Financial Structure Mix: Effect on Growth and Earning of Small and Medium Enterprises in Nigeria

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Abstract

The study examined the relationship between growth and earning and financial structure mix of the SMEs vis-à-vis various government funding schemes. The problem of high entry-exit rate of SMEs in Nigeria remains an issue in point. The study is a descriptive study which made use of structured questionnaire for data collection and percentages and chi-square for analysis purposes. The study revealed that granting pioneering status for tax purpose will go a long way to create a strong earning base for the SMEs. It was also revealed that personal saving is mostly used by the SMEs owner to start the business but it is not better than debt financing (government financing, leasing etc) at growth stage of the SMEs' life. It was recommended that government policy formulation and implementation in regard to SMEs should have grassroots content. It was also recommended that professionalism should be adopted in financial structure mix and management of the SMEs for increasing earning and growth.

Key Words: financial structure, capital structure, SMEs, debt, shares,

Introduction

Today more than ever before the small and medium scale enterprises (SMEs) is pivotal to the economic growth of the nation, almost 80% of the total population of Nigeria are either self-employed or running a small and medium scale business in one or the other segment of the economy (kehinde, 2003). The SMEs also contribute strongly to the national economic productivity, and it is the bedrock of economic growth and development. The means of financing the SMEs remain an issue to many owner of the SMEs, they often start the firms using seed-capital from either personal saving, retirement benefit, family and other relations, sometimes less often than not the start-up capital are provided by loans from financial institutions. The experience in SMEs growth has shown that the entry-exit rate is very high in SMEs' development. The SMEs have most times been bedeviled by poor funding by the proprietors (at the growth stage) since all the sources available to them have limited funding capacity. The need, therefore, to expand the business using debt finance remains vital to the expansion, growth and improved earning structure of SMEs.

To ensure that the SMEs grow and increase, government of Nigeria over the past forty years have implemented various developmental schemes relating to funding, management and marketing of services and products by the SMEs,( ) however, the resultant effect of the supportive and developmental schemes of the government have been very low. Most SMEs have an all equity financial structure over many years as they could not assess debt finance from the private financing institutions (Commercial banks), as well as from the government funding scheme partly due to stringent conditions by the commercial banks and the poor implementation of government schemes. Thus, this study is aimed at evaluating the relationship between the SMEs growth and financial structure mix in Nigeria.

Conceptual Frame Work

Capital structure, in finance, refers to the way a corporation finances its assets through the combination of equity, debt, or hybrid securities. It is the ratio of different kinds of securities raised by a firm as long-term finance. The capital structure of a firm described the combination of both debt and equity finance structure of the firm. A firm's capital structure is therefore the composition or 'structure' of its liabilities.

The relative ratio of securities can be determined by process of capital gearing. On this basis, the companies are divided into two namely highly geared companies: this are   firms whose proportion of equity capitalization is small. Low geared companies: this are firms   whose equity capital dominates total capitalization (Wikipedia, 2012, MSG, 2012)

The Modigliani–Miller theorem (1958) of capital structure states that, under a certain market price process in the absence of taxes, bankruptcy costs, agency costs, and asymmetric information, and in an efficient market, the value of a firm is unaffected by how that firm is financed, that is, it   does not matter if the firm's capital is raised by issuing shares or debt finance . It does not matter what the firm's dividend policy is. Thus, this theory by the Modigliani–Miller is often called the capital structure irrelevance principle. The Modigliani and Miller (M&M) capital structure relevant and irrelevant theorems posit that   in the absence of company taxes, there are no benefits, in terms of value creation, to increasing leverage and on the other hand in the presence of taxes, such benefits, by way of interest tax shield, do accrue when leverage is introduced and/or increased. The capital structure theory by Modigliani and Miller are three types' namely static trade-off theory, agency theory and theories based on information asymmetries (Cohen, 2004)

