School of Management

Blekinge Institute of Technology

EXPLORING THE FINANCIAL GAP FOR SMALL AND MEDIUM-SIZED ENTERPRISES (SMEs) IN GHANA: A CASE STUDY OF GHANA

BY

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MAY, 2012

ABSTRACT

Small and Medium Scale Enterprises (SMEs) tend by their very nature to show a far more volatile pattern of growth and earnings, with greater fluctuations, than larger companies. According to Organization for Economic Co-operation and Development (OECD) policy brief report on SME development in 2006, Financing is necessary to help Small and Medium Scale Enterprises (SMEs) set up and expand their operations, develop new products, and invest in new staff or production facilities.

The study reveals that the major sources of finance for SMEs in Ghana are trade credit, bank overdraft and bank loans. The internal sources of finance and leasing or hire purchase are the minor source to which only few entrepreneurs resort to. The availability of external financing depends on various factors for instance, general economic outlook, access to public financial support including guarantees, firm-specific outlook with respect to their sales and profitability or business plan, firm's own capital, firm's credit history and willingness of commercial banks to provide loan.

Many SMEs believe that access to internal funds, for example from retained earnings and sale of assets, bank loans, equity investments in the SMEs, trade credit, and other forms of financing, for example loan from a related company or shareholders, excluding trade credit, loan from family and friends, leasing and factoring are expected to improve the profitability and development of their businesses.

ACKNOWLEDGEMENTS

The authors wish to express their gratitude to all those who supported in diverse ways during the process of writing this paper. We are most grateful first of all to God for helping us through this Course, the School of Management, Emma Olsson, lecturers and supporting staff of BTH.

We are especially grateful to Dr. Urban Ljungquist, Head of Course and Examiner, and our supervisor, Dr. Fredrik Jörgensen for his comments, encouragements and patience not forgetting his contributions to this work.

We acknowledge the support of the all institutions that supported us in diverse ways for making this work a reality.

Finally; to Mrs. Agbozo & Sedem K. Agbozo, whose patience and encouragement have been immeasurable during the entire period of this course. Your support and understanding are appreciated.

-EA

To Joyce, Phoebe, Lisa and Lesa, whose unconditional love motivates me to strive daily to earn them respect. Your commitments to our life make all things possible. Your support and encouragement of this project was absolutely invaluable.

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CHAPTER ONE

BACKGROUND

The ultimate hope for developing countries is that by protecting property rights, entrepreneurs can be brought out of the black market and into the open. De Soto (Source) advocates for the poor businessmen of developing nations and considers them the key to change. He argues that in order to create a productive, successful economy, you need to get rid of beneficiaries, politicians, and bureaucrats that protect the status quo and resist change.

Developing countries are plagued with market and institutional imperfections. A key symptom of this is the finding that the marginal product of capital is considerably higher than prevailing interest rates. Such capital market imperfections result in the misallocation of capital, lower productivity, and can even lead to poverty traps. No wonder, therefore, those policy initiatives have focused on dealing with the underlying causes of capital market frictions.

There is growing recognition of the important role small and medium enterprises (SMEs) play in economic development. They are often described as efficient and prolific job creators, the seeds of big businesses and the fuel of national economic engines. Even in the developed industrial economies, it is the SMEs sector rather than the multinationals that is the largest employer of workers (Mullineux, 1997). Interest in the role of SMEs in the development process continues to be in the forefront of policy debates in most countries. Governments at all levels have undertaken initiatives to promote the growth of SMEs (Feeney and Riding, 1997). SMEs development can encourage the process of both inter and intra-regional decentralization; and, they may become a countervailing force against the economic power of larger enterprises.

More generally, the development of SMEs is seen as accelerating the achievement of wider economic and socio- economic objectives, including poverty alleviation (Cook and Nixson, 2000). According to an OECD report, SMEs produce about 25% of OECD exports and 35% of Asia's exports (OECD, 1997).

SMEs represent over 90% of private business and contribute to more than 50% of employment and of GDP in most African countries (UNIDO, 1999). Small enterprises in Ghana are said to be a characteristic feature of the production landscape and have been noted to provide about 85% of manufacturing employment of Ghana (Steel and Webster, 1991; Aryeetey, 2001). SMEs are also believed to contribute about 70% to Ghana's GDP and account for about 92% of businesses in Ghana.

1.1 A General Overview of the SMES Sector in Ghana

In Ghana, available data from the Registrar General indicates that 90% of companies registered are micro, small and medium enterprises. This target group has been identified as the catalyst for the economic growth of the country as they are a major source of income and employment.

Data on this group is however not readily available. The Ministry of Trade and Industry (MOTI), in 1998 estimated that the Ghanaian private sector consists of approximately 80,000 registered limited companies and 220,000 registered partnerships.

Generally, this target group in Ghana is defined as:

- Micro enterprises: Those employing up to 5 employees with fixed assets (excluding realty) not exceeding the value of $10,000
- Small enterprises: Employ between 6 and 29 employees with fixed assets of $100,000

- Medium enterprises: Employ between 30 and 99 employees with fixed assets of up to $1million.

Data from the Social Security & National Insurance Trust (SSNIT) reflects that, by size classifications, the Ghanaian private sector is highly skewed, with 90% of companies employing less than 20 persons, and a small number of large-scale enterprises. A typical characteristics of this target group is as follows:

i. They are, dominated by one person, with the owner/manager taking all major decisions. The entrepreneur possesses limited formal education, access to and use of new technologies, market information, and access to credit from the banking sector is severely limited.
ii. Management skills are weak, thus inhibiting the development of a strategic plan for sustainable growth.
iii. This target group experiences extreme working capital volatility.
iv. The lack of technical know-how and inability to acquire skills and modern technology impede growth opportunities.

Many non-financial constraints inhibit the success of such enterprises. SMEs owners are reluctant to be transparent or open up involvement of their businesses to outsiders. They seem to be unaware of or oblivious to the obligations and responsibilities they have toward capital providers, and the need to acquire or seek support for technical services like accounting, management, marketing, strategy development and establishment of business linkages.

Management and support services are perceived to be cost prohibitive and non-value adding. SMEs have not taken full advantage of Government-sponsored business support services such as the National Board for Small Scale Industries (NBSSI), which operates in the 10 regional capitals under the Ministry of Trade and Industries and the Ghana Regional Appropriate Technology and Industrial Service (GRATIS), a foundation that provides skill training and basic working capital tools for start-ups.

Policy interventions for the promotion of SMEs have generally had the following broad themes:

- Adequate support structure, transfer of appropriate technology
- Entrepreneurial training and labour skills development
- Access to sources of funds including reducing collateral requirements, and providing safeguards for the credit delivery system
- Promoting linkages between large and small industries

Based on the above, the study will start with the cautionary note that access to financing should be seen as only one component of a national SMEs policy. Without a holistic approach covering the key developmental constraints of SMEs, SMEs financing schemes implemented in isolation are unlikely to be effective.

The formal financial sector in Ghana comprises commercial banks (including Merchant Banks and Development Banks), 17 of which operate a network of 303 branches in the country; 115 rural and community banks, savings and loan companies and non-bank financial institutions. Recently, as banks and other financial institutions have sought to broaden their loan portfolio, SMEs have become an increasingly attractive customer group. Traditionally, however, financial institutions in Ghana have been cautious with lending to SMEs groups because of high default rates and risks associated with the sector. Few banks have therefore developed an explicit policy for SMEs target groups taking the particular requirements and needs into consideration, e.g. developing earmarked financial products and appropriate credit management systems. Only few banks have SMEs specific loan products, and many of these are donor funded. Few banking institutions have SMEs desks or departments. For the others, lending to micro and small businesses is simply transacted by credit officers from corporate finance departments of the bank who generally apply the same appraisal and lending principles to SMEs. None of the commercial banks have any specialised training for credit officers in proven SMEs lending techniques, and most credit officers do not have any prior SMEs specific experience.

A recent GTZ survey of SMEs has provided insight into the lending practices of financial institutions towards Small to Medium Scale Enterprises (SMEs):

1. Banks and other financial institutions have traditionally looked at the SMEs sector with caution. As a result, there are usually no separate SMEs lending policies, and loan requests are handled quite stringent. Some institutions only give cash-secured overdrafts to enterprises for a maximum of a six-month period after which the transaction can be renewed, pending revision. This type of overdraft can be secured by the borrower upon presentation of fixed deposit or treasury bills. A maximum of 95% of their value is granted, with a lien placed them, to minimize the risk of default.

2. Terms and Conditions: SMEs loans financed out of the normal business portfolio of a commercial bank are granted for 12 months or considerably less, secured by deposits or other

sources with a view to categorise it as a "secured loan" under Bank of Ghana (BOG) conditions, and carries the upper band of interest rates.

3. SMEs Lending within the Organisational Structure of the Financial Institution:

Commercial banks find it difficult to integrate SMEs finance effectively into their existing organisational structure. Four (4) out of the seven (7) banks or Savings and Loans surveyed have a separate SMEs desk. Solutions are different and sometimes unique to a single institution. The following more unusual organisational setups were found when conducting a sample survey of 8 banks and non-bank financial institutions:

- SMEs lending below a certain threshold are initiated and processed by the bank's marketing department since SMEs are targeted primarily with a view to attracting their deposits with small loans granted only to establish initial client contact
- SMEs lending is transacted by credit officers from corporate finance departments of a bank.

4. Systems and Procedures: Almost without exception, the financial institutions attempt to service SMEs clients with a package modified from their existing smaller "light" corporate clientele. As a result, there is strong emphasis on business documentation and financial reports. These are analysed basically in the same format as corporate applications, including time consuming cash flow analyses.

5. All the analysed institutions work towards a longer term client – credit officer relationship, avoiding changes in dealing staff. However, selective checks in client files showed that changes in dealing officers are quite common.

1.2 Research Questions

Generally, SMEs in Ghana lack access to credit and this is as a result of the unwillingness on the part of financial institutions in Ghana to grant credit facilities with flexible terms of payment. Due to this situation, SMEs face the challenge of financing their expansion using both traditional (financial institutions) and non-traditional schemes. In an attempt to deal with this challenge, this study sought to answer the following questions:

i. What are the alternative sources of raising capital for SMEs in Ghana?

ii. Are the alternative financial gaps accessible to the SMEs in Ghana?

1.3 Research Objective

The limited availability of credit through the traditional financial institutions indicates that interventions are needed through special schemes. However, it appears that there is no coordinated policy response to the SMEs financing gap in Ghana. Credit schemes have been developed on an ad hoc basis without considering the institutional support mechanisms that would provide a sustainable flow of credit to the SMEs sector.

1.4 Research Methods

The main objective of this study is to investigate the challenges and problems of accessing finance from the traditional commercial banks by small and medium-sized companies; in addition, the study also looks at identifying other alternative sources of gaining finance for the small and medium-sized enterprises in Ghana such as the non-bank financial institutions. According to Ghauri (2005: 3) research is a process of planning, executing and investigating in order to find answers to our specific questions. In order to get reliable answers to our questions, we need to do this investigation in a systematic manner, so that it is easier for others to understand the logic and believe in our report. Three approaches can be used in any research work, and they are the inductive approach, deductive approach and finally a combination of both the inductive and deductive approach called the mixed method (Romano 1989).

The deductive approach is characterized by drawing conclusions through a pattern of logical reasoning, hypothesis are built from existing knowledge and literature and then subjected to empirical scrutiny to draw conclusions (Ghauri, 2005). This is also known as the qualitative approach because it is characterized by more of descriptions instead of numerical data and aim to create a common understanding of the subject being studied.

