the ability to issue stock and their stockholders have the freedom to resell their stock. This ability facilitates the process of accessing finance for expansion.

Cassar (2004) observed that lenders may perceive incorporation as a sign of credibility and formality of operations. Abor (2007) argue that the form of ownership could affect the debt-equity decisions of SMEs. Thus, corporations and limited liability companies may be more likely to finance their projects with equity, while sole proprietors are more likely to employ debt financing. (Coleman and Cohn, 2000) also find evidence suggesting a positive relationship between leverage and incorporation.

Thus we hypothesize that:

H3: Ownership structure has a positive effect on firms' access to finance such that incorporated firms are likely to have more access to finance

Effect of Business Type on Access to Finance

The industry in which a firm operates does determine its capital structure albeit indirectly via the nature and composition of the firm's assets (Hall *et al.*, 2000). Barbosa and Moraes (2004) argue that the relationship between industry classification and financial leverage is based on the



assumption that industry classification is a proxy for business risk. Firms in the same industry face the similar environmental and economic conditions and, thus, tend to cluster with respect to variance of earnings and sales. Abor (2007) found that SMEs in the agricultural sector exhibit the highest capital structure and asset structure or collateral value, while the wholesale and retail trade industry has the lowest debt ratio and asset structure.

Theories from strategic management and industrial organization have emphasized the importance of industry affiliation to firm performance. Barriers to entry and other structural features of industries create significant differences in firm performance (Bain, 1951). Because of differences in sunk and fixed-cost requirements by industry, firm performance may differ significantly by industry regardless of country affiliation (Sutton, 1990). Thus, even among firms with different affiliations by country, important differences may arise in performance by industry (Porter, 1981). We argue that some industries are characterized by higher risk and thus because lenders assess risk levels of the industry, risk exposed sectors may not access as much finance as compared to other less risky sectors. In the same vein, some sectors are less profitable than others. Because profitability is a yardstick used by lenders, then it means that some sectors may be disadvantaged in access to finance.

Thus we hypothesized that:

H4: Business type has an effect on access to finance such that manufacturing firms have more access to capital

METHODS AND DATA

We targeted all 515 SMEs in Eldoret Town, however, we managed to get 203 completed and usable questionnaires making a response rate of 39 percent. We utilized primary sources of data using a Likert type questionnaire in which the respondents had the choice of five scales. A set of questions were framed to interrogate whether the respondents firm had easy access to finance on a scale of 1-5 (1 strongly disagree, and 5 strongly agree). The summated responses of these questions provided a value for access to finance. This study deviates from others studies that have used a dummy coding for access 1 and no access 0 because we feel that some firms may have no access at all, some have little access while others have ease of access. Business type was measured using a dummy coding 1 for manufacturing firms and 0 for firms in the service industry. Similarly, 5 categories of age was developed to measure the age of the firm, business size was measured using a 5 scale indicating the size of the firm based on the number of employees, while ownership structure was measured as a dummy coding of 1 if the business is registered and 0 otherwise.

We analyzed our data using multiple regression analysis. But before subjecting the data to regression analysis, we tested the data for possible violations of regression assumptions. First, we



tested data for normality using Kolmogorov-Smirnov test and we found the data to be normally distributed. Secondly, we also tested the data for possibility of multicollinearity using Variance Inflation Factors (VIF) as well as Pearson's Correlation. In all the results, we did not find multicollinearity to be a problem. We also tested data for reliability using Cronbach Alpha and we found the data to be reliable i.e. above the threshold of .50 which is considered acceptable level (Fraenkel and Wallen, 1993). To test for the presence or lack of serial correlation, Durbin Watson statistic was used. We found Durbin Watson statistic to be 2.084 which is within the threshold of 1.9 to 2.5. Thus there was no serious problem of serial correlation among the variables in the study (Scott, 2002).

Model Specification

The model Specified for this study is of the form:

$$\text{Access to Finance} = \alpha + \beta_1 (\text{Firm Size}) + \beta_2 (\text{Firm Age}) + \beta_3 (\text{Ownership Structure}) + \beta_4 (\text{Business Type}) + \varepsilon$$

Where: β_1 , β_2 , β_3 , and β_4 is partial slope coefficients and ε , is the error term.

RESULTS

Descriptive Statistics

Table 1 presents descriptive and correlation results between the study variables. The correlation results show that access to finance had a positive and significant correlation with business age, business size, and ownership structure. However, we did not find any significant correlation on business type. This indicates that older business enterprises, larger in size and incorporated are more likely to access finance. The results indicate however, that it may not matter much the type of business enterprise to access of finance.

