



# Assessing Determinants of Financial Constraints on Small and Medium Enterprises in Kumasi Metropolis, Ghana

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## To cite this article:

Francois Mahama, Etornam Kwame Kunu, Patience Ama Nyantakyiwaa Boahen, Albert Kweku Bediako. Assessing Determinants of Financial Constraints on Small and Medium Enterprises in Kumasi Metropolis, Ghana. *Journal of Business and Economic Development*. Vol. 2, No. 4, 2017, pp. 198-203. doi: 10.11648/j.jbed.20170204.11

**Received:** December 11, 2016; **Accepted:** May 27, 2017; **Published:** June 28, 2017

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**Abstract:** This study seeks to determine the hitches of accessing financial institutional loans; determine the sources of financial assistance to SMEs apart from financial institutions and determine the determinants of financial constraint on SMEs in the Kumasi Metropolis, Ghana. A descriptive, cross-sectional survey was conducted among 300 purposively selected SME operators. Both descriptive and inferential statistics were computed during the analysis of the data using both SPSS and Microsoft Excel. Results show that the hitches they encountered are “high interest rates”, “lack of business registration”, “lack of collateral” and “poor or no business plan”. Also about 34.3% depend on personal savings, 32.7% of them depend on the firm profit and 21.3% of them also depend on assistance from family and friends whilst 11.7% of them also depend on trade credit as other sources of finance. Finally, the “Age of the firm”, “Professional and entrepreneurial experience”, “Firm ownership type”, “Performance of the firm”, and “High interest rate payments” were the determinants of financial constraints on SMEs. Therefore, SMEs should endeavor to formalize their business operations registration and pay appropriate taxes. Government should also create favourable environment and policies that will reduce the financial constraints on SMEs leading to success of entrepreneurship in the country.

**Keywords:** SME, Determinant, Financial, Constraint

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## 1. Introduction

Small and medium-sized enterprises (SMEs) are the backbone of economies in advanced industrialized countries, as well as emerging and developing countries, as they are a key source of economic growth, innovativeness, and poverty reduction. SMEs constitute the dominant form of business organization, accounting for over 95% and up to 99% of enterprises depending on the country [1]. According to [2] small and medium sized enterprises in both developing and developed countries play important roles in the process of industrialization and economic growth, by significantly contributing to employment generation, income generation and catalyzing development in urban and rural areas. [3] affirm that Africa and Asia has the majority of their

population living in rural areas where small scale enterprises deliver about 20% - 45% of full-time employment and 30% - 50% of rural household income. In Sub-Saharan Africa, the SME sector accounts for over 90% of all enterprises of which 70% - 80% are micro and very small enterprises. In his contention [4] indicated that, in spite of the significant role SMEs play in socio-economic development of developing countries in general and Ghana specifically, the sector continues to be plagued with a myriad of challenges such as unstable government policies, gross under capitalization, high operating costs, lack of clear cut government support and assistance, and difficulty in assessing credit from financial institutions and banks

Having access to finance gives SMEs the chance to develop their business and to acquire better technologies for

production, therefore ensuring their competitiveness. However, there is a huge challenge for SMEs globally when it comes to sourcing for initial and expansion capital funds from traditional commercial banks. The situation is even dire in developing countries and in Ghana in particular where, access to and cost of credit is so prohibitive. Access to finance is rated as major constraint by around 30% of small and medium enterprises, a similar proportion as economic policy uncertainty and corruption. Furthermore, financing is one of the few characteristics of the business environment that together with crime and political instability is robustly linked to firm growth [5] while other features have at most an indirect effect on firm growth [6]. Small firms consistently report higher financing obstacles than medium and large enterprises. The relationship is not only statistically but also economically significant. According to [5] the probability that a small firm lists financing as a major obstacle to its growth is higher than that of a big firm. SMEs' financing constraints include the access to and the cost of finance. The difference between small and large firms is at least as big or even bigger for some of the specific financing obstacles, such as collateral requirements, bank paperwork, interest rate payments, the need for special connections and banks' lack of lending resources. Also the lack of access to specific forms of financing such as export, leasing and long-term finance is significantly more constraining for small firms' growth than for large firms' growth [7].