In the Inductive approach specific observations are made that leads to broader generalizations and theories. The approach is characterized by beginning with specific observations and measures and then goes on to detect patterns and regularities, formulate some tentative hypotheses that can be explored, and finally end up developing some general conclusions or theories, it is also known as the quantitative approach since it is largely based on numerical observations that aims at generalizing a phenomenon through formalized analysis of selected data.

The mixed-method strategy is one in which more than one method of approach is used in data collection and analysis while conducting research (Romano 1989). This approach is similar to what Mikkelsen (1995) and Denzin (1978) described as triangulation. The multiple-method strategy will be adopted for this study to reduce the possibility of personal prejudice by not depending on only one method of approach or response coming from only one firm. Both the inductive and deductive will be used in a variety of ways, relying largely on secondary data from the Ghana Statistical Service and National Board for Small Scale Enterprises in Ghana. Primary data from Semi-structured interviews based on open-ended, flexible questionnaires will be conducted with from 25 SME's in Ghana who have accepted to be part of this research work. The questionnaire will adopt the Laket Scale. The analysis will be done by using Statistical Package for Social Science (SPSS – V19) and Microsoft Excel 2010 will be used for the graphical presentation.

1.5 Delimitations of the Study

This study will focus solely on SMEs sector in Ghana. Furthermore, this is a qualitative study made through semi-structured questionnaires with people working within the SMEs sector and thus the results may not be necessarily applicable to other areas within the financial institutions in Ghana. The aim is to answer the research question and not to provide universal conclusions.

1.6 Significance of Study

It is generally accepted that the broad goal of SME policy is to accelerate economic growth and in so doing alleviate poverty. While there are many developmental constraints on the SME sector, bridging the financing gap between SMEs and larger enterprises is considered critical to economic growth.

1.7 Structure of the Project Work

This project work is structured in five chapters. The first chapter is Introduction, providing reader with the background of the subject, main objectives of the research, its delimitations and definitions of main concepts in the field. In order to deeper understand these topics the next chapter will present a Literature Review where the topics will be ordered from a broader business context to more project specific setting. The third chapter of the project work is addressing Research Method. Both theoretical and practical methodologies are described within this chapter. The first one is related to the research philosophy definition, as well as research approach and strategy presentation. On the other hand, practical methodology part is providing the reasons for the choice of the subject, data collection methods, interviewee information and other relevant topics. The next chapter presents Findings and Discussion of the research with the attempt to analyze and explain the results of the study. Finally, Conclusions and Recommendations chapter is offering final comments and indicating possible areas for further research.

CHAPTER TWO

LITERATURE REVIEW

The issue of what constitutes a small or medium enterprise is a major concern in literature. Different authors have usually given different definitions to this category of business. SMEs have indeed not been spared with the definition problem that is usually associated with concepts which have many components. The definition of firms by size varies among researchers. Some attempt to use the capital assets while others use skill of labour and turnover level. Others define SMEs in terms of their legal status and method of production. Storey (1994) tries to sum up the danger of using size to define the status of a firm by stating that in some sectors all firms may be regarded as small, whilst in other sectors there are possibly no firms which are small.

The Bolton Committee (1971) first formulated an "economic" and "statistical" definition of a small firm. Under the "economic" definition, a firm is said to be small if it meets the following three criteria:

- It has a relatively small share of their market place;
- It is managed by owners or part owners in a personalized way, and not through the medium of a formalized management structure;
- It is independent, in the sense of not forming part of a large enterprise. Under the "statistical" definition, the Committee proposed the following criteria:
- The size of the small firm sector and its contribution to GDP, employment, exports, etc.
- The extent to which the small firm sector's economic contribution has changed over time;
- Applying the statistical definition in a cross-country comparison of the small firms' economic contribution.

The Bolton Committee applied different definitions of the small firm to different sectors. Whereas firms in manufacturing, construction and mining were defined in terms of number of employees (in which case, 200 or less qualified the firm to be a small firm), those in the retail, services, wholesale, etc. were defined in terms of monetary turnover (in which case the range is 50,000 - 200,000 British Pounds to be classified as small firm). Firms in the road transport industry are classified as small if they have 5 or fewer vehicles. There have been criticisms of the Bolton definitions. These focus mainly on the apparent inconsistencies between defining characteristics based on number of employees and those based on managerial approach.

The European Commission (EC) defined SMEs largely in term of the number of employees as follows:

- firms with 0 to 9 employees - micro enterprises; 220 International Research Journal of Finance and Economics - Issue 39 (2010)
- 10 to 99 employees - small enterprises;
- 100 to 499 employees - medium enterprises.

Thus, the SMEs sector comprises 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 (Storey, 1994). Finally, the EC definition did not assume the SMEs group is homogenous; that is, the definition makes a distinction between micro, small, and medium-sized enterprises. However, the EC definition is too all-embracing to be applied to a number of countries. Researchers would have to use definitions for small firms which are more appropriate to their particular "target" group (an operational definition). It must be emphasized that debates on definitions turn out to be sterile, unless size is a factor which influences performance. For instance, the relationship between size and performance matters when assessing the impact of a credit programme on a target group (Storey, 1994).

Weston and Copeland (1998) 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. Van der Wijst (1989) considers small and medium businesses as privately held firms with 1 – 9 and 10 – 99 people employed, respectively. Jordan et al (1998) define SMEs as firms with fewer than 100 employees and less than €15 million turnover. Michaelas et al (1999) consider small independent private limited companies with fewer than 200 employees and López and Aybar (2000) 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 (Department of Trade and Industry, 2001).

The UNIDO also defines SMEs in terms of number of employees by giving different classifications for industrialized and developing countries (see Elaian, 1996). The definition for industrialized countries is given as follows:

- Large - firms with 500 or more workers;

- Medium - firms with 100-499 workers;
- Small - firms with 99 or less workers.

The classification given for developing countries is as follows:

- Large - firms with 100 or more workers;
- Medium - firms with 20-99 workers;
- Small - firms with 5-19 workers;
- Micro - firms with less than 5 workers.

It is clear from the various definitions that there is not a general consensus over what constitutes an SME. Definitions vary across industries and also across countries. It is important now to examine definitions of SMEs given in the context of Ghana and South Africa.

2.1 The Ghanaian Situation

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 (Kayanula and Quartey, 2000). 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-sized enterprises. Ironically, the GSS in its national accounts considered companies with up to 9 employees as SMEs (Kayanula and 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 10 million Ghanaian cedis. The Ghana Enterprise Development Commission (GEDC), on the other hand, uses a 10 million Ghanaian cedis upper limit definition for plant and machinery. It is important to caution that the process of valuing fixed assets poses a problem. Secondly, the continuous depreciation of the local currency as against major trading currencies often makes such definitions outdated (Kayanula and Quartey, 2000).

In defining small-scale enterprises in Ghana, Steel and Webster (1991), and Osei et al (1993) used an employment cut-off point of 30 employees. Osei et al (1993), however, classified small-scale enterprises into three categories. These are: (i)Micro - employing less than 6 people; (ii) Very small - employing 6-9 people; (iii)Small - between 10 and 29 employees.

A more recent definition is the one given by the Regional Project on Enterprise Development Ghana manufacturing survey paper. The survey report classified firms into:

- Micro enterprise, less than 5 employees;
- Small enterprise, 5 - 29 employees;
- Medium enterprise, 30 – 99 employees;
- Large enterprise, 100 and more employees (see Teal, 2002).

In this study, SMEs were defined in terms of the number of employees instead in terms of both asset base and the number of employees. This was done because it was not possible to obtain information about the asset base of the SMEs before sampling decision could be made. As a result, in this study, SMEs were defined as firms with less 99 employees. This definition is consistent with the definitions provided by Ghana's National Board for Small Scale Industries, UNIDO, and EC.

2.2 Small and Medium Scale Enterprises Financing In Ghana

The SMEs often complain that their growth and competitiveness are constrained by a lack of access to financing and the high cost of credit. Recent events in Latin America and East Asia lend credence to the argument that SMEs are more likely than larger firms to be denied new loans during a financial crisis (World Bank, 2000). In Ghana, because competition in the banking sector is limited, banks have not been under pressure to improve their lending to smaller clients. In addition, SMEs access to the formal financial sector is constrained by the high risks and transactions costs, real or perceived, associated with commercial lending to that segment of the market. Lenders are faced with a lack of reliable information on borrowers, difficulties in enforcing contracts (the result of inadequate legal frameworks and inefficient court systems), and the lack of appropriate instruments for managing risk (Hallberg, 1999). Often, the problem is compounded by supervisory and capital adequacy requirements that penalize banks for lending to enterprises that lack traditional collateral.

In the traditional approach to SMEs development, governments have provided credit to SMEs through first-tier development banks, second-tier credit facilities channeled through banks and other financial institutions, and portfolio requirements on banks, often supplemented by credit guarantee schemes. Subsidized interest rates and guarantees were common in the past and continue to be used. In part, this reflects a presumption that the high cost of credit is the main constraint facing SMEs, even though there is evidence that SMEs care more about access to credit than its cost (Sakai and Takada, 2000). The traditional approach of subsidized credit also may have been a reflection of the importance of state owned banks in Ghanaian financial markets.

Direct and subsidized credit programs have done little to achieve what should be their fundamental objective, which is, increasing the access of small enterprises to financial services. Instead, they inhibit the development of sustainable financial institutions and often foster a "non-repayment culture" among enterprises. Low rates of loan recovery push ex-post subsidies even higher than those intended in credit programs. Credit subsidies also create distortions in financial markets, since they discourage firms from using non-credit forms of financing. The traditional approach has failed to deal with the fundamental problems that raise the cost of credit and make banks reluctant to serve SMEs; the high risks and transaction costs (real or perceived) associated with commercial lending to the small scale segment of the market (Sacerdoti, 2005).

A market-oriented strategy for improving SMEs access to financing focuses on reducing the risks and transactions costs associated with this segment of the markets, strengthening the capacity of financial institutions to serve smaller clients, and increasing competitive pressure in financial markets. The aim is to increase the number of financial institutions that find lending to SMEs to be profitable, and therefore sustainable. Elements of this strategy would include:

- Reducing barriers to entry, for example, by reconsidering capital adequacy requirements and prudential regulations that may be inappropriate for financial institutions serving smaller clients;
- Reducing the risks associated with lending to small businesses, focusing on laws governing the enforcement of contract, forfeiture and collection of collateral, and the use of movable assets as collateral;
- Developing the policy, legal, and regulatory frameworks that are essential to the development of innovative financial institutions and instruments, including venture capital, small equity investments, and leasing;
- Promoting innovation in specialized lending technologies that reduce the administrative costs associated with credit application, monitoring, and payment;
- Strengthening the capacity of financial institutions to evaluate SME creditworthiness in a cost-effective manner, for example, through the use of credit scoring techniques; and
- Providing information on the credit worthiness of potential borrowers, through the establishment of credit bureaus, and ways to help SMEs prepare business plans and financial projections.

Okraku and Croffie (1997) argued that in Ghana SMEs rely primarily on personal savings of owners, business profits, family members or friends for their financial needs. They have little or no access to external credit. The effect of this is inadequate fixed capital as well as working capital. The consequences of these are very slow growth rate and frequent failures among small businesses. At the regulation level, the problems identified are high interest rates charged by banks thus making bank borrowing very expensive. The lending rates at Ghana are as high as 40 percent. At the institutional level, banks were not motivated enough to lend to small business enterprises. The size of loanable funds available for lending to the sector is also small. Banks insist on tangible collateral as security as well as owner's equity for loans. At the enterprise level, SMEs are unable to mobilize owner's equity to satisfy banks requirement for loan, inability to provide acceptable collateral security to support loan and the lack of banking culture and practices.