Trade-Off Theory of Capital Structure

In the trade-off theory of capital Structure the bankruptcy cost is allowed to exist. It states that there is an advantage to financing with debt (namely, the tax benefits of debt) and that there is a cost of financing with debt (the bankruptcy costs and the financial distress costs of debt). The marginal benefit of further increases in debt declines as debt increases, while the marginal cost increases, so that a firm that is optimizing its overall value will focus on this trade-off when choosing how much debt and equity to use for financing. Empirically, this theory may explain differences in D/E ratios between industries, but it doesn't explain differences within the same industry.(Cohen, 2003)

 The theory never the less, states that with no taxes, there are no debt-related tax benefits, and with no such benefits [assuming everything else remains constant] there is no optimal capital structure. With no optimal capital structure, therefore, one could only conclude that the whole notion [based on the contention that E + D = constant] of trying to locate the optimal capital structure becomes self-contradictory and, thus, meaningless (Cohen, 2003)
In another study by Cohen(2004) on determination of weighted average cost of capital   and firms value in relation to capital structure with intent to locate the optimal capital structure, taking   into consideration the relationship between debt, equity and taxes, and placing emphasis on the effects of default risk, as well as on the assumptions that underlie the curves discovered that   the conventional   optimal capital structure theory by Modigiliani and Millan is flawed as is not commonly used in practice,

Cohen also in the study of the difference in the capital structure of depository institutions(banks) and that of the corporate firms .using the   basic Modigliani-Miller [M&M] methodology, but instead of using a constant EBIT as stated by (M &M), as classically done for corporate firms used a variable EBIT, which hinges on the interest earnings from the asset-based loans made to the borrower discovered that the optimal capital structure of a depository institution is not as easily identifiable as that of a corporate firms. The reasons for this include, among others, (i) the existence of regulatory capital restrictions, (ii) an inter-dependence between the borrower and the lender and (iii) a dramatic change in the behaviour of the return on equity with respect to leverage when risks and credit spreads of both, lender and borrower, are accounted for. The study also highlighted some of the main differences that exist between the treatment of the capital structure of corporate firms and depository institutions.

Mac an Bhaird (2010) In a study of samples of   the capital structure of 299 Irish   small and medium sized firms (SMEs) Using hypotheses formulated from pecking order and agency theories and also incorporating a financial growth life cycle approach discovered that the age, size, level of intangible activity, ownership structure and the provision of collateral are important determinants of the capital structure in SMEs.

Zellner(1962) also in a study of the capital structure in several firms discovered that the influence of age, size, ownership structure and provision of collateral is similar across industry sectors, indicating the universal effect of information asymmetries and also discovered that firms overcome the lack of adequate collateral security by providing personal assets as collateral for business debt, and by employing additional external equity .

Murphy, Ofer and Satterthwaite (2009) stated that Modigliani and Miller in their 1958 article showed that if firms are in the same risk class and in an economy with a perfect capital market having no transaction costs, taxes, or no bankruptcy costs, then their relative market values are independent of their capital structures how ever where they are in a taxable situation then their capital; structure counts in determination of their net return

Pecking Order Theory

Pecking Order theory tries to capture the costs of asymmetric information. It states that companies prioritize their sources of financing (from internal financing to equity) according to the law of least effort, or of least resistance, preferring to raise equity as a financing means "of last resort". Hence: internal financing is used first; when that is depleted, then debt is issued; and when it is no longer sensible to issue any more debt, equity is issued. This theory maintains that businesses adhere to a hierarchy of financing sources and prefer internal financing when available, and debt is preferred over equity if external financing is required (equity would mean issuing shares which meant 'bringing external ownership' into the company). Thus, the form of debt a firm chooses can act as a signal of its need for external finance. The pecking order theory is popularized by Myers (1984) when he argues that equity is a less preferred means to raise capital because when managers (who are assumed to know better about true condition of the firm than investors) issue new equity, investors believe that managers think that the firm is overvalued and managers are taking advantage of this over-valuation. As a result, investors will place a lower value to the new equity issuance.(Myers, 1984, Mac an Bhaird ,2011))

Strebulaev (2012) study the capital structure theory using the calibrated dynamic trade-off model to simulate firms' capital structure path   and stated   that in the presence of frictions, firms adjust their capital structure infrequently. As a consequence, in a dynamic economy the leverage of most firms is likely to differ from the "optimum" leverage at the time of readjustment. It also noted   from the results of standard cross-sectional tests on selected data a consistency between the practice and theory of capti9al structure with a little difference   and thus suggest a rethinking of the way capital structure tests are conducted.

