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Does the Legal Form of Small and Medium Enterprises Determine their Access to Capital?

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Abstract

Small and Medium Enterprises [SMEs] in Ghana are often denied capital by the financial institutions. Hence, this study utilized data from self-administered questionnaires to 123 SME operators in the Cape Coast Metropolis to ascertain if the financial institutions consider the legal form of business ownership of SME before lending capital. Descriptive statistics, Chi-square and Hierarchical regression were employed to analyse data. We failed to reject the null hypothesis which implied that the financial institutions do not put much emphasis on the legal form before lending capital to SMEs, neither does the legal form determine the amount of capital borrowed. The recommendations were that the National Board for Small Scale Industries (NBSSI) must ensure that all the SMEs are registered and their business operations formalized. Besides, they should also train SME operators on basic business management skills, particularly, keeping accounting records. Government SME financing scheme managers must work professionally by administering the funds to SMEs based on merit and not on other irrelevant considerations such as political affiliation, cronyism or nepotism. Finally, SMEs must revamp their various trade associations to create a formidable union.

Keywords: Small and Medium Enterprises [SMEs], legal form and financial institutions.

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Introduction

Small and Medium Enterprises (SMEs) are continually gaining importance in the global economy. Both theoretical and empirical studies admit the invaluable contributions of SMEs to the economic growth of a country (Yeboah, 2015). Omar, Arokiasamy and Ismail (2009) considered SMEs to be one of the principal driving forces in economic development, in that SMEs stimulate private ownership and entrepreneurial skills, and adapt quickly to changing market demand and supply situations. Kongolo (2010) emphasized that SMEs contribute immensely to the economic progress of many countries. The activities of SMEs greatly influence the economic development and accelerated growth of developed countries. The percentage contribution of SMEs to the Gross Domestic Product (GDP) of some selected developed countries is as follows: 57% in Germany; 55.3 % in Japan; 60% in China and 47.3% in Malaysia. In the US, SMEs provide more than half of the country's gross domestic product (Ngek, 2014). Ilegbinosa and Jumbo (2015) concluded that SMEs contribute more than 50% of the GDP in developed countries. It is widely agreed that the common goal of promoting SME development is to empower individuals to create jobs and in so doing alleviate poverty. Particularly in developing countries, SMEs provide employment opportunities for the unskilled workforce since they dominate the population of such countries (Phillips & Bhatia-Panthaki, 2007). Africa's SMEs are regarded as the enabler for economic growth and development. In many African countries, SMEs make up about 50% of job creation. For example, SMEs constitute 91% of formalized businesses, contributing 57% and 61% to GDP and employment respectively in South Africa (Kongolo, 2010 & Ngek, 2014). But, Fatoki and Garwe (2010) intimated that, the creation rate of successful SMEs in South Africa is the lowest in the world and most SME fail in the fifth year of operation (Willemse, 2010). SMEs in Nigeria account, on average, 50% of employment, 70% of the manufacturing sector and 50% of its industrial output (Osotimehin, Jegede & Akinlabi, 2012). But, Nigeria's SMEs' inability to have adequate capitalisation and collateral is a key constraint to their access to capital (Ireghan, 2009; Ilegbinosa & Jumbo 2015).

Ghana's economic development is appreciably enhanced by the SME sector. About 92% of businesses are SMEs and they creates 85% of employment in the manufacturing industry and estimated to contribute about 70% to GDP (Frimpong, 2013 & Asare, 2014). Notwithstanding, the enormous economic benefits a country derives from a robust SME industry, there are numerous impediments restraining the development and growth of the SME sector. Unlike developed countries where SMEs benefit from an immense deal of stimulus incentives, Africa's SMEs are confronted by generic problems such as the absence of the requisite infrastructural development and apt government policies to spur the development and growth of SMEs. The key SME constraint is the lack of access to capital from both the banking sector and the capital markets. SMEs are compelled to change their funding mix as the cost of borrowing has gone up. SMEs mostly rely on short-term funding options including overdrafts, bank loans and lines of credit. These sources can be valuable during the start-up phase but do not enable long-term financing as SMEs mature and seek growth. Abor and Quartey (2010) opined that SMEs long-lasting development and competitiveness is pampered by the unending and repeatedly heightened restrictions on access to formal sector finance. The financial sector perceives lending to SMEs as a risky business practice because SMEs are noted for high mortality rate and lack appropriate collateral required by the financial institutions. Frimpong (2013) remarked that the SMEs are living on the edge as financial institutions dedicate much of their loan portfolio to big companies.