Evaluating the impact of intervention on SME performance can benefit from the use of a logical framework that clearly defines the program's objective and links activities and inputs to outcomes and impact. However, many of the often repeated justifications for the scale-based enterprise support have little empirical evidence. But whether their actions are based on myth or reality, government in both developing and industrialized countries do intervene to promote SMEs. Their SMEs assistance strategies often try to achieve a combination of equity objectives (alleviating poverty, and addressing social, ethnic, and gender inequalities); and efficiency objectives (raising the productivity and profitability of the business or firms). The confusion created by multiple objectives often leads government to over subsidize services that could be provided by the market (Hallberg, 1999). Added that direct provision of credit and non-financial assistance to SMEs tend to substitute for markets rather than dealing with the underlying causes of market underdevelopment.

Consequently, the supports for SMEs through the development of markets for financial and non-financial services are only successful if their market-development effects outweigh their market-distortion effects. In turn, this depends upon whether the support resolves the underlying problems that constrain market development. This underscores the need to begin with a good understanding of the structure and performance of existing markets and to build upon institutions and inter-firm or business networks that are already in place.

2.3 Microcredit

According to the Ghana's 2000 Population and Housing Census, 80% of the working population is found in the private informal sector. This group is characterized by lack of access to credit, which constrains the development and growth of that sector of the economy. Clearly, access to financial services is imperative for the development of the informal sector and also helps to mop up excess liquidity through savings that can be made available as investment capital for national development.

The former UN Secretary General Kofi Annan during the launch of the International Year of Micro Credit (2005) said, "…Sustainable access to microfinance helps alleviate poverty by generating income, creating jobs, allowing children to go to school, enabling families to obtain health care, and empowering people to make the choices that best serve their needs." (Kofi Annan, December 2003).

Micro credit is thus one of the critical dimensions of the broad range of financial tools for the poor, and its increasing role in development has emanated from a number of key factors that include; The fact that the poor need access to productive resources, with financial services being a key resource, if they are to be able to improve their conditions of life; The realization that the poor have the capacity to use loans effectively for income-generation, to save and re-pay loans.

According to Simanowitz and Brody (2004, p.1), micro-credit is a key strategy in reaching the MDGs and in building global financial systems that meet the needs of the most poor people." Littlefield, Murduch and Hashemi (2003) state, "…micro-credit is a critical contextual factor with strong impact on the achievements of the MDGs. Micro-credit is unique among development interventions: it can deliver social benefits on an ongoing, permanent basis and on a large scale".

However, some schools of thought remain skeptical about the role of micro-credit in development. For example, while acknowledging the role micro-credit can play in helping to reduce poverty, Hulme and Mosley (1996) concluded from their research on micro-credit that "…most contemporary schemes are less effective than they might be" (1996, p.134). The authors contended that micro-credit is not a panacea for poverty-alleviation and that in some cases the poorest people have been made worse-off.

This notwithstanding, microfinance has emerged globally as a leading and effective strategy for poverty reduction with the potential for far-reaching impact in transforming the lives of poor people. It is argued that microfinance can facilitate the achievement of the Millennium Development Goals (MDGs) as well as National Policies that target poverty reduction, empowering women, assisting vulnerable groups, and improving standards of living as could be infer from Kofi Annan's speech above.

Access to finance remained a dominant constraint to small scale enterprises in Ghana. Credit constraints pertaining to working capital and raw materials were cited by respondents in a survey conducted by Parker (Parker *et al*, 1995). Aryeetey *et al.* (1994) reported that 38% of the SMEs surveyed mentioned credit as a constraint. This stems from the fact that SMEs have limited access to capital markets, locally and internationally, in part because of the perception of higher risk, informational barriers, and the higher costs of intermediation for smaller firms. As a result, SMEs often cannot obtain long-term finance in the form of debt and equity.

2.4 Needs of SMES in Ghana

A number of studies have been carried out to identify the needs of SMEs in Ghana. Notable among is the one by Tweneboa-Boateng (2008). According to Tweneboa-Boateng (2008), the major needs of SMEs include lack of enabling environment (political instability, micro-economic instability, and poor physical infrastructure), lack of entrepreneurial skills, and lack of access to finance.

Similarly, Mensah (2004), in exploring the SMEs financing schemes in Ghana, has suggested that various schemes exist for financing SMEs operations. According to him, there are many who believe that the single most important factor constraining the growth of the SMEs sector is the lack of finance. There are many factors that can be adduced for this lack of finance:

- A relatively undeveloped financial sector with low levels of intermediation
- Lack of institutional and legal structures that facilitate the management of SME lending risk
- High cost of borrowing and rigidities interest rates.

Because of the persistent financing gap, many interventions have been launched by governments and development partners to stimulate the flow of financing to SMEs over and above what is available from exiting private sector financial institutions. Existing SMEs financing interventions can be classified under:

- Official Schemes
- Financing provided by financial institutions

Official schemes are schemes introduced by government, either alone, or with the support of donor agencies to increase the flow of financing to SMEs (Mensah, 2004). Government has in the past attempted to implement a number of such direct lending schemes to SMEs either out of government funds or with funds contracted from donor agencies. These funds were usually managed by the Aid and Debt Management Unit of the Ministry of Finance and Economic Planning. Most of the on-lent facilities were obtained under specific programs with bilateral organizations in support of the Government of Ghana’s Economic Recovery Program and Structural Adjustment Program. Examples of such schemes are:

- Austrian Import Program (1990)
- Japanese Non-Project Grants (1987-2000)
- Canadian Structural Adjustment Fund and Support for Public Expenditure Reforms (SPER)

In addition to donor-supported schemes for direct lending, government has attempted at various times to operate lending schemes for SMEs (Mensah, 2004). The schemes have included the following:

- Business Assistance Fund: The Business Assistance Fund was operated in the 1990s to provide direct government lending to the SME sector. The program was widely seen to have been abused politically, with most of the loans going to perceives government supporters.

- Ghana Investment Fund: In 2002, the Ghana investment Fund Act (Act 616) was passed to establish a fund to provide for the grant of credit facilities by designated financial institutions to companies. However, the scheme was never implemented.
- Export Development and Investment Fund (EDIF): Under this scheme, companies with export programs can borrow up to $500,000 over a five-year period at a subsidized cedi interest rate of 15%. While the scheme is administered through banks, the EDI board maintains tight control, approving all the credit recommendations of the participating banks.

Besides, Section 13 of the Loans Act of 1970 (Act 335) empowers the Government of Ghana (GoG) to provide government guarantee to any external financiers who wish to advance funds to any Ghanaian organization and the terms of such facility require the provision of guarantee from the Government. Guarantee facilities are contingent liabilities of the Government. The onus for repaying the facility lies with the borrower and not the Government. The facility crystallizes and becomes liability due from GoG if the borrower is unable to honour his/her loan obligation and the Government is called upon to settle the facility as a guarantor. In that case the borrower is required to subsequently reimburse the Government for the amount involved.

Kayanula and Quartey (2000) have also explored the constraints that SMEs in Ghana and Malawi. They reported that input constraints, lack of access to finance, labour market constraints, equipment and technology constraints, domestic demand constraints, international market constraints, managerial constraints, institutional constraints as well as regulatory constraints. However, greater attention has been attached to the financial constraints both by the SME owners and policy-makers. Given the lack of access to these sources of financing, it may be important to examine the alternative sources of financing available to SMEs and also determine which ones they can access successfully.

2.5 Financial System in Ghana

The financial system in Ghana includes commercial banks, insurance companies, discount houses, finance houses, leasing company's savings and loans associations, credit unions and a stock exchange. Added to this are several rural banks widely dispersed throughout the country. Before 1983 the formal banking system of the Ghanaian economy was dominated by the state owned banks. In fact they had a monopoly over the entire banking sector as regards their spread and operations. With the exception of two banks – Barclays and Standard Chartered, the country could not boast of any other foreign banks in the entire financial system. The number of branches of these foreign banks was limited to about four cities as opposed to the numerous branches of the state owned banks particularly the Ghana Commercial Bank which operated at least three branches in each of the ten regions of the country. With the exception of the State Insurance Corporation (SIC) and the Great African Insurance Company there was no other non-bank financial institution. The SIC was wholly government owned. Brokerage houses were simply non-existent.

There were several policy interventions which made it virtually impossible for business dealings to be as fluid as it should, for instance a currency conversion was undertaken in 1979, where individual households were made to send their foreign currencies to the central bank for local currency. This was followed in 1982 by a demonetization of the 50 Cedi note (the highest denomination of the Ghanaian currency at that time). There was also the freezing of bank deposits in excess of 50,000 cedis, whiles bank loans for financing trade inventories and business deals of more than 1,000 cedis was required to be conducted by cheque, all in an attempt to reduce money supply and hence inflation (Bank of Ghana and Quarterly Digest of Statistics).

2.5.1 Ghana's Financial System: Pre- Reform Era

In the pre-liberalisation era, interest rates were controlled and monitored not by the market but by the Bank of Ghana and a variety of controls were also imposed on the asset allocations of the banks, such as sectorial credit directives. The motivation for these policies was based on the fact that, market imperfections and the nature of the financial system inherited from the colonial rule would make it difficult for the desired pattern of investment to be achieved, hence the need for government intervention in the financial market. The policies were motivated by three objectives: to raise the level of investment, to change the sectorial pattern of investment, and to keep interest rate both low and stable. Until recently real interest rates on deposits have been negative. This gave individuals little incentives to hold savings in bank accounts. People preferred to hold cash.

The Ghanaian economy seems not to have enjoyed any of the benefits and advantages that go with positive interest rate. Low rate of financial innovation and poor quality of service throughout the financial sector could also be identified as another attribute of the pre-liberalization era of the Ghanaian financial system. Two reasons account for this development.

In the first place, the financial system itself is a very young institution in Ghana. The first bank in Ghana was established just after independence, which is 1959. Since financial development is a gradual process, it is only natural that the amount and rapidity of innovating financial instruments were lacking in the Ghanaian financial sector. Secondly the lack of competitiveness in the system as a result of the controlled environment under which the sector was operating was enough reason for the disappointing performance of the sector as regards its innovation and ability to render quality service. After all there did not seem to be incentives, anyway for such qualities under a restricted financial system. There were thus a limited variety of financial instruments.

The several obstacles and restrictions served to undermine private sector confidence in the system as a whole. What is inferred from the foregoing is that the financial sector reforms were needed. Apart from the state of the financial sector outlined above, reforms were actually needed to encourage the development of the financial market: the deepening of financial intermediation, the creation of new instruments for the people to invest in and the establishment of new financial institutions which will all go to make the economy much more competitive in the world economy. The liberalization of the system therefore could not have come at a more opportune time.

2.5.2 Ghana's Financial System: Reform Era

Financial liberalization is usually an important component of a country's strategy for economic growth. The contribution of the financial reform to the economic growth of the country has been immense. Financial Sector reforms have been implemented since the late 1980s as part of the ongoing Economic Recovery Programme (ERP). They began with the partial liberalisation of interest rates in 1987 and removal of sectorial credit ceilings in the following year. This was accompanied by liberalisation of access to foreign exchange and the licensing of foreign exchange bureaux. In 1989, the Financial Sector Adjustment Programme (FINSAP) was started, supported by a financial sector adjustment credit (FSAC) from the World Bank. The objectives of the FINSAP were to address the institutional deficiencies of the financial system, in particular by restructuring distressed banks, reforming prudential legislations and the supervisory system, permitting new entry into the financial markets by public or private sector financial instruments, and developing money and capital markets.

Further liberalisation of the financial market took place in 1992 with the adoption of indirect instruments of monetary control which entailed the introduction of market determined treasury bill rate. Since 1994, a second phase of FINSAP has been underway, major objectives of which are privatisation of the public sector banks and development of non-bank financial institutions to fill the gabs in the financial markets not served by the banks. The financial markets have therefore been progressively liberalised in Ghana. Liberalisation has entailed the removal of controls on interest rate and the sectorial composition of bank lending, and the introduction of market based instruments of monetary control. New financial institutions, including several merchants' banks with private sector participation, have been licensed and the latest phased of liberalisation involves the partial privatisation of government own banks.

