ANALYSIS OF THE EFFECT OF FINANCING ON PROFITABILITY OF SMALL AND MEDIUM ENTERPRISES (SMES) IN NIGERIA: LAGOS STATE OUTLOOK

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ABSTRACT

This study empirically analysed the effect of financing on the profitability of Small and Medium Enterprises in Lagos State. The study concentrated on different sources of finance available to Small and Medium Enterprises, and also determined the effect of financing on profitability of Small and Medium Enterprise. The descriptive statistics used were tables and percentages. Spearman's rank correlation coefficient and multivariate analysis of variance and covariance (MANOVA) were employed to analyze data through STATA 11 version. The results showed that finance and revenue generated is weakly but positively correlated at 0.181, the relationship between finance and Profitability is also weakly but positively correlated at 0.048. Also, 1% increases in finance increases the rate of profitability in small and medium by 0.33%. Following the outcome of this study, it is therefore concluded that that there is a strong positive relationship between finance and small and medium profitability in Nigeria. Increasing in finance of small and medium enterprises is directly correlated to the level of profitability in small and medium enterprises. It is now recommended that Banks and others financial institutions should always make loans available to small and medium enterprises with the barest of interest rates in order to boost their profitability which will invariably trigger employment opportunities in Nigeria.

KEYWORDS: Enterprises; Financing; Profitability; SMEs; Microfinance.

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INTRODUCTION

Background to the study

Experience all over the world is that small and medium enterprises constitute a vital engine to economic growth and development, there is a wide spread all over the world that small and medium enterprises play a significant role in the linkage of the various sectors of a country's Economy particularly inter-industrial and commercial linkages. CBN (2011) reveals that SMEs possess great potentials for employment generation, improvement of local technology, output diversification development of indigenous entrepreneurship and forward integration with large scale industries. Development of small and medium enterprises in Nigeria has been identified as an important factor in every economic and development growth strategy as it accounts for more than 60% of the economic activity in Nigeria and 94% the total share of the employment figure (Udechukwu, 2003). Report of the IFC shows that approximately 96% of Nigerian business are SMEs. Oyelarin (2010) opined that in spite of the fact SMEs constitute more than 90% of Nigeria business that their contribution to GDP is only about 1%. Researcher have confirmed that despite the composition of SMEs and their contribution to country development that their some limiting factor to SMEs success confirmed this is the research conducted by FSS 2020, SMEs sector report 2007 on key issue affecting SMEs in Nigeria, grouped into four namely; unfriendly business environment, poor funding, low managerial skill and lack of access to modern technology. But Fatai(2009) laid emphasis on capital to finance SMEs operation in line with this is findings of Ogujuiba et., al.,(2004) that finance contribute about 25% to SMEs success also Word bank report 2001 shows that 39% of SMEs in Nigeria lack capital to continue their business and that they are forced to close up because they are unable to access required fund. Ihyembe (2000) andAdelaja (2004) shown that financial problem contributes in greater proportion to the failure of most SMEs in Nigeria in terms of realizing their objectives.

Financing gap is more important in a fast changing knowledge based economy because of the speed of innovation. Adelaja (2004) when SMEs cannot find the financing they need, brilliant ideas may fall by the wayside and this represents a loss in potential growth for the economy.Nigeria Government started showing interest and commitment in small and medium enterprises in the early 1970's with the establishment of small scale industries division in the federal ministry of industries as well as the establishment of industrial development centres in the same year Akande and Ajagbe(2011). Ever since then, a number of institution or agencies and schemes have been formed and introduced to encourage the development of small and medium enterprises. These include the SME Apex unit (NERFUND). The National Economic Directorate of Reconstruction Fund industries scheme, the proposed National Agency for the development of small and medium scale industries, the small and medium enterprises Development Agency of Nigeria (SMEDIAN) , The Bank of Industry (BOI), the Small and Medium Industries Credit Guarantee Scheme (SMICGS), The Central Bank of Nigeria (CBN) in its monetary policy circular directs bank to give some percentage of their total loans and advances to small and medium enterprises

Government financing efforts through its financial institutions have not yield a significant impact in terms of sustainability and growth of the sub sector. Also government indirect efforts via monetary and fiscal policy measures implemented by the central banks to make private sector banks to participate in funding SMEs have also not yielded desired results. As identified earlier, banks see funding of these enterprises as highly risky and therefore would specify stiffer conditions as a way of securing their funds. But on their part, SMEs are unable to meet such conditions and they are unable to access the funds necessary for their operation Dalberg (2011).As financing is one of the major instruments in developing any business enterprises,this study therefore focuses on the effect of financing on the profitability of small and medium enterprises. There is a need to investigate the extent financing has contributed to the performance of SME's.