In Ghana the formal financial institutions led by the commercial banks and other traditional sources of credit have always considered SMEs as a greater risk than larger companies, and respond by adopting anti-risk measures like charging higher interest rates or demanding landed collateral security. This makes it more and more difficult or almost impossible for many SMEs to effectively borrow from banks where the price of credit is too high. If entrepreneurs cannot gain access to finance through the regular system or more 'bigger' banks, they may find it extremely difficult to start up a business or may simply go out of business, which represents a potential loss to the economy. The alternative left for such entrepreneurs may be to abandoned the formal system altogether and operate in the informal economy, and in the process possibly evade taxes and regulations, and thus not making a full contribution to economic growth and job creation. SMEs would therefore have no choice but turn to other sources of credit to finance their business.

[8] investigated the link between growth and financing using a sample of 164 Japanese SMEs and established that growth is measured by sales growth and asset growth. The "idle capacity" interpretation of firm growth has been linked to expectations that younger enterprises would be under a particularly strong incentive to pursue growth. Two alternative lines of argument have been proposed as to why this should be so [9]. The first is the "theory of learning" interpretation: younger enterprises tend to have higher growth rates than older enterprises because they have less understanding of the costs related to their activities and of how these costs vary over time. The insight of longer

established firms into the links between enterprise size and efficiency, on the other hand, is well developed and acts against the pursuit of growth. A similar argument is that new enterprises are characterized by a "liability of newness" because they have fewer opportunities to experiment with different resource combinations. In contrast, an entrepreneurial model of enterprise growth argues that young firms are more innovative, proactive and risk oriented than older firms; some emerge specifically to take advantage of a new opportunity.

A study by [10] revealed that globally SME sector has been reporting difficulties in access to finance. Access to external finance to SMEs has become costly and troublesome while their accessibility has done sharply declined. SMEs' financing constraints limit their investment opportunities and stagnant growth. Access to finance is widely perceived to be an essential factor for firms, and especially SMEs, to maintain their daily business operation as well as to achieve long-term investment opportunities and development targets. Presence of general limitations on access to capital markets, many African firms heavily rely on the banking sector for credit. Therefore, a well-functioning banking sector plays an important role in channeling resources to the best firms and investment ventures. Financing constraints crucially limit firm's growth, availability of productive resources resulting to sluggish of a sector which might pose threat to the sector's contribution to the economy.

The focus of this study would specifically be on determining the hitches of accessing financial institutional loans; determine the sources of financial assistance to SMEs apart from financial institutions and determine the determinants of financial constraint on SMEs in the Kumasi Metropolis, Ghana.

## 2. Literature Review

### 2.1. Concept of Small and Medium Scale Enterprise

Different authors have usually given different definitions to this category of business. The most commonly used and now accepted criteria for defining SMEs are the number of employees and the asset value. The European Commission (EC) defines SMEs largely in term of the number of employees as follows:

- (1) Firms with 0 to 9 employees – micro enterprises;
- (2) 10 to 99 employees - small enterprises;
- (3) 100 to 499 employees – medium enterprises.

Thus, the SME sector is comprised of enterprises (except agriculture, hunting, forestry and fishing) which employ less than 500 workers. In effect, the EC definitions are based solely on employment rather than a multiplicity of criteria. Secondly, the use of 100 employees as the small firm's upper limit is more appropriate, given the increase in productivity over the last two decades [11]. Finally, the EC definition did not assume the SME group is homogenous; that is, the definition makes a distinction between micro, small and medium-sized enterprises. [12] hold that definitions of size of

enterprises suffer from a lack of universal applicability. In their view, this is because enterprises may be conceived of in varying terms. Size has been defined in different contexts, in terms of the number of employees, annual turnover, industry of enterprise, ownership of enterprise, and value of fixed assets. For example, [13] considers small and medium businesses as privately held firms with 1 – 9 and 10 – 99 people employed, respectively. [14] define SMEs as firms with fewer than 100 employees and less than €15 million turnover. [15] consider small independent private limited companies with fewer than 200 employees and [16] considered companies with sales below €15 million as small. According to the British Department of Trade and Industry, the best description of a small firm remains that used by the Bolton Committee in its 1971 Report on Small firms. This stated that a small firm is an independent business, managed by its owner or part-owners and having a small market share [17].