Many financial as well as non-bank financial institutions were established. From a pre-liberalization number of about two foreign and five states owned banks with virtually no non-bank financial institutions, the sector has now widened. As at 1990, the Ghanaian banking sector comprised of the central bank-the Bank of Ghana, commercial banks, and 3 merchant banks. One of the most useful innovations was the establishment of the unit rural banks. It numbered about 100 after the liberalization of the sector. The non-bank financial institutions was made up of a stock exchange, 21 insurance companies, the Social Security and National Insurance trust, two discount houses, the Home Finance Company, a venture capital company, a unit trust and a leasing company. There has also been the influx of foreign banks into the country. There are four wholly owned foreign banks operating in the country and two others which are partnerships between foreign investors, the government and local private investors as well. At the end of the year 2002 there were seventeen banking institutions operating in Ghana; in addition to several rural banks widely spread all over the country. Foreign investors hold a majority of the shares in eight of the banks. There are nine purely commercial banks, five merchant banks and three development banks.

2.6 Interest Rates

Interest rates can be defined as the premium received by the lender after a stated period of time. From the borrowers' point of view, it is the cost of capital at the time of obtaining a loan. There are several schools of thought regarding the interest rates. According to the Classical school, the rate of interest is the main determinant of savings and investment. This school asserted that aggregate investment is inversely related to the rate of interest. This relationship has been observed to be a weak one; that is, investment tends to be fairly interest—inelastic because it is influenced by businessmen's expectations, and yields are normally estimated within a particular range, for example 10% to 15%, so if a small increase in the interest rate occurs, it will not disturb the long-run expansion of the enterprises.

The Neo-Classical school maintains that the interest rate is determined by supply (savings) and demand (marginal efficiency of capital). Autonomous increase in savings reduces the interest rate and the additional cost of capital. Because additional investment contributes to diminishing returns, this will cause a 'switch' from less capital- intensive to more capital-intensive methods of production. The phenomenon of re-switching has led to the two Cambridges' controversy of capital theory (Hardwick, Khan and Langmead, 1990). Keynes believed that the quantity of money played a key role in determining the rate of interest. He viewed the equilibrium interest rate as that rate which equates the supply of money with the demand for money. In a more fundamental sense, the equilibrium rate of interest is determined by factors affecting the supply of money and the money demand. The modern view of interest rates is based on the imperfect information paradigm as explained by Hoff and Stiglitz (1990).

Operationalising interest rate in the context of the demand for credit by the SMEs shows the interplay of several factors. According to Funkor (2000), some of these factors include high inflation, cost of intermediation, high credit risk, exchange rates, high bank interest rate and high Treasury bill rates. The average Ghanaian business operator in the private sector, views interest rate as a measure of the price paid by a borrower to a lender for the use of financial resources for a time interval. This research views interest rate as the cost of borrowing money within a stated period.

Before 1988, interest rates were administratively set by the Bank of Ghana (BoG). The financial sector suffered from the distorted macroeconomic policies and deteriorated greatly. Cheap credit was directed to the favoured borrowers, mostly the public sector, at the expense of economic efficiency and productive investment. As a result, financial intermediation in the economy declined. People abandoned the banking system deposits that yielded negative real interest rates of return. These rates were fixed below the rate of inflation, and this resulted in negative real interest rates. The "high negative" values that were recorded were as a result of the heightened economic crisis caused by the rippling effect of petroleum shocks in 1975, drought, etc.

The liberalization of the financial sector sought to inject efficiency through competition into the financial system. The liberalization of interest rates occurred in 1988 as part of the Financial Sector Adjustment Programme (FINSAP). This action programme aimed at restructuring distressed banks, strengthening the regulatory and supervisory framework of the BoG, developing financial and capital markets and more generally, liberalizing the financial environment to improve efficiency of resource (savings) mobilization and credit allocation. Thus, a major policy initiative under the FINSAP was financial liberalisation in line with the theoretical postulates of McKirmon (1973), Shaw (1973) and Galbis (1977) among others.

2.7 Demands for Credit

The role of credit is to bridge the gap between enterprise owner’s financial assets and the required financial assets of the enterprise. Due to persistence of this imbalance, enterprises are forced to demand credit. Demand for credit, according to Aryeetey et al (1994) can be categorised into perceived, potential and revealed demand. Perceived demand is represented by a situation where enterprises that assume to be in need of cash, mention finance as a constraint. Potential demand is characterised by a desire for credit which is not actualised due to market imperfections and institutional barriers. Revealed demand is characterised as written application for financial support at a given rate of interest.

This study agrees with the above categorisation of demand for credit. However, in I the case of revealed demand definition which is of cardinal importance to lenders and borrowers, a further distinction needs to be underscored because the application for credit, even if backed by a bankable project, may not necessarily be translated into effective demand. Gale (1991) defined effective demand as the amount of loans that lending institutions are prepared to release to borrowers. We agree with Gale, but in addition, our definition of effective demand is the actual amount released to the borrowers.

The debate on whether high interest rates affect the demand for credit is inconclusive and may go on indefinitely. There are two main schools of thought. The first school advocates that high interest rates negatively affect the demand for credit because only limited borrowers with high risk projects may have their demand satisfied. Prominent among this school are Stiglitz and Weiss (1981), Stiglitz (1989) and Besley, (1994) who argue that high interest rates encourage adverse selection of loan seekers. Those who take high risk and get their loans approved are those with high default rates.

These high risky enterprises may not include SMEs because they cannot afford risky and high cost investment. In his analysis of demand for rural credit among farmers in Sao Paulo, Brazil, Nehman (1973) observed that borrowing costs strongly affect the willingness of the rural poor to seek loans from formal lenders. Although Aryeetey etal (1994) did not make it explicit, they acknowledged implicitly that demand for credit at 30% interest rate was somewhat weaker among medium-sized firms. The second school of thought's assertion is that high interest rates do not affect the demand for credit. The study by Aryeetey et al (1994) indicated that the high interest rates were not a major concern for SMEs. In that study, SMEs considered an average annual interest rate of 19.5% to be fair and reasonable; and this fell below the minimum market rate at that time by seven percentage points.

Non-availability of credit for SMEs prevents them from engaging in productive enterprises or expanding their businesses. Limited access to bank credit can be attributed to bureaucracy and high interest rates which are in line with the first school of thought's assertion. This means that the high interest rates constrain the demand for credit (Boon, 1989). Evidence on the impact of financial sector liberalization on SMEs shows the following: Steel and Webster (1992), Aryeetey et al (1994) and Nissanke and Aryeetey (1995) revealed that the financial sector liberalization did not improve access to borrowing by SMEs. They attributed this to tightening of monetary controls, introduction of high- yielding securities to mop up liquidity, and efforts to raise the performance of loan portfolios. Steel and Webster (1989) also pointed out that growth of SMEs has been hampered by the difficulty of financing working capital and new investment. In our view, the latter implies that limitations on the credit to the Poor and SMEs can be explained by the information asymmetry model which portrays limited access to financial capital.

There is opportunity cost attached to decisions to lend monies to SMEs given the relative scarcity of finance. Banks normally feel reluctant to lend to SMEs and this affects the supply of credit to SMEs. Preliminary estimates from recent survey conducted in the year 2000 showed that out of the 16 commercial banks in Ghana, only six provided credit equivalent to ¢1O billion to the micro finance sub-sector which was in need of total credit demand of ¢380 billion. The provision of credit to the tune of ¢1O billion constituted only t 1% of the loans and advances in the same year (Opare, 2001). Most commercial banks appear not to have proven-lending methodology for the financing of the SMEs. Banks underestimate bankable SMEs' demand for credit because they have not developed techniques for overcoming high transaction costs and risks p (Aryeetey et al, 1994; Opare, 2001).

This problem has contributed to the closure of their branches at the district and sub—district levels. These same banks readily disburse donor loans to SMEs because of the possible foreign exchange gains. Appraisal systems are relaxed because these funds are either guaranteed or provided by donors (Opare, 2001).

High yield of Government of Ghana's risk and assets particularly treasury bills coupled with unfavourable macroeconomic environment also contributed to the limitation of credit supply. Credit supply limitation was mentioned by Quaicoo (2001). According to her, Akatakyiman Rural Bank's deposit base registered a remarkable growth of ¢800.6 billion in the 2000/2001 financial year whilst the same bank's investment in treasury bills alone stood at ¢600 billion. This means that less financial resources could be made available to borrowers including SMEs. Furthermore, the decline of donor funds due to fatigue and the quest for commercialisation of micro-lending have both contributed to the low level of credit to SMEs. In sum, the literature on the demand for credit portrays the difficulty in deriving reliable estimates of demand for credit. A fact acknowledged by Aryeetey (1996).

2.8 Loan Repayment

Lenders of funds in the formal financial sector use the deposits of their clients whilst lenders operating in the informal sector use mainly their own funds to advance money to borrowers. In either case, the transactions are expected to lead to recouping the financial capital. If this does not happen, borrowers benefit at the expense of lenders. Assuming this continues, bankruptcy will be the ultimate result and this will reduce financial intermediation.

According to Stiglitz and Weiss (1981), high interest rates lead to adverse selection of loan seekers that affect loan repayment. Besley and Coate (1995) also made it clear that repayment rate will not be 100% at a positive interest rate. Assuming the project return is very low, borrowing at zero interest rate will still not make the borrowers capable of repaying the loan. Thus a positive interest rate increases cost of production, reduces returns from a productive activity and promotes loan default among borrowers.

The modern approach to the problems of credit markets — especially markets which serve SMEs is based on the theoretical exposition of Hoff and Stiglitz (1990) which emphasise imperfect information and imperfect enforcement of loan contracts. The two authors based their observations on screening, incentive and enforcement problems. The screening problem is due to the inability of lenders to determine satisfactorily the extent of risk inherent in projects submitted for credit facilities. The incentives problem is the cost which lenders would have to incur to make certain that borrowers take the appropriate actions to enhance loan repayment. The enforcement problem, essentially, occurs due to limitations of legal provisions for the enforcement of payments of loans, for example, the selling of collaterals.

Empirical evidence indicates that higher loan repayment performance occurs in Asia as compared to Africa. High {loan repayment performance of 80% to 98.6% was reported for four successful rural finance institutions in Asia. These are Bank for Agriculture and Agriculture Co-operatives (BAAC) in Thailand, the Badan Kredit Kecamatan (BKK) and the Bank Rakyat Indonesia Unit Desa (BUD) in Indonesia, and the Grameen Bank (GB) in Bangladesh (Yaron, 1994). According to Yaron (1994), three main factors contributed to the success story of the aforementioned banks. First, the time of submission of application and disbursement of loans ranged between 1 and 2 weeks for the first time borrowers and in the case of repeat borrowers, the period was just about a day.

Second, the use of existing social structures or peer groups to ensure prompt payment and thirdly, the rigid structure of loan repayment and routine meetings, especially of GB group members, in which social pressure was applied to achieve prompt payment and the flexible loan repayment terms that were tailored to cash flow patterns and specific income earning activities of lenders.