The absence of readily available capital to persons in the informal sector in Ghana puts a grave load on entrepreneurs to obtain the needed amount of capital for business development and this explains why it is difficult for ideas to grow into enterprises in Ghana. Closing the financing gap between SMEs and larger enterprises is regarded imperative for SME growth. SMEs' access to capital must be one of the priorities of all governments if SMEs are to attain their full potential by moving from start-ups to growth oriented business firms. It is generally agreed between academic and business fields that SMEs in Ghana are plagued with challenges and one of the key problems adversely affecting their investment and business expansion is the inefficient external capital mobility. Moreover there is a common consensus on the influence of SMEs characteristics on the financing schemes chosen by SMEs. In support of this agreement, Abor and Biekpe (2006) identified the legal form of business as one of the factors determining the decisions of SMEs regarding their capital structure. Consequently, this study has sought to seeks is to expand the scope of discussion by investigating how the legal form of business determines SMEs' access to capital while controlling the interference of demographic variables. This article proceeds with a literature review of the legal forms of business ownership and its implication for SMEs, and SME Financing Schemes in Ghana. The hypothesis is stated, followed by the methodology and discussion of results.

Literature Review

Legal forms of business ownership

The decision on the type of legal form to operate a business firm is one of the early executive decisions to make. The choice is very crucial to the success or otherwise of the business since it would determine the legal implications for the business. Entrepreneurs must be aware of the nature and future directions of the businesses, how to exit the business as and the responsibilities bothering on reporting, compliance, tax liabilities and liability in personal capacity. Most importantly, the entrepreneurs must ensure that the legal form fits the growth strategy of the business firm. The legal forms of business ownership comprise of three types: Sole proprietorship, Partnership and Corporation. Sole proprietorship is owned by one person and legally not separate from the owner. Partnership has two or more owners of an enterprise with a detailed written document covering the partnership agreement. The partnership is not a separate legal entity from its owners but, can acquire properties and incur debts in its name. Corporation is an "artificial person" created and operated by laws. This "artificial person" exists on "paper" but exercises the interests, rights and liabilities of a natural person. The Corporation is established by filling a form with the registrar of company, known as the article of incorporation (Barringer & Ireland 2006)

The Implications of the legal forms for SMEs

The sole proprietorship is the easiest and less costly to form. The owner enjoys absolute control over the business as well as all the profits and loss. Yeboah (2015) remarked that owners of SMEs have an overwhelming preference for sole proprietorship due to the relative freedom they enjoy. However, the disadvantage is that the owner has an unlimited liability, implying that all business debts are personal debts attached to the owner. The death of the owner might end the existence of the business. A business operated as a partnership is also easy to establish. Partners combine resources which lead to adequate physical and intangible resources; hence, enough available capital and better business decisions are reached. Nevertheless, a partnership firm also has an unlimited liability as all business debts are borne by all the partners, the action of one partner affects the remaining partners and the partnership collapses when a partner dies or withdraws himself/herself from the partnership.

Regarding corporation, owners have limited liability because it is the invested amount that they lose. Corporations enjoy a perpetual succession. The key disadvantage of operating corporation is double taxation which makes both the corporation as a legal entity and shareholders pay taxes (Barringer & Ireland 2006). Quite a number of studies have indicated the relationship between firm characteristics and business performance. Dean, Bulent and Christopher (2000) opined that firm characteristics are core determinants of firm success. Mohd (2005) affirmed that firm characteristics determine the overall performance of a firm. Ural and Acaravci (2006) intimated that a positive relationship exists between company size and profitability. Findings from a study carried out by Yeboah (2015) indicated that SMEs operating as sole proprietors experienced significant increases in sales. However, other researchers documented that limited liability company experience rapid growth in sales (Stiglitz & Weiss, 1981; Reynolds & Miller, 1988).