Table-1. Descriptive and Pearson Correlation Results

Variables	Mean	Std. Dev.	Access to Finance	Business Type	Firm Age	Firm Size	Ownership Structure
Access to Finance	3.61	1.09	1.000				
Business Type	.87	1.21	0.010	1.000			
Business Age	3.21	3.10	0.321**	-0.281*	1.000		
Business Size	4.13	2.10	0.506**	-0.272*	0.343**	1.000	
Ownership Structure	.63	1.02	0.492**	-0.125	0.171†	0.298*	1.000

N=203, Significance level, $p < 0.01$ **: $p < 0.05$ *; $p < 0.1$ †

Empirical Results

The study applied multiple regression analysis to test the hypotheses. Table 2 reports the regression results. Hypothesis 1 postulated that the size of business has a positive effect on access to finance



such that larger SMEs have more access to finance. The regression results supported this hypothesis ($\beta = .158$; $p < .01$). Hypothesis 2 predicted that the age of the firm has an effect on access to finance such that older firms have more access. Results provide support for the hypothesis ($\beta = .088$; $p < .05$).

Hypothesis 3 conjectured that ownership structure of the business has an effect on access to finance such that incorporated businesses have more access to finance as opposed to unincorporated entities. Again the results support the prediction ($\beta = .221$; $p < .01$). Finally, Hypothesis 4 postulated that business type or the industry to which the business belong has a positive effect on access to finance. Specifically, manufacturing firms have more access to finance as opposed to finance in the service industry ($\beta = .148$; $p < .01$).

Table-2. Regression Results

Variables	Parameters	Standard Error	T-values	Significance
Intercept	.751	.224	3.346	.001
Firm Size	.158	.034	4.611	.000
Firm age	.088	.039	2.233	.028
Ownership Structure	.221	.047	4.665	.000
Business Type	.148	.056	2.662	.009
R Square	.441			
Adjusted R Square	.418			
F Statistic	19.30**			

** Significant at $p < .01$

DISCUSSIONS AND CONCLUSIONS

The study set out to address the question of whether firm-specific characteristics influence access to finance. Indeed results confirm the prediction that firm-specific characteristics affect the ability to access finance. First, consistent with the extant literature, the size of the business affect the ability to access finance. The probable reason for this is that larger firms are likely to have collaterals that act as a security in securing finances. Another reason is that large size in itself provides information to lenders that the firm is able to meet the needs of other constituencies and thus is able to grow in size. Secondly, firm age was found to play a role in firms' access to finance. More specifically, firms that are older were found to have more access to finance. These results were not unexpected because older firms have the network capital generated overtime and also credit history that can be used by lenders to assess their credit worthiness. In contrast, younger firms may lack the necessary connections on the providers of finance and also the historical performance of the firm may be lacking.

Thirdly, the ownership structure was found to affect firms' access to capital. Firms incorporated have more access to finance than their unincorporated counterparts. Reason attributed to this is that incorporated firms have inherent characteristics such as perpetual existence unlike unincorporated counterparts which are likely to dissolve in the event of death or for whatever reason. Perpetuity therefore is an important ingredient to lenders because it promises the fulfillment of obligations in an event of uncertainty in the owners of the business. Lastly, the industry with which the business belongs was also found to have an implication on access to finance. Given that different sectors enjoy dissimilar opportunities, profitability, and risks, some sectors have more opportunities and thus make more profits. Consistent with capital structure theories, it has been found that manufacturing firms have more access to finance because of asset tangibility (Titman and Wessels, 1988) which acts as collaterals in debt financing. It is also noteworthy that the risks in each industry vary and that service industry is relatively volatile as compared with manufacturing firms. Thus lenders are inclined to lend more to manufacturing firms as compared to service firms.

It is important to note the study's limitations. First, the study sample may be small and drawn from a homogenous environment. We hope that this can be expanded to make it more generalizable by testing the same model in different contexts and increasing the sample size. Secondly, we focused only on firm-specific characteristics; however, we contend that these may not be the only factors that influence access to finance. Future studies may need to include external factors into the model. Thirdly, we measured direct effect of the firm-specific factors on access to finance. We also believe that this can be improved by including moderating variables such as firm performance in the model. Future research can therefore interrogate the moderating effects of other firm specific outcomes in determining access to finance.