In Africa, loan repayment performance has been poor. For example, 14% to 20% for commercial banks in Tanzania (Bagachwa, 1996), and about 45% for small agricultural loans in Ghana

(Aryeetey and Nissanke, 2000). In Ghana, such success stories of loan recovery are not easy to come by. We may pose the following question: what is it that has been impeding the loan recovery rates? Besley (1994) asserted that enforcement of loan repayment constitutes a major difference between rural credit markets in developing countries and credit markets in developed countries. Most lending institutions do not have experienced personnel capable of developing innovative financial products suitable for SMEs (Aryeetey et al, 1994). The repayment of loans by SMEs was recognised as one of the most troublesome problems facing rural financial institutions in Africa. Collateral, access to local information and appropriate local mechanisms to enforce loan repayment are important. A study into the effectiveness of persuasive pressure exerted on default borrowers in Edumafa in the Central Region of Ghana concluded that this can lead to improvement in recovery rates (Kamara and Micah, 2000). Africa compared with EU countries showed that the latter's commercial banks is closer to SMEs due to their wide networking and proven experience in loan recovery.

A close supervisory and monitoring relationship between financial institutions and clients enhances loan recovery. In the case of Ghana and other African countries, there is evidence of poor supervision and monitoring by banks (Lassort and Clavier, 1989; Aryeetey et al, 1994). Loan misapplication and its consequences for loan repayment has been recognised by several authors. It is a phenomenon that can be described as moral hazard. There are several factors that can lead to misapplication of loans. In the first instance, the delay in the release of funds can contribute to this. This viewpoint was brought up vividly by Armah (2001) when she posed this question: "Of what use is a loan to a woman who cultivates groundnuts after the farming season is over?". In the second instance, the percentage of the amount granted tends to be lower and this affects the working capital of SMEs (Aryeetey et al, 1994; Armah, 2001).

Eventually, the low amount granted affects the returns and the payment of loans. If the percentage of the amount granted is considered low by the borrower, he/ she may misapply the loan, that is, use it for consumption purposes which endangers loan repayment. According to Armah (2001), a woman who became the breadwinner due to the retrenchment exercise under the Structural Adjustment Programme, took a loan of ¢56700,000 under the PAF programme. After settling her personal bills, she was left with only ¢200,000 to expand her business.

We share the view of the author when she posed this question: "Is it practically possible to expand one's business with as meager an amount as ¢200,000?" Aryeetey et al (2000) also remarked that high interest rate may encourage borrowers to use the money to settle previous loans rather than finance working capital or investment. Several lending practices showed that the grace periods have been Grace period is defined as the time lag between the release of funds and the start of the loan repayment too short to serve their intended purpose. Especially, this can be felt in the start-up phase of the business. The grace period also affects repayment of loans, although it is intended to protect the lending institutions (Lassort and Clavier, 1989).

Conflicts in society lead to political instability and fuel risk and uncertainty because they can contribute to different signals given to actors in the financial sector. SMEs get caught in the uncertainties and this affects their ability to pay back loans. We agree with Steel and Webster (1989) and Dzambo (2001) that the success of SMEs credit programmes is contingent upon a minimum level of economic and political stability. Political instability induces changes in political orientation leading to changes in policy paradigms that undermine SMEs projects (Steel and Webster, 1989).

Political pressure for loan disbursement has been the bane of all SMEs credit programmes initiated by governments. Political pressure for loan disbursement without knowledge about borrowers' working environment has been recognised by McGregor (1994) to be among the major causes of poor loan recovery. This is the adverse selection outcome. Evidence in Ghana and several countries indicate that the subsidised schemes are not self-sustainable due to political pressure in the disbursement of loans. For example, out of ¢245.7 million disbursed under the PAF by the Ho District Assembly, only 16.4% has been paid back. Due to the poor loan recovery performance, the District Assembly has temporarily suspended further disbursement of the fund (Agbelie, 2001). In the Bawku West District in Ghana, the District Chief Executive also reported that ¢62.12 million out of a total of ¢127 million disbursed to beneficiary groups and individuals for income generation activities has been recovered. This amount represents less than 50% of the total loan disbursed (Seini, 2001). The low rate of recovery can be attributed to the poor strategy used in the project appraisal. Many beneficiaries acknowledge such loans as "thank you from government", therefore, they do not see the need to pay back such loans.

The review of literature has shown that there are theoretical and empirical gaps. The direct link between higher interest rates and the demand for credit by SMEs could not be made manifest by all the studies under review. Also, the literature does not establish positive correlation between higher interest rates and loan recovery. Therefore, there is the need to close the gap and this is exactly what this study aims at.

2.9 Access to Finance SMES

Access to finance has been identified as a dominant constraint facing SMEs (Lader, 1996). A World Bank study found that about 90% of small enterprises surveyed stated that credit was a major constraint to new investment (Parker et al., 1995). Levy (1993) also found that, there is limited access to financial resources available to smaller enterprises compared to larger organizations and the consequences for their low growth and development. This stems from the fact that SMEs have limited access to capital markets partly due to the perception of higher risk, informational barriers, and the higher costs of intermediation for smaller firms. In Sub-Saharan Africa, most small businesses fail in their first year due to lack of support from government and traditional banks (Biekpe, 2004).

In Ghana, the idea that problems in financing small firms have significantly hindered the role they play in the overall macroeconomic performance of the Ghanaian economy is deeply rooted since the overthrow of the first Republic of Dr. Nkrumah (Boapeah, 1993). Previous studies have identified a growing gap in the financial support offered to Ghanaian SMEs. The high interest rates, collateral requirements and the cumbersome processes have often been mentioned as the main impediments to SMEs' access to bank loans in Ghana (see Sowa et al., 1992; Aryeetey et al., 1994; Bigsten et al., 2000; Buatsi, 2002). These studies however focused mainly on the difficulties SMEs face in accessing commercial credit from conventional banks and other financial institutions.

The present study examines how the finance gap for SMEs might be addressed by means of policies to support other financing initiatives other than commercial finance by the conventional financial institutions. The study seeks to investigate the awareness and use of these various financing schemes (quasi-commercial credit) available to SMEs in Ghana. The issue is of critical significance given the important role SMEs play in the Ghanaian economy. SMEs have been noted to contribute about 85% of manufacturing employment (Steel and Webster, 1991). They represent about 80% of the private sector and also account for about 92% of businesses in Ghana. For the current Ghana government's slogan of "Golden Age of Business" to succeed and for the country to reach the per capita income of US $1,000 by 2012, there is the need to steadily increase the rate of economic growth from the present level of 4-5% to 7-10%. Given that SMEs represent a vast portion of the firm tissue in Ghana, they have an important role to play in spurring growth.

CHAPTER THREE

RESEARCH METHODS

The chapter considers the methodological aspects and data analysis as well. The main objective of this study is to investigate the finance for SMEs development and also the challenges and problems of accessing finance from the traditional commercial banks; in addition, the study also looks at identifying other alternative sources of gaining finance for the small and medium-sized enterprises in Ghana such as the non-bank financial institutions.

3.1 Design of the Study

The objectives of this study suggest that the impact of the financial sector on development and growth of SMEs. The study therefore seeks to relate access to finance by SMEs to the availability of finance for their growth and progress as the entrepreneurs operate. This has certain implications for the design of the study. It suggests that a number of SMEs would be studied and their opinion about both internal and external financing for the development of their business.

3.2 Population

The target population of the study is 30 Small and Medium Enterprise owners who in and around Accra and data from the National Board for Small Scale Enterprise. Thus, it could be said that combination of both primary and secondary data were explored. The secondary data being the database obtained from the Head Office National Board for Small Scale Enterprise and primary data would be the data gathered from respondents.

3.3 Sampling

A random sampling method would be adopted in this instance. According to Alreck and Settle (1985), a sample must be large enough to meet the requirement for reliability but not too large as this will waste resources. Alreck and Settle (1985) also note that sample size of ten percent of a population is enough to obtain adequate confidence. For the purposes of this study, the researcher would administer 30 questionnaires upon which specific analysis and conclusions would be made.

3.4 Data Collection

In order to achieve the purpose of the study, questionnaires would be administered to the respondents. A Likert Scale questionnaire is adopted to help collect specific data for the study. For the purpose of analysis, the designed questionnaires would help gain deduction and intuition from the survey thus portraying the real or the almost real picture on the ground of investigation. The study extensively analyzed the relevant data from surveys that would be conducted and discuss the prevalent finance options available for SME development.

The questionnaire is subdivided into four basic sections. The first section deals with basic profile of SME in question. This would be achieved by gathering data on the number of employees that a particular SME operator engaged, the main activity of the company, the characteristics of the enterprise and the number of years of existence. The next section of the questionnaire seeks information on the current situation of SME operator and in fact the SME itself. The fundamental information to be looked out for is the current pressing problem (finding customers, competition, access to finance, costs of production or labour, availability of skilled staff or experienced managers among others) the SME firm is facing. The other is the relevant indicators for the income generation of the SME. This attest whether certain key indicators like turnover, labour cost, materials, energy, profit (Net Income After Taxes), and mark up (Selling Price minus Production Cost per Unit) have decreased, remained unchanged or increased over a specific period.

The third section of the questionnaire looks out for information on financing of the SMEs. It first of all seeks to know the financing structure of the SMEs, types of external financing available and the particular one they owners would like to use. The term and condition available for a particular finance option, and the confidence of the entrepreneurs in acquiring a particular finance method would also be examined. Schmidt and Crop (1987) have indicated that the type of financial institution and its credit policy will determine the access problem. Where credit duration, terms of payment required security and the provision of supplementary services do not fit the needs of target group, potential group, potential borrowers will not apply for credit even where it exists and when they do, they will be denied access. The final part looks at the future perception of the SME owner with regard to say financial challenges.

3.5 Procedure for the Analysis

In conducting this study, the possibilities of the hypothesis set out in the beginning of this research are tested to verify if they true or false. Therefore an extensive review of other surveys previously made was done to trace the trend of the existing finance for SME development. In addition, an analysis of the results obtained from the conducted surveyed would be done to make comparison between the existing theories put forward and the actual fact on the ground and then to also see why the problem is there and what possible solutions can be employed to tackle the issue.

CHAPTER FOUR

EMPIRICAL FINDINGS AND DATA ANALYSIS

The analysis took the form of descriptive statistics. This is because the study was descriptive in nature as it sought to determine the situation as far as SME financing in Ghana. As a result, percentages were computed for the various responses they provided. In the paragraphs below, descriptive statistics about the characteristics of companies and the SME financing situation in Ghana are presented.

4.1 Company Profile

Thirty respondents were randomly selected and interviewed from the target population thus representing the sample size. The first stage of our findings focuses on the company profile, the results of which are summarized as follows. Among the companies investigated 22 owners or directors representing 73 percent of the total sample size, have employed less than 10 people and the remaining 27 percent employed more than ten people. No single company employed more than 100 people. This really indicates that they are classified among the small and medium scale enterprises and more within the Ghanaian of African context.