SME Financing Schemes in Ghana

SME financing in Ghana takes place in two forms: either as an official scheme developed by government and or other international agencies; or financing provided by private institutions. The official schemes are managed by the Aid and Debt Management Unit of the Ministry of Finance and Economic Planning. The motive has been to increase the availability of capital to the SMEs to help them increase productivity, and boost their local and international competiveness. The funds under the official schemes include the Ghana Investment Fund, Business Assistance Fund, EDIF, Ghana SME fund and other guarantee facilities. Ghana's development partners have provided various credit schemes through both commercial banks and micro finance institutions, in addition to training and providing business support services to SMEs. Some of Ghana's donors are USAID, UNDP, UNIDO, CIDA, DANIDA and GTZ. Examples of partnership funding schemes between the government and donors are Private Enterprise and Export Development Fund (PEED) supervised by the Bank of Ghana but administered through banks, and Trade and Investment Program (TIP) managed by USAID and the Ministry of Finance (Mensah, 2004). Unfortunately, because of the obnoxious experience of direct lending by government to SMEs in the past, current donors prefer to use exiting financial institutions as intermediaries to channel funds to SMEs. The Small Business Loan Portfolio Guarantee and European Investment Bank Facility are examples of schemes operated by donors and financial institutions (United Nations Conference on Trade and Development, 2011).

Financing provided by private institutions are mostly in reference to lending offered by the banks, non-bank financial institutions and private equity to SMEs. Mensah (2004) revealed that equity capital needed by growth-oriented SMEs is virtually non-existent in Ghana and reiterated that in the past, the United State Agency for International Development (USAID) and the Commonwealth Development Corporation (CDC) sponsored the formation of a venture capital fund in Ghana. The business details of SMEs make equity capital unattractive due to the high uncertainty of SME profits and the cost of supervising shareholding in SMEs.

Microfinance has become an important component of SMEs funding in Ghana. Microfinance is the provision of financial services to poor or low income clients who are normally excluded from the formal financial sector. They are described "unbankable" due to their failure to provide collateral and are predominantly found in the informal sector (Westover, 2008). Microfinance institutions provide services such as business consultancy, loans, savings, money transfer services and micro insurance (Helms, 2006). In the view of Todaro and Smith (2009), the emergence of microfinance institutions is significantly assisting the business course of SMEs by providing them with adequate capital which could otherwise be difficult to obtain. They argued SMEs need not only credit, but also savings, cash transfers and business insurance. Frimpong (2014) intimated that despite all the foregoing funding facilities, SMEs in Ghana still do not get needed financial assistance owing to a mirage of problems such as inadequate legal and regulatory systems as well as poor institutional framework, SME managerial capacity issues and inappropriate risk management. At present, banks and financial institutions have recognised SMEs as an attractive customer group and are gradually broadening their loan portfolio to cover them. Nonetheless, financial institutions perceive lending to SMEs a high risk due to the high default rates. As a result, only a few financial institutions have SME specific loan products. To mitigate the high risk of lending to SMEs, financial institutions demand collateral and also charge higher interest rates on loans. Government funding schemes to SMEs are failing or not effective as required because clients default to pay back the funds as governments also politicize the disbursement of the funds. The funds are given to owners of SMEs not based on merit but, characterised by nepotism and cronyism. It is widely agreed the lack of available external capital is not the sole problem bedeviling SMEs in Ghana; nevertheless, adequate available capital could enhance SMEs' access to the required resources to guarantee their business growth and success.

Hypothesis

H_1: *The legal form of business ownership does not significantly influence SME access to capital.*

Methodology

Population and sampling size

The study was conducted in the Cape Coast Metropolis, the capital city of the Central Region. Cape Coast Metropolis is the commercial hub of SMEs in the Region. The SMEs are engaged in wholesale and retail, building and construction, manufacturing, fabric designing, hair dressing and agriculture. A list of 182 registered SMES was obtained from the National Board of Small Scale Industries (NBSSI), Cape Coast office. The list of SMEs was categorised into the various industrial classification as specified by the Ghana Investment Promotion Council. A sample size of 127 was drawn from the 182 SMEs based on the formula developed by Krejcie and Morgan (1970). Table 1 depicts the size of SMEs in each industry and the corresponding sample size as well as the number of questionnaires retrieved.

Table 1 Sampled SMEs for the Study

Industry	Population	Sample Size	Retrieved Questionnaire
Manufacturing	55	39	38
Retailing	65	45	44
Service	53	37	36
Construction	9	6	5
TOTAL	182	127	123

The sample size for each industrial classification was obtained by using the formula $n_1 = \frac{n \, x \, N^1}{N}$ Where; n_1 = Sample size, n= sample population N = general population and N_1 = stratum (population). Out of the 127 questionnaires administered, 123 were retrieved representing a success rate of 96.85%.