There have been various definitions given for small scale enterprises in Ghana but the most commonly used criterion is the number of employees of the enterprise [18]. In applying this definition, confusion often arises in respect of the arbitrariness and cut off points used by the various official sources. In its industrial statistics, the Ghana Statistical Service (GSS) considers firms with fewer than 10 employees as small scale enterprises and their counterparts with more than 10 employees as medium and large size enterprises. Ironically, the GSS in its national accounts considered companies with up to 9 employees as SMEs (Kayanula & Quartey, 2000). The value of fixed assets in the firm has also been used as an alternative criterion for defining SMEs. However, the National Board for Small Scale Industries (NBSSI) in Ghana applies both the International Research Journal of Finance and Economics – Issue 39 (2010) 221 “fixed asset and number of employees” criteria. It defines a small scale enterprise as a firm with not more than 9 workers, and has plant and machinery (excluding land, buildings and vehicles) not exceeding 1,000 Ghana Cedis. The Ghana Enterprise Development Commission (GEDC), on the other hand, uses a 1,000 Ghana Cedis upper limit definitions for plant and machinery. It is important to caution that the process of valuing fixed asset poses a problem. Secondly, the continuous depreciation of the local currency as against major tradition currencies often makes such definitions outdated [18].

## **2.2. Determinants of Financial Constraints**

Access to finance and the cost of finance is often ranked as one of most constraining features of the business environment by SMEs. Specifically, the cost of finance is rated by over 35% of small and medium enterprises as major growth constraint in a sample of 71, mostly in developing countries, more than any other characteristic of the business environment. Others characteristics including tax rates and macroeconomic instability, are also rated by many SMEs as major growth constraints [5]. Access to finance is rated as major constraint by around 30% of small and medium

enterprises, a similar proportion as economic policy uncertainty and corruption. Access to finances is directly linked to firm growth, while other features have at most an indirect effect on firm growth [6]. Small firms consistently report higher financing obstacles than medium and large enterprises [5]. Smaller, younger and domestic as opposed to foreign-owned enterprises report higher financing obstacles even after overcoming other firm characteristics. The relationship is not only significant statistically but also economically.

The probability that a small firm lists financing as a major obstacle as opposed to moderate, minor or no obstacle is 39% compared to 36% for medium-size firms and 32% for large firms. The higher financing obstacles reported by small as compared to large firms are also reflected in financing patterns. While small firms finance less than ten percent of their investment needs with bank finance, large firms finance more than 20% with bank credit. Large firms have a similar, though not as strong, advantage, in trade credit and development finance, while small firms seem to finance a larger part of their investment with equity and informal finance, compared to large firms [7]. Researchers have come up with theories on the financing of SMEs. Some of the theories that have been explored include the pecking order theory and the tradeoff theory.

Several evidences have been adduced as to the determinants of funding for the SMEs. Among these is firm size which determines how much finance a firm is able to access [7]. Firm size plays a critical role in determining its financing obstacles. Older and larger firms tend to have lower financing obstacles compared to new and relatively smaller firms. This phenomenon is attributed to transaction cost and information asymmetries. Small firms are relatively more opaque and less to offer as collateral compared to large firms and thus face higher risk premiums. Age and technology indicate the level of efficiency in a firm being able to utilize the funds advanced to it [6]. Firms which have matured in their operations and advanced in technology tend to have easy time accessing finances compared to new firms which are just venturing the market. Financial institutions would assess the operation of firms in terms of performance by looking at their books of accounts for a certain period of time before they make a decision on whether to offer a credit facility. The use of technology to reduce cases of inefficiency also forms a major determinant of lenders to finance activities of particular firms.

## **3. Methodology**

This study used descriptive, cross-sectional study design. The setting was the Kumasi Metropolis in Ashanti Region, Ghana. The population for this study included sampled SME's operating in the Kumasi Metropolis. A total of 300 SME operators all in the Municipality were selected for the research. The study employed a purposive sampling technique in selecting the entrepreneurs located in various parts of the Kumasi Metropolis in Ashanti Region, Ghana.

Purposive method was used because these entrepreneurs are scattered all over the Municipality.

Data for the study was obtained using questionnaire. The questionnaire had two sections. The first section consisted of demographic information such as gender, age, and duration in business. The second section consisted of information on the ownership structure, hitches of accessing financial institution loans, sources of financial assistance apart from financial institutions and the determinants of financial constraint.