REFERENCES

- Abor, J., 2007. Industry classification and the capital structure of Ghanaian SMEs. *Studies in Economics and Finance*, 24(3): 207-219.
- Adizes, I., 2004. *Managing corporate lifecycles, how and why corporations grow and die and what to do about it*. China: Adizes Institute Publications.
- Atieno, R., 2009. Linkages, access to finance and the performance of small-scale enterprises in Kenya, research paper no. 2009/06. UNU World Institute for Development Economics Research (UNU-WIDER).
- Ayyagari, M., K. Demurguc, A. and V. Maskimovic, 2006. How important are financing constraints? The role of finance in the business environment. World Bank Policy Research working Paper 3820.
- Bain, J.S., 1951. Relation of profit rate to industry concentration. *American Manufacturing, Quarterly Journal of Economics*, 65(3): 293-324.



- Barbosa, E.G. and C.C. Moraes, 2004. Determinants of the firm's capital structure, the case of the very small enterprises retrieved. Available from http://econpa.wustl.edu.8089/eps/fin/papers_0302/0302001.pdf.
- Beck, T. and K. Demurguc, A. , 2006. Small and medium -size enterprises: Access to finance as a growth constraint. *Journal of Banking & Finance*, 30(11): 2931-2943.
- Beck, T., K. Demurguc, A. and P. Honohan, 2009. Access to financial services: Measurement, impact, & policies. *World Bank Research Observer*, 24(1): 119-145.
- Bougheas, S., P. Mizen and C. Yalcin, 2005. Access to external finance: Theory and evidence on the impact of monetary policy and firm-specific characteristics. *Journal of Banking & Finance*, 30(1): 199-227.
- Cassar, G., 2004. The financing of business start-ups. *Journal of Business Venturing*, 19(2): 261-283.
- Chandler, J.G., 2009. Marketing tactics of selected small firms in the east london cbd area, south africa. University of South Africa.
- Coase, R.H., 1937. The nature of the firm. *Economica*, 4(16): 286-405.
- Coleman, S. and R. Cohn, 2000. Small firms use of financial leverage: Evidence from 1993 survey of small business finances. *Journal of Business Entrepreneurship*, 12(3): 81-98.
- Cooley, T.F. and V. Quadrini, 2001. Financial markets and firm dynamics. *American Economic Review*, 91: 1286-1310.
- Demsetz, H., 1973. Industry structure, market rivalry, and public policy. *Journal of Law & Economics*, 16: 1-9.
- Dietmar, H., S. Konrad and M. Woywode, 1998. Legal form, growth and exit of west german firms-empirical results for manufacturing, construction, trade and service industries. *The Journal of Industrial Economics*, 46(4): 453-488.
- Dun, J. and S. Girma, 2012. Firm size, source of finance, and growth- evidence from china. *International Journal of Economics of Business*, 19(3): 397-419.
- Evans, D.S., 1987. The relationship between firm growth, size, and age: Estimates for 100 manufacturing industries. *Journal of Industrial Economics*, 35(4): 467-581.
- Fraenkel, J.R. and N.E. Wallen, 1993. How to design and evaluate research in education. 2nd Edn., New York: McGraw-Hill.

- Girabi, F., and Mwakaje, A. E. G., 2013. , 2013. Impact of microfinance on smallholder farm productivity in tanzania. The Case of Iramba District, Asian Economic & Financial Review, 3(2): 227-242.
- GOK., 2005. Sessional paper no. 2 of 2005 on development of micro and small enterprises for wealth and employment creation for poverty reduction. Government Printers, Nairobi.
- Hall, G., P. Hutchinson and N. Michealas, 2000. Industry effect on the determinants of unquoted smes capital structure. International Journal of the Economic of Business, 7(3): 297-312.
- Honhyan, Y., 2009. The determinants of capital structure of the smes: An empirical study of chinese listed manufacturing companies. Available from <http://www.seiofbluemontain.com/upload/product/200911/2009.pdf>
- Ngoc, T.B., T. Le and T.B. Nguyen, 2009. The impact of networking on bank financing: The case of small and medium enterprises in vietnam. Entrepreneurship Theory and Practice, 33(4): 867-887.
- Olusola, O.J. and O.A. Olusola, 2013. Estimating growth in investment of micro and small enterprises in nigeria. Asian Economic & Financial Review, 3(1): 111-123.
- Porter, M., 1981. The contributions of industrial organization to strategic management. Academy of Management Review, 6(4): 609-620.
- Scott, M.W., 2002. Applied logistic regression analysis, second edition, quantitative applications in social sciences. . London: Sage Publications.
- Sutton, J., 1990. Sunk costs and market structure: Price competition, advertising, and the evolution of concentration. Cambridge, MA: MIT Press.
- Titman, S. and R. Wessels, 1988. The determinants of capital structure choice. The Journal of Finance, 43(1): 1-19.
- Villalonga, B., 2004. Diversification discount or premium? New evidence from the business information tracking series. The Journal of Finance, 59(2): 479-506.