Research Instrument and Analysis

Data was collected using self-administered questionnaire. The questionnaire was grouped into two parts. Part A elicited demographic and business information. In Part two, the respondents were required to indicate whether they had ever obtained any external capital, and what type it was. The items on the questionnaire were developed from the review of literature. Descriptive statistics, Chi-square and hierarchical region were employed to analyse data.

Results and discussions

Characteristics of SMEs

The SMEs operators were 64.2% males and 35.8% females. It is obvious males dominated the SME sector; 45.5% were between 35 and 44 years, followed by 45 to 54 year group with 23.6%, 19.5% were older than 54 years and 11.4 percent were between 25 and 34 years. This gives a picture of a youthful adult population of SME operators. Besides, 39.0% had JHS/Middle school education, 30.9% had Senior High School and 16.3 % had Post Secondary Diploma education. 6.5% and 4.6 % had Commercial/Technical/Vocational and Primary education respectively while, 2.4 % obtained a Bachelor Degree. This results show that the majority of the SME operators were JHS/Middle school education leavers. Hence, their inability to effectively manage their businesses, leading to low rate of access to finance.

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Regarding the business characteristics of the SMEs, 73.2 % preferred to double as owners and managers while, 26.8% employed managers. Sole proprietorship was the most preferred legal form with 58.5% as opposed to 32.5% for company and 8.9% opted for partnership. Moreover, 35.8% of the SME operators were engaged in retailing, 30.9 % were manufacturers. Service providers recorded 29.3% and those in construction were 4.1%. The majority (42.3%) of the SME operators have owned and/or managed their business for more than 10 years; 31.7% for between 7 and 10 years; 17.1% for 3 to 6 years and 8.9 % had associated with their business for less than 3 years.

SMEs Access to Capital

It is a common practice that financial institutions, particularly the banks only give capital to clients who operate an account with them and therefore the objective was to find out whether the SME operators have an account with a financial institution. An overwhelming majority of 98.4% have opened an account with a financial institution compared with just 1.6% with no account. This implies that the SME operators are aware of the benefits of holding an account with a financial institution. With regard to the type of account, 56.9% and 41.5% indicated they operated saving and current account respectively; 68% of the SME operators answered in the affirmative that they have borrowed capital from a financial institution and 32% responded negatively. Furthermore, 53% admitted they have borrowed from microfinance companies, 36% had borrowed from credit unions and 11% from banks. This result confirms the argument that Banks in Ghana are very cautious lending to SMEs and as such, most SMEs do not rely on banks for financial assistance because of their inability to provide the requisites demanded by the bank.

Hypothesis Testing

H_1: *The legal form of business ownership does not significantly influence SME access to capital.*

The null hypothesis was stated to determine whether the financial institutions as part of their requirements also consider the legal form of business ownership before lending capital to SMEs. Previous studies suggest that the firm characteristics of SMEs influence their business performance. The Chi square analysis was used to test this hypothesis. The results as depicted at the appendix recoded no significant association between legal form and access to capital [x (1) = 0.59, p= .743]. Both the Phi and Cramer's V recorded a weak association. Thirty-six (36) of the SME operators are operating as sole proprietorship, 6 as partnership and 23 as a company all indicated they have borrowed capital from a financial institution. But, SME operators of 36 sole proprietorships, 5 partnerships and 17 companies have not borrowed any capital from any financial institution. Therefore, we failed to reject the null hypothesis. This means that the financial institutions do not consider the legal form of the SME before lending money to them; that is, regardless of legal form [sole proprietorship, partnership and company], SME operators have equal opportunity to obtain capital from the financial institutions.