Both descriptive and inferential statistics were computed during the analysis of the data using both SPSS and Microsoft Excel. The descriptive aspect employed frequency tables; pie and bar charts whilst the inferential aspect of the analysis employed binomial test to categorize the proportion of success and the proportion of failure and Mann-Whitney Test which is used to compare differences between two independent groups when the dependent variable is either ordinal or continuous, but not normally distributed. Here it tests whether significant difference exist between the responses of the male and the female category of respondents.

#### 4. Results and Discussions

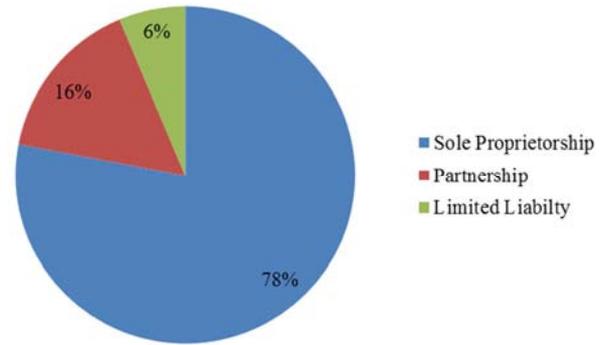
This subsection looks at the summary statistics of the respondents. A total of 300 female students completed the questionnaire. Table 1 summarizes the socio-demographic information of the respondents. Out of the 300 respondents 56% of them were female, 44% were males. Also 33.7% of the respondent between the ages of 31 and 40, 29.7% of them are between 26-30 age group and 22.3% were in 41-50 age group. The analysis further revealed that about 52.3% of the respondents were operating the SME business between 1 to 5 years, 39.7% were operating between 6 years and above and finally, 8% of them were operating less than a year.

**Table 1.** Demographic information of the participants (n=300).

| Variables            | Frequency | Percentages |
|----------------------|-----------|-------------|
| Gender               |           |             |
| Male                 | 132       | 44          |
| Female               | 168       | 56          |
| Age                  |           |             |
| 26-30                | 89        | 29.7        |
| 31-40                | 101       | 33.7        |
| 41-50                | 67        | 22.3        |
| 51 and above         | 43        | 14.3        |
| Duration in Business |           |             |
| Less than a year     | 24        | 8.0         |
| 1-5 years            | 157       | 52.3        |
| 6 and above          | 113       | 39.7        |

Source: Field data (2016)

From Figure 1, majority of respondents indicated that the type of ownership structure they belong to is sole proprietorship for 78%, 16% of the respondent indicated they belong to partnership type of ownership structure and finally, 6% of the respondents belong to limited liability.



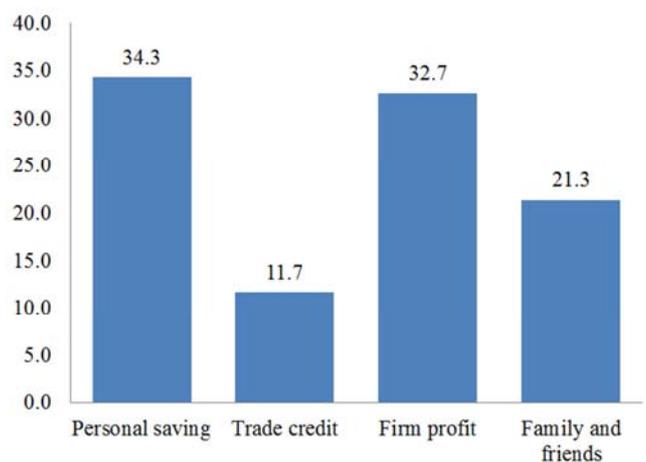
**Figure 1.** A Pie Chart Showing the Type of Ownership Structure.

Table 2 below indicates that there were 1144 responses to the series of questions on hitches of accessing financial institution loans by SMEs. The highest responses came from four factors “High interest rate”, “Lack of business registration”, “Lack of collateral” and “Poor or no business plan”, with the above factors having about 22.2%, 21.2%, 20.1% and 17.9% of the total responses respectively.