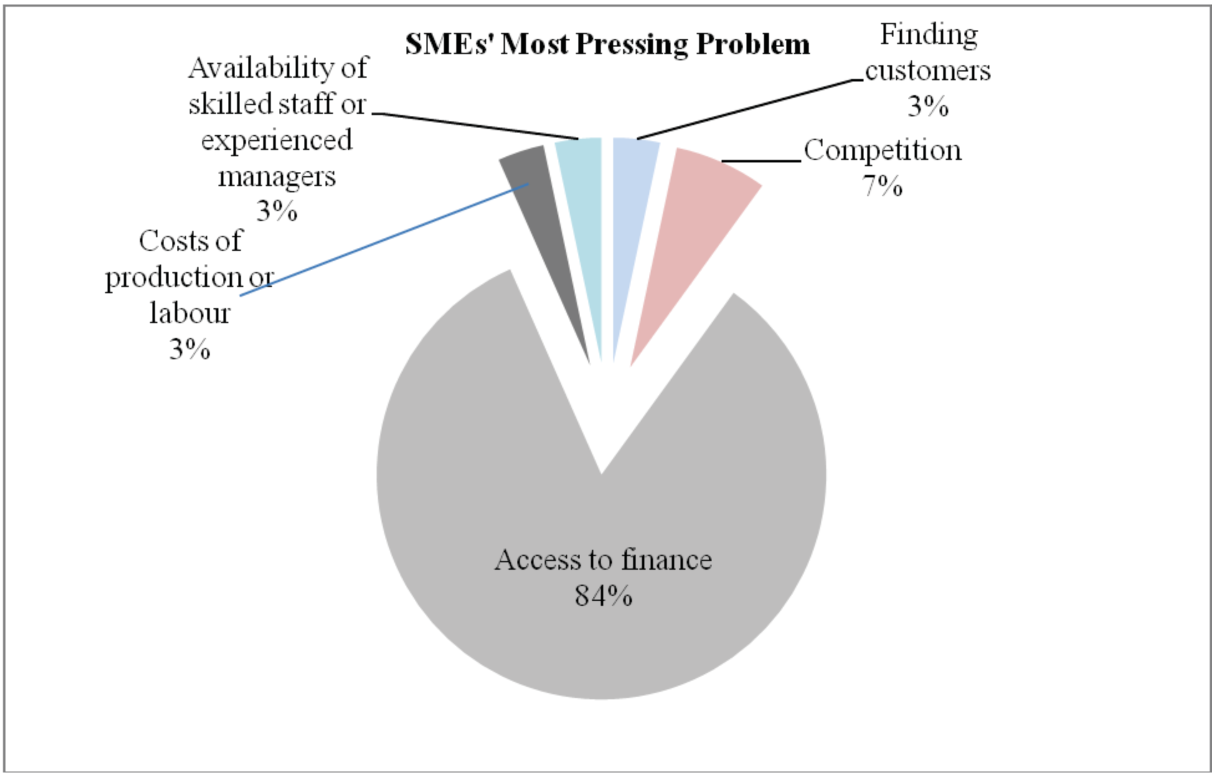
In trying to know the kind of activity these organizations are engaged in, various options were made available to the respondents among which are; manufacturing, service, wholesale or retail trade, construction, transport, real estate, farming, and financial services. The summary of the results show that 10 percent are engaged in manufacturing, 7 percent in providing services, 50 percent are into wholesale and retail trade, 3 percent are into construction i.e. based on their acquired skills or profession, 20 percent are into transport and the rest 10 percent are into farming. The findings undoubtedly represent the kind of businesses most SMEs are engaged in as indicated by Fisher and Reuber (2000) in terms of activity, they are mostly engaged in retailing, trading, or manufacturing.

The characteristics of the SMEs also indicate that 47% are sole proprietors, 30% are partnership businesses and 23% are limited liability companies. In addition, 7 percent existed for less than 2 years, another 7 percent exist for 2 years or more but less than 5 years, 23 percent exit 5 years or more but less than 10 years and 63 percent exist for more than 10 years. Further assessment of the ownership of the firms under study also reveals that, 10 percent are owned by shareholders, 17 percent are owned by family members, 13 percent are owned by business associates, 3 percent by venture capital firms, and 57 percent is owned by only one owner. Thus most SMEs are one-person businesses; the largest employment category is working proprietors (Schmitz, 1995).

4.2 Situation of the Firm

This part of the study investigates the most pressing problem that an SME faces and indicators that are relevant for income generation to the firm. The figure 4.1 below shows that among the respondents, 84 percent indicated that their most pressing problem is access to finance. 3 percent said that is lack of patronage (finding customers); another 3 percent indicated that is the lack of availability of skilled staff or experienced managers and costs production or labour respectively. The remaining 7 percent said it is competition.

Figure 4.1: Most Pressing Problem of SMEs

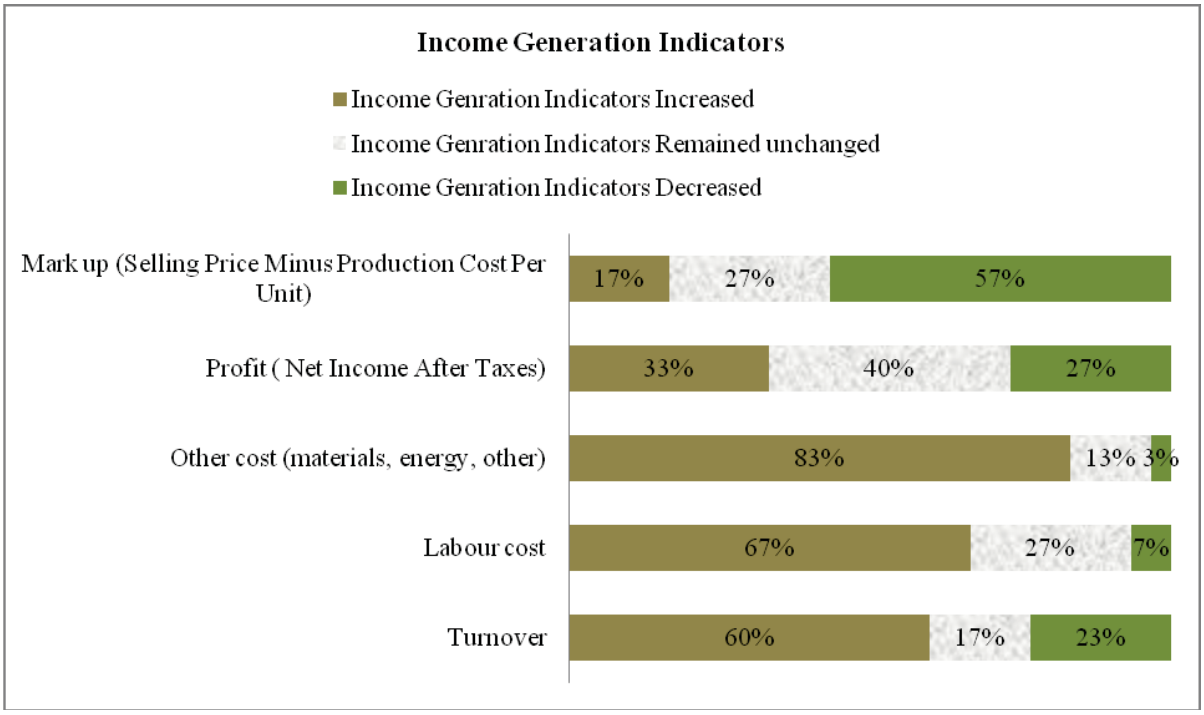


Source: Survey on Finance for SMEs Development in Ghana.

The next part under this section of the study enquires from the respondents, which among other indicators are relevant for the income generation of their SME, i.e., which of them have decreased, remained unchanged or increased over the past 6 months. Among these indicators are; labour cost, other cost (materials, energy, other), labour cost, turnover, profit (Net Income after Taxes), and mark up (Selling Price minus Production Cost per Unit). The results as summarized in the figure 4.2 below demonstrate that 17 percent, 27 percent and 57 percent of the respondents indicated that markup has increased, remained the same and decreased respectively over the past 6 months in their organizations. Another 33 percent, 40 percent and 27 percent indicated that profit has increased, remained unchanged and decreased respectively. With regard to other cost i.e. cost of material, energy among others, 83 percent, 13 percent, and 3 percent of

the respondents indicated that they have increased, remained the same, and decreased respectively over the past six months. In addition 67 percent indicated that labour cost has increased, 27 percent observed no change, while the remaining 6 percent said there was a decrease. Finally, 60 percent experienced increased turnover, 17 percent observed no change, and 23 percent have seen some decrease.

Figure 4.2: Income generation indicators

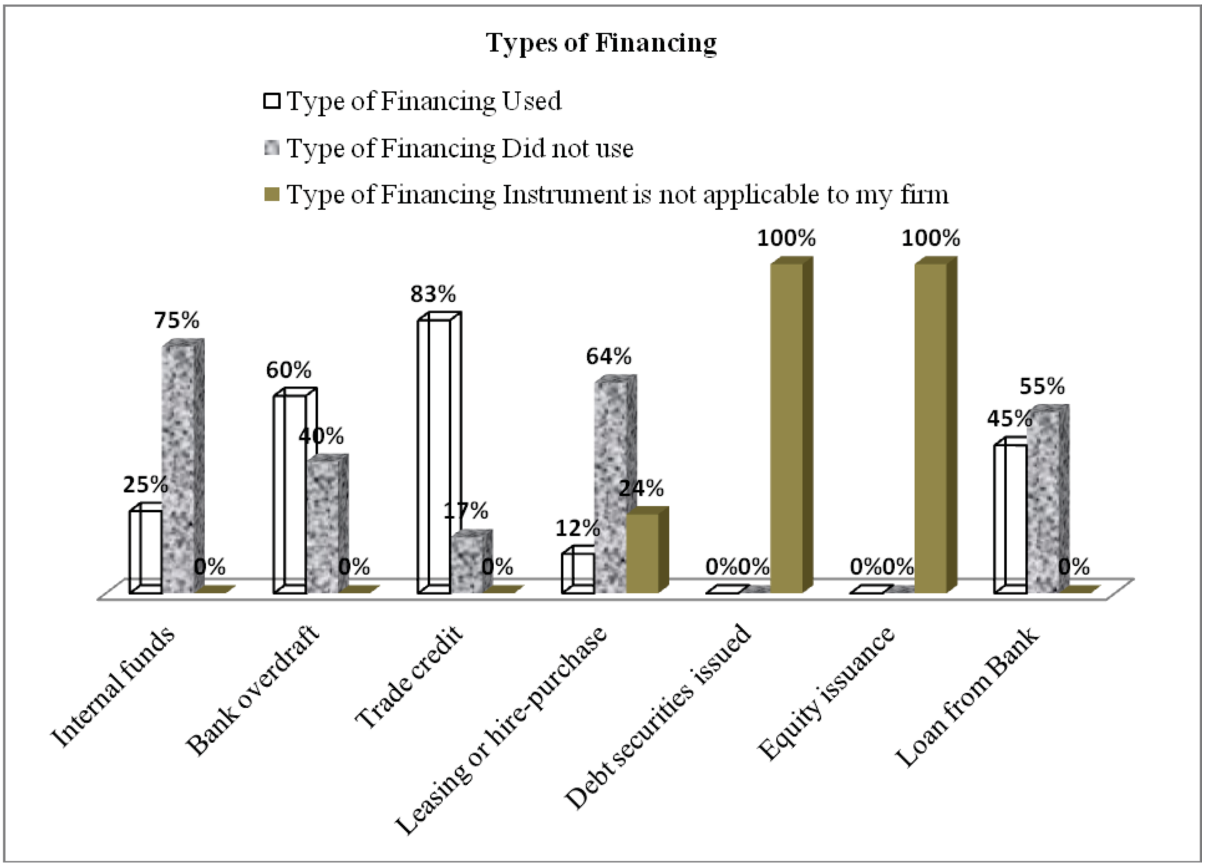


Source: Survey on Finance for SMEs Development in Ghana.

One could say that since the majority of the respondents showed that access to finance is their most pressing problem they face as business owners, lack of finance restrains growth of most SME in general. This problem coupled with increase in input cost like labour, material, electricity, water bills among others hinder profit making since the mark up is eaten up by other incremental costs. Thus despite the SMEs' turnover increased over time there is no incentive to make profit thus hold back development.