The Influence of Legal Form on the Amount of Capital Accessed

This section seeks to determine the influence of legal form on the amount of capital accessed by the SMEs from the financial institutions while, controlling for gender, age and educational qualification. Hierarchical regression was employed to achieve this objective. The analysis output is displayed at the appendix. The results show that the demographics (gender, age and education) significantly influenced the amount of capital SMEs have accessed (R^2= .422, p =.000). Specifically, the coefficients table revealed that each of the demographic variables had a significant influence on the amount of capital borrowed by the SME operators. This suggests that demographic characteristics of SME operator influence 42.2% of the financial institution's decision to lend an amount of capital to SMEs. The second mode added legal form as the third additional predictor variable. The new R-Square and p- value were .519 and .000 respectively. The inference is that legal forms singularly influence the financial institutions by 9.7% in deciding the amount of capital to lend to SMEs. This outcome corroborates with the result of the hypothesis testing, which indicated there is no significant association between the legal form and SME access to capital. Hence, it is possible for SMEs to operate as sole proprietorship, partnership or company to have access to the same amount of capital from the financial institutions. This conclusion is drawn because 9.7% is not a very significant influence on the financial institutions, the presumption could be that the financial institutions put premium on other requirements deemed imperative.

Conclusion and recommendations

The thrust of this study was to find out if the financial institutions consider the legal form of business ownership of SMEs before lending capital. The findings suggested that the majority of the SME operators have opened a savings account and have borrowed capital from a financial institution. Specifically, they have borrowed from a microfinance company. We failed to reject the null hypothesis which implied that the financial institutions do not put much emphasis on the legal form of the SME before lending capital to them. Also, the legal form to some degree does not determine how much capital the financial institutions lend to the SMEs because the hierarchical regression output revealed that legal form influences the amount of capital accessed by 9.7% if the age, gender and educational qualification of the SME operator are controlled. Therefore, it is likely that the SME regardless of the legal form can have access to the same amount of capital from the financial institutions. The following points are suggested to enable the SME sector in Ghana have access to the needed capital. The state institutions mandated to supervise the SME sector, notably the National Board for Small Scale Industries (NBSSI), must ensure all the SMEs are registered and their business operations formalized. Also, NBSSI training for SMEs must be demand-driven and coordinated effectively towards equipping SME operators with basic business management skills, particularly keeping accounting records of all business transactions. The SME operators may hire the services of professional individuals to prepare their financial statements. Formalizing the SMEs sector and improving the business management and accounting skills of SME operators would reduce the perceived risk financial institutions have on lending to SMEs. Additionally, a formalized SME sector would enable the government to develop apt stimulus packages for the development and growth of SMEs as well as guarantee for loans SMEs receive from the financial institutions. Government SME financing schemes must be managed by independent institutions staffed with competent personnel. SME fund managers must work professionally by administering the funds to SMEs, based on merit and not on other negative considerations such as political affiliation, cronyism or nepotism. Finally, SMEs must revamp their various trade associations to create a formidable union in assisting its members to obtain capital from financial institutions. A vibrant trade union can guarantee the loans SMEs obtain from financial institutions.

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Appendix

H_1: The legal form of business ownership does not influence SME access to capital.

Have you accessed capital from a financial institution. * Which of the following best describes the legal form of your business? Crosstabulation

			Which of the following best describes the legal form of your business?			
			sole trader	partnership	company	Total
Have you accessed capital from a financial institution.	Yes	Count	36	6	23	65
		% within Have you accessed capital from a financial institution.	55.4%	9.2%	35.4%	100.0%
		% within Which of the following best describes the legal form of your business?	50.0%	54.5%	57.5%	52.8%
		% of Total	29.3%	4.9%	18.7%	52.8%
	No	Count	36	5	17	58
		% within Have you accessed capital from a financial institution.	62.1%	8.6%	29.3%	100.0%
		% within Which of the following best describes the legal form of your business?	50.0%	45.5%	42.5%	47.2%
		% of Total	29.3%	4.1%	13.8%	47.2%
	Total	Count	72	11	40	123
		% within Have you accessed capital from a financial institution.	58.5%	8.9%	32.5%	100.0%
		% within Which of the following best describes the legal form of your business?	100.0%	100.0%	100.0%	100.0%
		% of Total	58.5%	8.9%	32.5%	100.0%