**Table 2.** Hitches of Accessing Financial Institution Loans by SMES.

|                               | Responses |         | Percent of Cases |
|-------------------------------|-----------|---------|------------------|
|                               | N         | Percent |                  |
| Lack of financial deposit     | 101       | 8.8%    | 33.7%            |
| Poor or no business plan      | 205       | 17.9%   | 68.3%            |
| Lack of collateral            | 230       | 20.1%   | 76.7%            |
| Lack of business registration | 242       | 21.2%   | 80.7%            |
| Poor asymmetry of information | 112       | 9.8%    | 37.3%            |
| High interest rate            | 254       | 22.2%   | 84.7%            |
| Total                         | 1144      | 100.0%  | 381.4%           |

However, factors like lack of financial deposit, and poor asymmetry of information are not highly rated by the respondents with the three having responses of 11.3%, and 5.1% of the total responses respectively.



**Figure 2.** A Bar Chart Showing Source of Finance Apart from Financial Institutions.

Figure 2 above showed that majority of respondents indicated that apart from financial institutions, dependent on personal saving was a major source of financing accounting for 34.3% of respondents. 32.7% of respondents indicated

that they are dependent on the firm profit as a financing source, 21.3% of respondent depend on contribution from family and friends and only 11.7% depended on trade credit.

**Table 3.** Response to the Determinant of Financial Constraint on SMEs.

|   |         | Category | N   | Observed Prop. | Test Prop. | Asymp. Sig. (2-tailed) |
|---|---------|----------|-----|----------------|------------|------------------------|
| Age of the firm                             | Group 1 | <= 3     | 108 | 0.36           | 0.50       | 0.000                  |
|   | Group 2 | > 3      | 193 | 0.64           |            |                        |
|   | Total   |          | 301 | 1.00           |            |                        |
| Size of the firm                            | Group 1 | <= 3     | 142 | 0.47           | 0.50       | 0.387                  |
|   | Group 2 | > 3      | 158 | 0.53           |            |                        |
|   | Total   |          | 300 | 1.00           |            |                        |
| Professional and entrepreneurial experience | Group 1 | <= 3     | 113 | 0.38           | 0.50       | 0.000                  |
|   | Group 2 | > 3      | 187 | 0.62           |            |                        |
|   | Total   |          | 300 | 1.00           |            |                        |
| Firm ownership type                         | Group 1 | <= 3     | 75  | 0.25           | 0.50       | 0.000                  |
|   | Group 2 | > 3      | 225 | 0.75           |            |                        |
|   | Total   |          | 300 | 1.00           |            |                        |
| Location of the firm                        | Group 1 | <= 3     | 144 | 0.48           | 0.50       | 0.525                  |
|   | Group 2 | > 3      | 156 | 0.52           |            |                        |
|   | Total   |          | 300 | 1.00           |            |                        |
| Performance of the firm                     | Group 1 | <= 3     | 24  | 0.08           | 0.50       | 0.000                  |
|   | Group 2 | > 3      | 276 | 0.92           |            |                        |
|   | Total   |          | 300 | 1.00           |            |                        |
| Assets tangibility                          | Group 1 | <= 3     | 163 | 0.54           | 0.50       | 0.149                  |
|   | Group 2 | > 3      | 137 | 0.46           |            |                        |
|   | Total   |          | 300 | 1.00           |            |                        |
| High interest rate payments                 | Group 1 | <= 3     | 102 | 0.34           | 0.50       | 0.000                  |
|   | Group 2 | > 3      | 198 | 0.66           |            |                        |
|   | Total   |          | 300 | 1.00           |            |                        |

Source: Field data (2016)

The variables above are indicators of the determinant of financial constraint on SMEs. From the table above, group 1 (<= 3) are those who strongly disagree or disagreed to the variables indicating the determinant of financial constraint on SMEs; group 2 (> 3) are those who strongly agreed and agreed. At a significant value of 0.05; it appears that five exact significant values except three are less than 0.05, suggesting that the respondents are unanimous on them as a determinant of financial constraint on SMEs. The significant variables are “Age of the firm”, “Professional and entrepreneurial experience”, “Firm ownership type”, “Performance of the firm”, and “High interest rate payment” with 64%, 62%, 75%, 92% and 66% agreement respectively.

However, those that has a significant value greater than 0.05 are “Size of the firm”, “Location of the firm”, and “Assets tangibility”. The implication of this is that the respondents are divided on the effectiveness of that statement as a determinant of financial constraint on SMEs.

From Table 4 at a significant value of  $\alpha = 0.05$ , it appears that none of the asymptotic is less than 0.05. It therefore suggests that there is no significant difference between the male and female respondents rating of the eight variables describing the determinant of financial constraint on SMEs; and that there are no significant difference between the responses of the males and that of females entrepreneurs. The findings are thus supported by the next output table which shows the mean rank for samples from male and female populations.