4.3 Financing of SMEs

Figure 4.3: Type of Financing

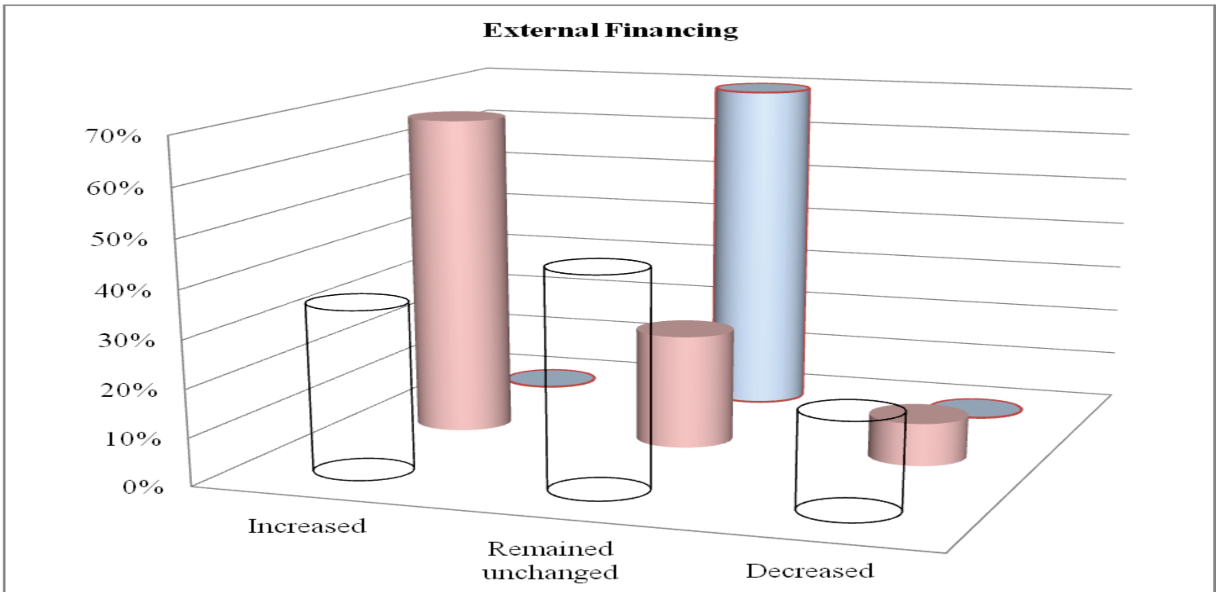


Source: Survey on Finance for SMEs Development in Ghana.

The respondents were presented with financing options and the questionnaire finds out if among these finance options (Internal funds, Bank overdraft, Trade credit, Leasing or hire-purchase, Debt securities issued, Equity issuance, and Loan from Bank) which of them the respondent used over the past six months. The Figure 4.3 above presents the summarized result of the respondents' reaction. Twenty-five percent (25%) indicated that they used internal financing (e.g. plough back of profit), 75 percent did not use this type while the remaining did not show whether they used internal financing or not and did not indicate whether the type financing is not available to their enterprise. Meanwhile 60 percent indicated that they used bank overdraft and 40 percent did not use such financing type over the past six months. Surprisingly, almost all, i.e. 83 percent indicate that they used trade credit over the past six months while the remaining 17 percent did not use it. Only 12 percent resorted to hire purchases and 45 percent used bank loan. The remaining finance type like debt security and equity issuance were not available for the enterprises.

It could be concluded here that the major sources of finance for SMEs are trade credit (postponed immediate payment for goods and services from suppliers to a further date), bank overdraft and bank loans. The internal sources of finance and leasing or hire purchase are the minor source to which only few entrepreneurs resort to. Debt issue and equity issue are not available for SMEs. A further investigation into the external sources of finance reveals that 35 percent of the interviewees showed that access to loan has improved over the past six months, while 45 percent stated that they observed no change, 20 percent said the service has decreased. In addition 67 percent of them showed that trade credit has improved, 24 percent observed no change and 9 percent showed that there was a downward movement. With regard to equity financing, 70 percent saw no change and no comment was made for debt security. Again, trade credit and bank loans were identified as the external sources of finance that saw improvement over the past six months as shown in figure 4.4 below.

Figure 4. 4: External Financing



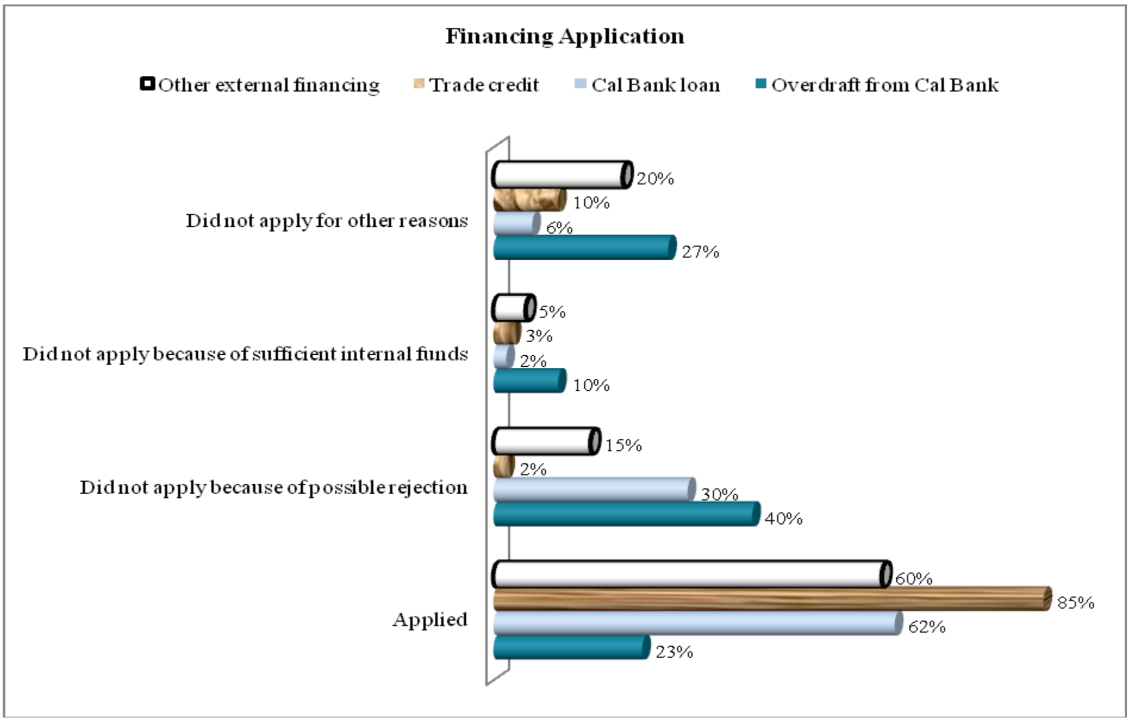
	Increased	Remained unchanged	Decreased
Cal Bank loan	35%	45%	20%
Trade credit	67%	24%	9%
Equity investments	0%	70%	0%

Source: Survey on Finance for SMEs Development in Ghana.

The figure 4.5 below is the pictorial representation of the perception of the respondents (Applied, Did not apply because of possible rejection, Did not apply because of sufficient internal funds, Did not apply for other reasons), to trade credit, overdraft from Bank and other external financing. 60 percent applied for other external financing, 85 percent applied for trade credit, 62 percent applied for Bank loan, and 23 percent applied for overdraft from Bank. Meanwhile, 15 percent, 2 percent, 30 percent and 40 percent did not apply for other external financing, trade credit, Bank loan, and overdraft from Bank respectively due possible rejection. In addition, 5 percent, 3 percent, 2 percent, and 10 percent of the respondents did not apply for other external financing, trade credit, Bank loan, and overdraft from Bank respectively due to sufficient internal funds. The remaining did not apply because of other reasons.

It could be summarized that trade credit was highly applied for, followed by Bank loan, then external financing and bank overdraft. This could be due to the fact that suppliers give credit to the wholesalers or retailers as a form of pre-financing their business in order to increase patronage for their products. Bank loans are the next resort because it attracts interest and allows some time to pay. While bank overdraft gives the opportunity to the client to overdraw his or her accounts at a particular time, it is repayable within a short time with interest. External financing basically loan from friends that are arranged based on the good relation one has with the lender is mostly applied for by the SMEs. Not to forget about the private lenders who are another source of external finance and the terms arranged based on guarantees.

Figure 4.5: Financing Application



Source: Survey on Finance for SMEs Development in Ghana.

Table 4.1 below is another summary of the respondents' view about the various financing negotiated for i.e. bank credit, trade credit and others and as to whether, they applied and got all, or got part of it, applied but refused because the costs was too high and applied but rejected. 5 percent of the respondents stated that they applied for bank loan and got everything; and 25 percent applied for other source of external finance and got all. 52 percent applied for bank loan, 90 percent for trade credit, and 56 percent applied for other external financing and got only part of it. The rest negotiated for the above mentioned finance options and were refused or rejected. It could be realized that only few Bank clients applied for either loan, trade credit or other external financing and get all. Majority applied and got part of their required finance level.

Table 4.1: Financing Negotiation

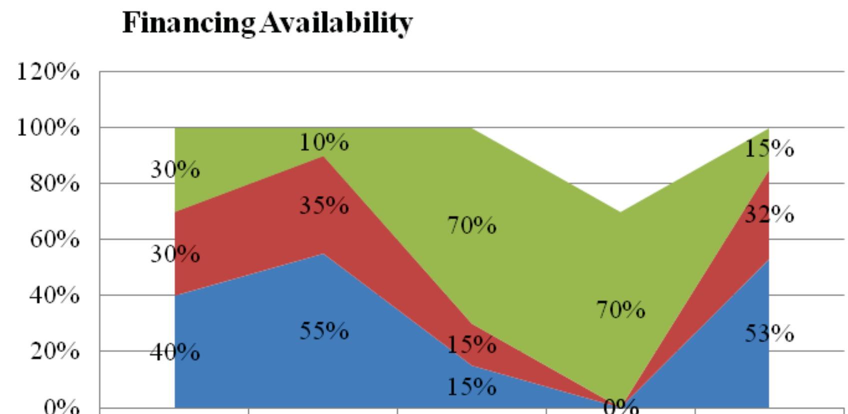
Financing Negotiation				
	Applied and Got everything	Applied but only got part of it	Applied but withdrew because cost too high	Applied but was rejected
Bank loan	5%	52%	38%	5%
Trade credit	0%	90%	10%	0%
Other external financing	25%	56%	10%	9%

Source: Survey on Finance for SMEs Development in Ghana.

With regards to finance availability, 30 percent of the respondents stated that availability of bank loan deteriorated over the past six months for the business, 10 percent said the deterioration was in the availability of trade credit, while a great number of them i.e. about 70 percent said there was much more deterioration in the availability of equity investments and debt security (bonds, notes, and bills) and 15 percent recorded a deterioration in the availability in the other form of financing (loan from a related company or shareholders, excluding trade credit, loan from family and friends, leasing and factoring). On the other hand improvement has been recorded by the respondents in the areas of bank loans (40%), trade credit (55%), equity investments (15%), and other form of financing (53%). The rest of the respondents attest for no change in the available types of financing as represented in the figure 4.6 below.

It is realized that much improvement has been recorded in the availability of bank loan but impressive, trade credit by more than half of the respondents and other form of financing (loan from a related company or shareholders, excluding trade credit, loan from family and friends, leasing and factoring).

Figure 4.6: Financing Availability



	Bank loans	Trade credit	Equity investments in your firm	Debt securities issued	Other
Financing Availability:- Deteriorated	30%	10%	70%	70%	15%
Financing Availability:-Remained unchanged	30%	35%	15%	0%	32%
Financing Availability:-Improved	40%	55%	15%	0%	53%

Source: Survey on Finance for SMEs Development in Ghana.

Considering the terms and conditions of the bank financing available to the firms, for each of the items provided in the table 4.2, the respondents were asked to indicate whether there were increment, no changed or decrease in the list provided for the past 6 months. The results as seen in the table 4.2 have shown that majority of the respondents indicated that there was increment in the level of interest rates, charges, fees, commissions, available size of loan or credit line, collateral requirements and others for instance loan covenants, required guarantees, information requirements, procedures, time required for loan approval.