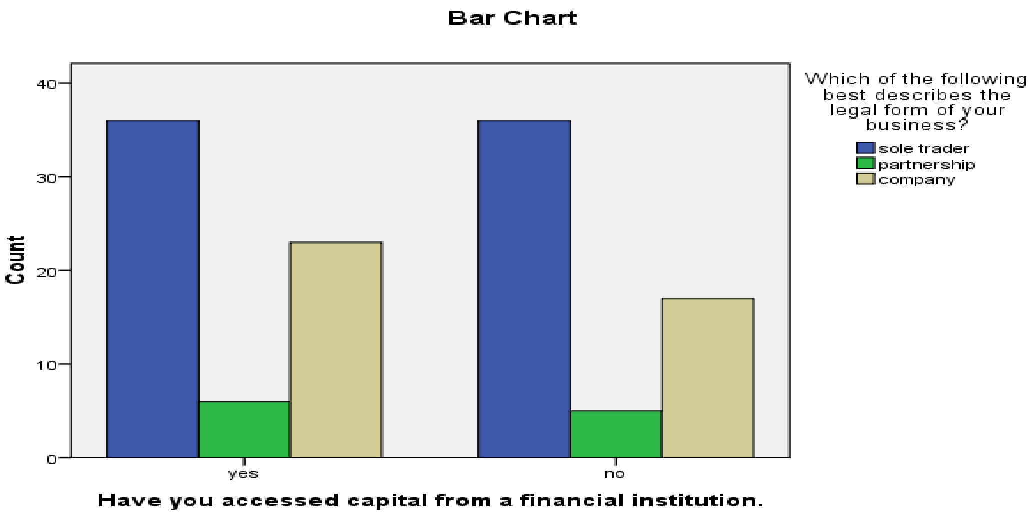
Chi-Square Tests

	Value	df	Asymp. Sig. (2-sided)
Pearson Chi-Square	.594[a]	2	.743
Likelihood Ratio	.596	2	.742
Linear-by-Linear Association	.587	1	.444
N of Valid Cases	123		

a. 0 cells (.0%) have expected count less than 5. The minimum expected count is 5.19.

Symmetric Measures

		Value	Approx. Sig.
Nominal by Nominal	Phi	.070	.743
	Cramer's V	.070	.743
	N of Valid Cases	123	



The influence of legal form on the amount of capital accessed while, controlling for gender and educational qualification.

Model Summary[c]

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics					Durbin-Watson
					R Square Change	F Change	df1	df2	Sig. F Change	
1	.650[a]	.422	.408	.70944	.422	28.995	3	119	.000	
2	.720[b]	.519	.503	.65013	.097	23.706	1	118	.000	1.518

a. Predictors: (Constant), What is your highest educational qualification? , gender, In which of the following age group are you?

b. Predictors: (Constant), What is your highest educational qualification? , gender, In which of the following age group are you?, What nature of business do you operate?

c. Dependent Variable: Which of the following best describes the legal form of your business?

NOVA[c]

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	43.781	3	14.594	28.995	.000[a]
	Residual	59.894	119	.503		
	Total	103.675	122			
2	Regression	53.801	4	13.450	31.822	.000[b]
	Residual	49.874	118	.423		
	Total	103.675	122			

a. Predictors: (Constant), What is your highest educational qualification? , gender, In which of the following age group are you?

b. Predictors: (Constant), What is your highest educational qualification? , gender, In which of the following age group are you?, What nature of business do you operate?

c. Dependent Variable: Which of the following best describes the legal form of your business?

Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.	95% Confidence Interval for B		Correlations			Collinearity Statistics	
		B	Std. Error	Beta			Lower Bound	Upper Bound	Zero-order	Partial	Part	Tolerance	VIF
1	(Constant)	-1.155	.364		-3.173	.002	-1.876	-.434					
	gender	.303	.134	.158	2.264	.025	.038	.567	.138	.203	.158	.997	1.003
	In which of the following age group are you?	.139	.032	.310	4.355	.000	.076	.202	.175	.371	.303	.955	1.047
	What is your highest educational qualification?	.310	.035	.622	8.733	.000	.239	.380	.557	.625	.608	.958	1.044
2	(Constant)	-.901	.338		-2.667	.009	-1.569	-.232					
	gender	.342	.123	.179	2.787	.006	.099	.585	.138	.249	.178	.993	1.007
	In which of the following age group are you?	.154	.029	.344	5.234	.000	.096	.212	.175	.434	.334	.945	1.058
	What is your highest educational qualification?	.334	.033	.672	10.168	.000	.269	.400	.557	.683	.649	.935	1.070
	What nature of business do you operate?	-.142	.029	-.316	-4.869	.000	-.199	-.084	-.191	-.409	-.311	.967	1.034

a. Dependent Variable: Which of the following best describes the legal form of your business?