Statement of the Problem

Small and medium enterprises have been acclaimed as the engine of growth for most economics most SMEs in Nigeria have common are besieged with a lot of problems which have hundred the development of the small and medium enterprises in the country. The financial problem however appears to be paramount. Because there are a lots of claims that finance has either positive or negative effect on profitability of small and medium enterprises. However, on the other hand, prospects may abound for small and medium enterprises if properly financed and note the effect of finance on profitability. These prospects may include enhanced employment for the citizen, increased revenue for the government of the land lower cost of production, quality goods and services amongst others.

Objective of the study

The main objective of the study is to empirically examine the effect of financing on profitability of small and medium enterprises. Other specific objectives are to:

i evaluate the major sources of financing of SME's.

ii assess the major financing constraints of SME's

iii analyse the effects of financing on profitability of SME's

Research Hypothesis

Ho1: There is no significant relationship between financing and profitability of small and medium enterprises.

LITERATURE REVIEW

What are the Small and Medium enterprises?

Small businesses are seen to be sacrosanct to stimulating entrepreneurial development, contributing to the transformation of the traditional sector into a modern one, creation of employment, reducing rural and urban migration and serving as a training ground for managerial skill acquisitions. Although small business suffers definitional consensus, scholars agree on various criteria to define what constitute a small business. Akinsulire (2005). There is no consensus on the definition of small and medium enterprises throughout the world due to differences in general economic development and the prevailing social conditions within each country (Pacific Economic Cooperation Council, 2003). Thus, various indices such as number of employees, invested capital, asset employed, sales volume, production capability and a contribution of these variables are used by various countries to classify a business under the small and medium enterprises. Essien (2006)defined a small and medium enterprises as an enterprises with a total capital employed of over N1.5m but not more than N50 million, including working capital but excluding cost of land and or a labour sizes of 11-10 workers. This depicts small businesses. However, majority of small and medium enterprises in Nigeria might not be able to boast of capital employed of N1.5m due to low per capital income of the citizens.

The central Bank of Nigeria may also define small and medium enterprises from an entirely different point of view. Criteria like few numbers of employees, low amount of investment and annual business turnover, smallness in size within the industry and owners managed have also been variously used to define small business (Akande and Ajagbe, 2011).

Small businesses are seen to be stimulating entrepreneurial development, contributing to the transformation of the traditional sector into a modern one, creation of employment, reducing rural and urban migration and serving as a training ground for managerial skill acquisitions. Although small business suffers definitional consensus, scholars agree on various criteria to define what constitute a small business (Akinsulire, 2005).Frequently it is said that there is a shortage of finance for small firms but it could be rather that there is an information gap, that small firms are unaware of the range of institutions which want to aid are able to provide them with funds, or of the scope of the services available (Faleye, 2005). As is widely known in most countries, unemployment is the greatest threat to economic growth and development. Therefore, proliferation of virile small business serves as an antidote to large scale unemployment (Akande and Ajagbe, 2011).

Financing Strategies Available to Small and Medium Enterprises

Every business is unique, from its size to operating cost to credit histories. There are various financing strategies available to small and medium enterprise (i.e. sources) and some of them are discussed hereunder. A small and medium enterprise owner will therefore decide on which form is right for this needs as well as the source to adopt.The various source of financing small and medium enterprises in Nigeria are:

1. **Owners' Equity:** Owner's equity as a source of finance includes personal savings, loan from friends and relations and ploughed back profit. One of the advantages of this type of finance is that the cost of raising them is usually low.
2. **Personal savings**: This is the commonest means of financing a business venture. It usually results from the owners past savings, windfall, and gifts from parent or well-wishers. The amount realizable from this source of fund depends on the owner's saving ability.

3. **Money from friends and Relations:** Depending on the business owner's relationship with friends and relations, they can help him in raising start-up and expansion capital forms him. However, the amount realizable from this source of fund is usually limited by relationship of the business owner with this or her friends and relations.

4. **Ploughed Back Profit:** This is also known as retained earnings. It is used in financing working and expansion capital.

5. **Debt: Money** borrowed from outside either formally or informally is classified as det. The repayment period and transaction cost however depends on the term, source and the procedure involved in borrowing it. The following sources of funds fall under this categories:

- **Trade credit:** This is an arrangement with goods seller by the business owner to buy goods on credit and pay later within the shortest period of time. The integrity and credibility of the business owner play important role as long as this source of finance is concerned.
- **Bank Loan:** Depending on the relationship between the business owner and his banker, a credit facility can be extended to him. This can e short, medium or long term loan. In most cases, provision of collateral security and guarantors will be required as conditions to be met before the loan is granted.
- **Bank Overdraft:** Sometimes the business owner will be allowed by his banker to overdraw his account as long as his credibility is established by the bank.
- **Bankers Acceptance:** This is a time whereby drafts are payable on or before the maturity date which is usually less than six months.
- **Accrual accounts:** These are outstanding payments such as rent, rate and o on that usually occur as account payable to business balance. The amount is expected to be settled within one year of a particular year.
- **Shares:** This is used when the small and medium enterprises operator wants to go public. That is, he wants the business to be quoted in the capital market. This might be through initial public offer (IPO) or through the secondary market.
- **Others:** Some other sources of finance under this category include; hire purchase, leasing, factoring of debtors, inventory financing and many others.