**Table 4.** Significance Test for Samples from Male and Female Populations.

|   | Mann-Whitney U | Wilcoxon W | Asymp. Sig. (2-tailed) |
|---|----------------|------------|------------------------|
| Age of the firm                             | 10464.5        | 24660.5    | 0.371                  |
| Size of the firm                            | 9866.5         | 24062.5    | 0.093                  |
| Professional and entrepreneurial experience | 10780          | 19558      | 0.657                  |
| Firm ownership type                         | 10587.5        | 24783.5    | 0.474                  |
| Location of the firm                        | 10355          | 24551      | 0.307                  |
| Performance of the firm                     | 11048          | 19826      | 0.948                  |
| Assets tangibility                          | 10901          | 25097      | 0.797                  |
| High interest rate payments                 | 10818          | 19596      | 0.705                  |

Source: Field data (2016)

It could be seen from Table 5 that the mean ranks don't show any significant difference. Therefore, it could be said that both sexes perceive determinant of financial constraint the same way with respect to age of a firm, size of a firm, professional and entrepreneurial experience, and firm ownership type. Both sexes also perceive determinant of financial constraint in the same way regarding the location of the firm, performance of the firm, assets tangibility, and high interest rate payments.

**Table 5.** Mean Rank for Samples from Male and Female Populations.

|                  | Gender | N   | Mean Rank | Sum of Ranks |
|------------------|--------|-----|-----------|--------------|
| Age of the firm  | Male   | 132 | 155.22    | 20489.50     |
|                  | Female | 168 | 146.79    | 24660.50     |
|                  | Total  | 300 |           |              |
| Size of the firm | Male   | 132 | 159.75    | 21087.50     |
|                  | Female | 168 | 143.23    | 24062.50     |

|   | Gender | N   | Mean Rank | Sum of Ranks |
|---|--------|-----|-----------|--------------|
| Professional and entrepreneurial experience | Total  | 300 |           |              |
|   | Male   | 132 | 148.17    | 19558.00     |
|   | Female | 168 | 152.33    | 25592.00     |
| Firm ownership type                         | Total  | 300 |           |              |
|   | Male   | 132 | 154.29    | 20366.50     |
|   | Female | 168 | 147.52    | 24783.50     |
| Location of the firm                        | Total  | 300 |           |              |
|   | Male   | 132 | 156.05    | 20599.00     |
|   | Female | 168 | 146.14    | 24551.00     |
| Performance of the firm                     | Total  | 300 |           |              |
|   | Male   | 132 | 150.20    | 19826.00     |
|   | Female | 168 | 150.74    | 25324.00     |
| Assets tangibility                          | Total  | 300 |           |              |
|   | Male   | 132 | 151.92    | 20053.00     |
|   | Female | 168 | 149.39    | 25097.00     |
| High interest rate payments                 | Total  | 300 |           |              |
|   | Male   | 132 | 148.45    | 19596.00     |
|   | Female | 168 | 152.11    | 25554.00     |

Source: Field data (2016)

## 5. Conclusion and Recommendation

Conclusively, it was established that majority of the respondents indicated that the hitches they encountered in accessing financial institutions loans are “high interest rates”, “lack of business registration”, “lack of collateral” and “poor or no business plan”. On the sources of financial assistance apart from financial institutions loans, majority of the respondents accounting for about 34.3% depend on personal savings, 32.7% of them indicated they depend on the firm profit and 21.3% of them also depend on assistance from family and friends whilst 11.7% of them also indicated they depend on trade credit. Finally, majority of the respondents agreed or strongly agreed to the following factors as the determinants of financial constraints on SMEs. These are “Age of the firm”, “Professional and entrepreneurial experience”, “Firm ownership type”, “Performance of the firm”, and “High interest rate payments”.

Therefore, SMEs should endeavor to formalize their business operations registration and pay appropriate taxes. They should also keep financial reports and form linkages to ease the burden of accessing financial assistance. Government should also create favourable environment and policies that will reduce the financial constraints on SMEs leading to success of entrepreneurship in the country. Finally, there should be empowerment of SMEs to access not just financial support but entrepreneurial education that gives an effective and enduring strategy for solving the capital problems of SMEs.

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