 Leary and Roberts (2012) empirically examine whether firms engage in a dynamic rebalancing of their capital structures while allowing for costly adjustment. They begin by showing that the presence of adjustment costs has significant implications for corporate financial policy and the interpretation of previous empirical results. It confirms that financing behavior is consistent with the presence of adjustment costs and that firms actively rebalance their leverage to stay within an optimal range. Our evidence suggests that the persistent effect of shocks on leverage observed in previous studies is more likely due to adjustment costs than indifference toward capital structure

Definition of SMEs

It important to define what is an SMEs and what the growth of SMES meant in this study Abiola (2012), define Small and Medium Scales Enterprises as firm which employ total of between 10 to 200 employees on the other hand   the government classified SMES as firms that employ up to 300 Peoples with a capital bases of N100millon. Abiola (2012). Also states that SMEs owners are not conscious of growth, by growth he meant the increase in size and earning of the firm. Abiola (2012) thus, measure growth in term of increasing earning of the firm and increase size of the firm.

Research problem

Time and again small and medium scale enterprises mushroom around within the economy in almost all segment of the economy but more often than not they die few period after their commencement, partly due to lack of fund to grow and survive, sometimes due to poor earning and profit structure, the SMEs are often stranded by stiff competition from cheap imported variance of their services or product(s). The government also over the years has formulated many well designed policies of funding and growth for the SMEs   notwithstanding the tide of the death of the SMEs remain very strong. The nation experience on SMEs is that of a high entry-exit style.

Thus, the question is why do most SMEs lack fund for growth purpose? Another question is why do most SMES die despite the many program of the government directed towards the finance of SMEs. Lastly, at what stage of the SMEs life do they need effective financial structure mix for growth?

Research Method

The research is a descriptive study of the relationship between SMEs growth/earning and financial structure mix in Nigeria.

The survey method using structured questionnaire was adopted for the study. The questionnaire consists of eight questions relating to the subject matter of the study. Lagos state was chosen as our study area, and four local governments within the state were covered, one hundred questionnaires were distributed evenly among the four selected local governments. The most senior-manager (s) of the SMEs were chosen for the study. Secondly, the samples were discretionarily selected to allow for quick and strong opinion representation since in every local government the opinion of the largest or biggest SME owner or senior manager will represent that of others in that industry. Of the 100 questionnaire distributed only 92 were retrieved, and of the 92 collected only 81 were usable. This give us 81% respondent which according to Osuagwu(2006) is good representation . The chi-square and percentage were the two analytical tools since the chi-square is more suitable for a descriptive study of a non-parametric nature.

Hypotheses

(1) Government exemption of SMEs from tax by granting of pioneer status will not help increase the earning base for SMEs growth
(2) Personal saving and equipment leasing are not better financing option than government finance when growing a small and medium scale business.
(3) Inaccessibility of government financing option is not the bane of SMEs growth in Nigeria

Data Analysis and Interpretation

Hypothesis1

Government exemption of SMEs from tax by granting of pioneer status will not help increase the earning base for SMEs growth

Table1

	Frequency	**percentage**
Indifference	36	44
Agreed	27	33
Strongly agreed	18	23
X2		6.000**

Note ** connote significance at 5% significant level

Interpretation

The spread of responses on the variance shows that 44% of the respondents are indifferent and 33% agreed while 23% strongly agreed, this shows the spread of responses and the divergent in opinion by respondents. The opinion converges at 53% showing as above average asymptotic convergent view. Variables significant level suggest a relieve

The variable is significant at 5% significant level with a chi-square value of 6.000 this means that government grant of pioneering status for tax purpose will help improve the earning base of SMEs growth.