Types of Finance available to small and medium enterprises

According to Kalu (2006), there are three major types of finance available to small business enterprises. They are as follows:

- **Equity Capital:** Equity capital is that part of fund invested in the business by the owner (s) which the business is under no obligation either to refund or pay interest on. It is often regarded as risk capital because it is under the risk of being lost should the business fail. Equity capital can only be recovered by way of dividend or when the business winds up for a small and medium enterprise owner or prospective investor, equity capital forms a good basis for obtaining loans from financial institution. It may be difficult to obtain loans if the acquisition of equity capital is not properly identified. It forms the borrowing power of the business. Because of the risk involved in equity capital, it becomes necessary that a small and medium enterprise investor should assess all these before committing his savings in a new business. Having done that he determined how much equity he will invest.
- **Short Term Loan**: Short term lending is mainly in form of overdraft and loan usually to be repaid in less than one year. Banks provide this type of fund in form of working capital to help in the day to day running of the business for example the buying of inventory and seasonal stock, and other operating expenses. Such loans are self-liquidating because they generated sales naira which could be used to offset them. It is important therefore that money borrowed for a short period of time will be used in profit producing area of the business and will be repaid out of business operation.
- **Medium and long term loans**: These types of loan are generally for more than one year. Such loans are necessary to get the business started. They form part of the initial capital of the new project. It also provides capital for expansion of an on-going concern to enable such a business increase its productivity. Medium and long term loans are usually repaid out of the cumulated profits over the years.

METHODOLOGY

The research is based on the small medium enterprises in Oshodi - Isolo local government Lagos state. Oshodi - Isolo local government area is located on the north east of Lagos State. Which itself is situated on the south western part of Nigeria, West Africa on the narrow coastal plain of the Bight of Benin. The Local Government covers land area of about

9.0sqk and has a growing population of over 1,000,000 people/ inhabitants. It shares boarder with the following local government; Ikeja local government on the north, Onigbogbo Local Government on the North-East and Mushin Local Government in South- South East.

Spearman's rank correlation coefficient and multivariate analysis of variance and covariance (MANOVA) were used to analyses the data. Spearman's rank correlation coefficient is stated below

$$rxy = \frac{n£xy - £x£y}{\sqrt{n£x^2 - (£x)^2 \times n£x_{y}2 - (£y)^2}}$$

RESULTS AND DISCUSSION

Table 1: Major source of Finance of Small and medium enterprises

Source of finance	Frequency	Percentage
Personal resources	45	71.4
Micro finance loan	12	16.0
Family and friends	6	8.5
Commercial bank loan	-	0
Specialized financial institution	-	0
	63	100
Total		

Source: field survey, 2015

Table 1 above shows that the major source of finance of Small and medium enterprises in the study area is Personal resources because it carries the highest percentage of 71.4% which was followed by bank with 16.0 % and the least source of finance was family and friends with 8.5%. However, none of the respondents selected specialized funding facilities and Specialized financial institution as their source of finance. This implies that majority of the respondents depend on their personal savings as their major source of finance.

Table 2: Frequency and percentage distribution of constraint affecting Finance of Small and medium enterprises

Constraints	Frequency	Percentage
High interest rate	98	65.3

Insufficient loan	22	14.7
Delayed in loan	30	20.0
Loan diversion		
Loan default		
Total	150	100

Source: field survey, 2015

Table 2 above shows that the major constraint facing financing of Small and medium enterprises in the study area is High interest rate from banks and other financial institution, because it carries the highest percentage of 65.3% which was followed by loan default with 20.0 % and the least constraint of financing was loan diversion with 14.7%. This implies that major constraint facing financing of Small and medium enterprises in the study area is high interest rate.

Table 3: Result of product moment correlation coefficient on the effects of financing on profitability of small and medium enterprises

	Financing	Revenue	Profitability
Financing	1.0	0.181	0.048
Revenue	0.181	1.0	0.093

Source: field survey, 2015

Table 3 above shows result of product moment correlation coefficient which was used to determine the effects of financing on profitability of small and medium enterprises and the result was as follows:

Finance and revenue generated was weakly but positively correlated (0.181) and this implies that as finance increases, revenue generated also increases and vice versa. The result also shows that finance and Profitability is also weakly and positively correlated (0.048) and this implies that as finance increases, profitability increases and vice versa. The revenue generated and Profitability is weakly and also positively correlated (0.093) and this implies that as has amount spend on business increase, profitability increases and vice versa. It can be concluded that financing has positive effect on profitability of small medium enterprises in the study area. Therefore the null hypothesis is rejected that is there is significant relationship between financing and profitability.