Hypothesis 2

Personal saving and equipment leasing are not better financing option than government finance when growing a small and medium scale business.

	Frequency	Percentage	Percentage	Percentage
	A	A	B	B
Disagreed	-	-	9	0.11
Agreed	45	0.55	54	0.67
Strongly agreed	36	3.45	18	0.22
	81	100	81	100
X2			1	42.00**

Note: A- personal saving variables and B- equipment leasing
   *, ** connote significance at 10% and 5% significant level

Variable A

The spread of opinion show 55% agreed and 45% strongly agreed, this reveal a strong convergent of opinion and show a strong decision point.

The variable is not significant at either 10% or 5% significant level hence the hypothesis that personal saving is not a better option than debt finance option by government in growing a small and medium scale enterprises is accepted. It means that although personal saving could be a good option in starting SMEs but obviously government debt finance option is better for growth and expansion.

Variable B

The opinion on the variable is strongly convergent at 89% (0.677%+22%) while the divergent opinion is at 11%. It is a good spread of opinion and well representing

The variable is significant at 5% significant level with a chi-square value of 42.00. It thus mean that the null hypothesis is rejected while the alternate hypothesis which state that equipment leasing option is better than outright purchase option using government debt finance provision is accepted.

Hypothesis 3

Inaccessibility of government financing option is not the bane of SMEs growth in Nigeria.

	Frequency	percentage
Indifference	18	22
Agreed	27	0.33
Strongly agreed	36	45
Chi-square		6.00*

*, ** connote significance at 10% and 5% significant level

Interpretation

The opinion of the respondent is well spread between indifference, agreed and strongly agreed with 22%, 33%, 45% respectively. It revealed a divergent view of 22% against a convergent opinion at 78%

The variable is significant at 10% significant level with a chi-square value of 6.000 thus; the inaccessibility of government financing option has been the bane of SMEs growth and spread in Nigeria

Findings and Conclusions

Findings

The research is a comprehensive study of the relationship that exists between the earning/growth and financial structure mix in small and medium scale enterprises in Nigeria. The study exclusively finds out that:

1. The inaccessibility of the various government loan and funding scheme have been greatly responsible for poor growth and incessant death of Small Scale Enterprises in the country. This is in consonance with the assertion of OECD (2006) the finance of most SMEs is limited to personal finance only with little ability to asses debt finance either directly from the government finance program or form the commercial banks
2. The study also discovered that equipment leasing will provide a good spread of risk and retention of cash and earning than other debt finance of SMEs debt finance.
3. It was also discovered that personal saving will provide a good start-up point and seed money for starting SMEs but debt financing option with low interest rate will provide a good growing point for the SMEs.

Conclusion

The SMEs provide the bedrock of economic growth and spread of opportunities and employment generation. It also provides a strong earning base for various proprietors of the SMEs, however, over the years the incessant death is due to poor administration of government financing and SMEs supporting schemes in Nigeria. Most SMEs have survived and grow based on personal financing. The various money market financing schemes or loans are quite out of reach of the SMEs' proprietors due partly to inability of the SMEs owners to satisfy the conditionality of the commercial banks providing the loans

Recommendations

1. The study recommends that government policy formulation and implementation in relation to SMEs financing should have grassroots content. The government should also be keenly interested in helping the growth and spread of SMEs through various schemes, such as equity participation scheme, loan-participation scheme and other growth motivation schemes, incubator schemes and investment development center schemes would equally .
2. To further the growth of the SMEs, those SMEs existing within the strategic segment of the economy should be granted pioneer status to enhance their growth and earning ability.
3. The government should also put in place import discouragement and export encouragement strategy so as to protect the SMEs from competition with imported variance of their products
4. The individual SME owners should also engage professionals either on contract bases or equity-ownership basis to help foster professional practice in management and finance , this will help position the SMEs for various government funding schemes and it will help meet the conditionality of the private funding institution, that is, commercial banks

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