Table 4: Relationship between Finance and Profitability of SME's using Spearman's rank correlation coefficient

Source of finance	profitability
Personal resources	-0.2089
Bank	0.2924
Family and friends	-0.0412

Source: field survey, 2015

The table 4 shows Spearman's rank correlation coefficient between each source of finance and profitability. The result shows that personal resources and profitability are negatively correlated, (-0.2089). This implies that there is a negative relationship between personal resources and profitability. Hence, personal resources have negative effect on profitability of small and medium scale enterprises. Bank and profitability are positively correlated, (0.2924). This implies that there is a negative relationship between personal resources and profitability. Hence, Bank has positive effect on profitability of small and medium enterprises. Family and friends as a source of finance and profitability are negatively correlated, (-0.0412). This implies that there is a negative relationship between family and friends as a source of finance and profitability. Hence, family and friends as a source of finance has negative effect on profitability of small and medium scale enterprises.

Table 5 -Analysis of the significant relationship between financing and small scale profitability by MANOVA

Source	Statistic		Df	F(df1, df2)	=	F	Prob>F
Source of Finance	W	0.3340	4	4.0 120.0		106.33	0.0000 e
	P	0.6760		4.0 120.0		106.33	0.0000 e
	L	1.7583		4.0 120.0		106.33	0.0000 e
	R	1.7583		4.0 120.0		106.33	0.0000 e
Residual			120	Number of obs =		150	
Total			124				

Dependent variable - small scale profitability. Source : MANOVA using STATA 11

Source: field survey, 2015

W = Wilks' lambda, L = Lawley-Hotelling trace, P = Pillai's trace, R = Roy's largest root, e = exact, a = approximate, u = upper bound on F

To authenticate the significant relationship between finance and small scale profitability by the outcome of Spearman's rank correlation coefficient stated above, the multivariate analysis of variance and covariance (MANOVA) was also employed. From table 5 above, according to Wills' lambda(W) statistic, 1% increases in finance increases the rate of small and medium profitability by 0.33%. also, with reference to Pillai's trace statistic, 1% increase in finance also increases the rate of small and medium profitability by 0.67%. in addition, with the outcome of Lawley-Hotelling trace (L) and Roy's largest root (R) statistic, 1% increases in finance leads to increase in the rate of economic development by 1.75%. All the statistic outcome suggest the positive significant relationship between finance and the rate of small and medium profitability. This also supported by F(52.33) and probablity of F (Prob>F) equal to 0.0000e. Increasing in finance of small and medium enterprises is directly and highly correlated to the level of profitability in small and medium enterprises.

SUMMARY AND CONCLUSIONS

This study was primarily concerned about the effect of financing on profitability of small and medium enterprises. The majority of the respondent believed that personal resources are the major source of financing their enterprises. High interest rate was the major constraint facing financing of small and medium enterprises in developing their business. Banks and other financial institution fail to offer loan to small and medium enterprises at a lower interest rate. The study conducted shows that finance has a negative effect on profitability of small medium enterprise in the study area. This may arises due to the fact that the major source of financing these enterprises is based on the personal resources and majority of this resource are not adequate to cater for expenses needed to finance the enterprises, lack of proper management, lack of financial and accounting system, high withdrawal of funds for personal uses, unfavourable government policies in term of high taxation and other relevant unfavourable factors. Amongst other are the problems that lead to negative effect of finance on profitability of these enterprises. Increasing in finance of small and medium enterprises is directly and highly correlated to the level of profitability in small and medium enterprises.

POLICY RECOMMENDATIONS

Based on the findings the following recommendations are proffered

1. Banks and others financial institutions should always make loans available to small and medium enterprises with the barest of interest rates in order to boost their profitability which will invariably trigger employment opportunities in Nigeria.
2. Every trace of bias and discrimination towards small and medium enterprises should therefore be eliminated by Government. They should be seen as partners in progress with large medium enterprises and other operators in the economy.
3. As it can be seen from the results and discussion that finance has a negative effect on profitability of small and medium enterprises in the study area, which is against the normal expectation this may arises due to lack of proper management, lack of financial and accounting system, high withdrawal of funds for personal uses, unfavorable government policies in term of high taxation and other relevant unfavorable factors. Small and medium enterprises should note all these problems and find a solution to them.
4. Small and medium enterprises must as a matter of necessity avoid all temptations to misuse loans they obtains and learn to operate a proper financial and accounting system such as book keeping entry, budget, cash flow analysis and other accounting system relevant to their operation.

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