The increment in the terms and conditions as observed in the table 4.2 below, depict the fact that

SMEs are facing financing difficulty especially with regard to the increase in the interest rate, charges, fees, commissions, loan covenants, required guarantees, information requirements, procedures, and time required for loan approval. The former are factors that really influence the level of finance demand by an entity or individuals.

Table 4.2: Terms and Conditions of Bank Financing

Terms and Conditions of Bank Financing			
	Was increased by the bank	Remained unchanged	Was decreased by the bank
Level of interest rates	43%	33%	0%
Charges, Fees, Commissions	73%	26%	1%
Available size of loan or credit line	52%	45%	3%
Collateral requirements	38%	58%	4%
Other, e.g. loan covenants, required guarantees, information requirements, procedures, time required for loan approval	55%	43%	2%

Source: Survey on Finance for SMEs Development in Ghana.

The availability of external financing depends on various factors for instance, general economic outlook, access to public financial support including guarantees, firm-specific outlook with respect to their sales and profitability or business plan, firm's own capital, firm's credit history and willingness of Bank to provide loan. The study further enquires from the respondents, which factors have improved, remained unchanged or deteriorated over the past 6 months.

The results in table 4.3 reveal that majority subscribe to an improvement in the above mentioned factors except for access to public financial support including guarantees and general economic outlook which 40 percent and 70 percent of the respondents respectively recorded that there was deterioration.

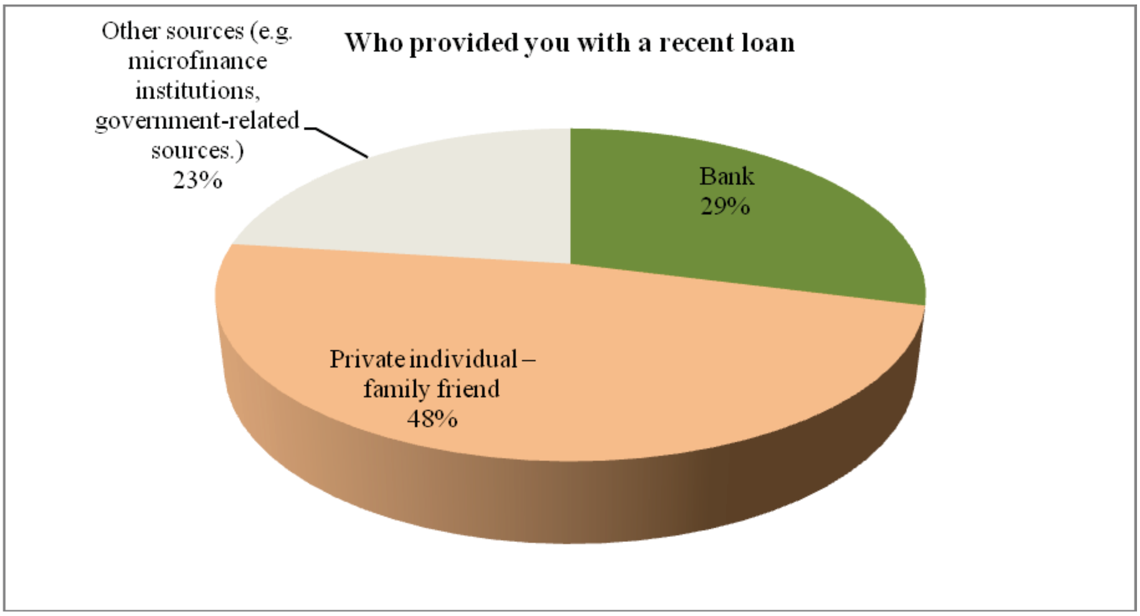
Table 4.3: External Financing and General Economic Situation

External Financing and General Economic Situation:			
	Improved	Remained unchanged	Deteriorated
General economic outlook	25%	35%	40%
Access to public financial support including guarantees	10%	10%	70%
Your firm-specific outlook with respect to your sales and profitability or business plan	38%	42%	20%
Your firm's own capital	45%	42%	13%
Your firm's credit history	45%	28%	27%
Willingness of Bank to provide a loan	45%	32%	23%

Source: Survey on Finance for SMEs Development in Ghana.

The figures 4.7 and 4.8 below depict from the respondents, the sources of their loans and how these monies are used for the growth of the business. That is the areas of the business the SMEs invest the loan acquired and the effect on their business. Figure 4.6 shows that due to the formalities involved in the acquisition of loan or advances form a formal financial institution like bank, the SMEs i.e. a great number of them resort to private loan providers and family friends or relatives. As depicted in the figure 4.6 below, 48 percent of the respondents said that they acquire their recent loans from Private individual – family friend, 29 percent of them stated Banks as their loan provider, and the remaining 23 percent said they got their recent loans from other sources (e.g. microfinance institutions, government-related sources).

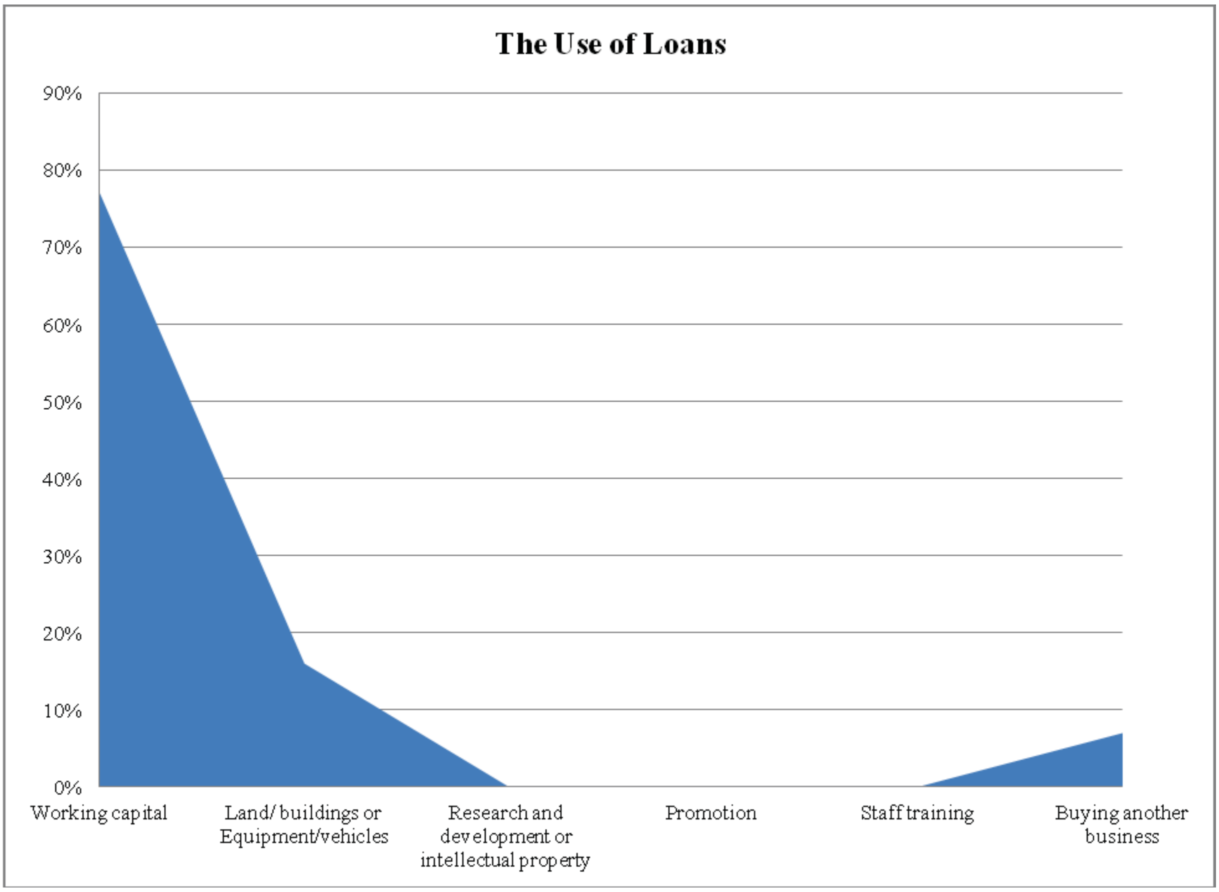
Figure 4.7: Who provided you with a recent loan?



Source: Survey on Finance for SMEs Development in Ghana.

The figure 4.8 below shows the respondents' answers as regard to how SMEs invest their loans. 77 percent shows that the loan acquired goes to working capital i.e. preliminarily into purchase of goods and services for trade, taking care of credits and cash. 16 percent said that the money acquired is used for investment into assets such as Land, buildings, equipment and or vehicles. The remaining 7 percent spent the loan obtained to acquire new business or going into another venture.

Figure 4.8: the use of loan

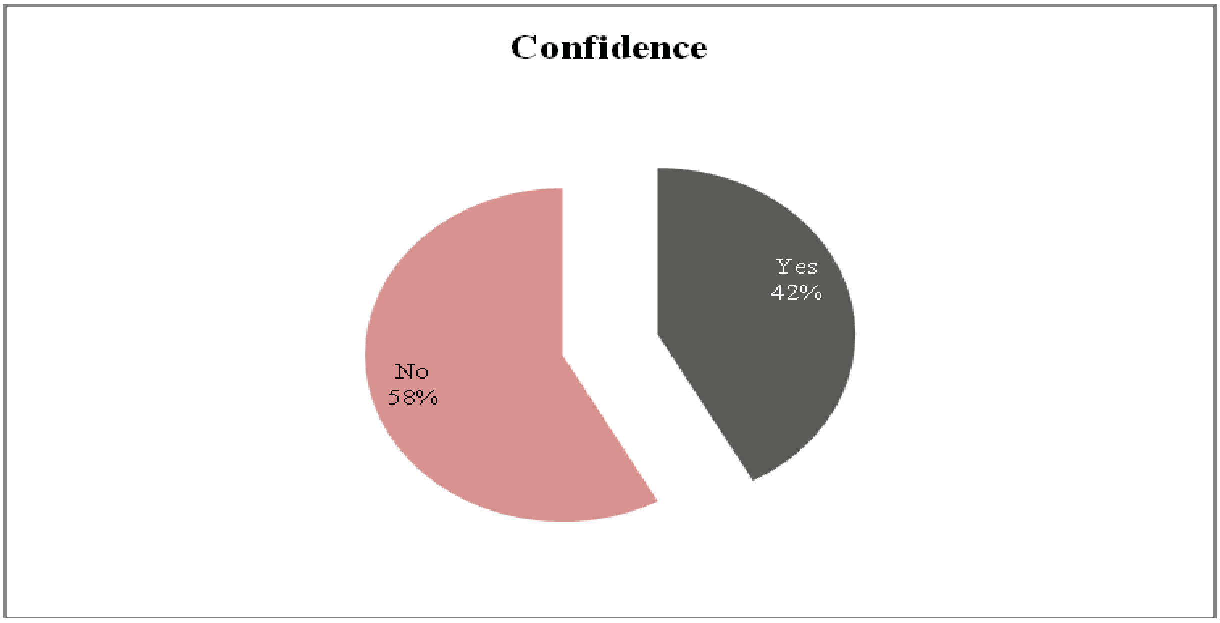


Source: Survey on Finance for SMEs Development in Ghana.

4.4 Future Growth and Obstacles to Growth

This last section of the chapter deliberates on the future growth and presumable obstacles to growth to SMEs. The study tries to find out from the respondents' perspective, how confident the SMEs feel to talk about loan from Banks and other financial institutions in general. In other perspective, if the SMEs need external finances to realize their growth ambitions, which type will they fall on? Finally the limiting factors of obtaining loan are discussed including the financing alternatives that could improve SME growth.

Figure 4.9: Confidence

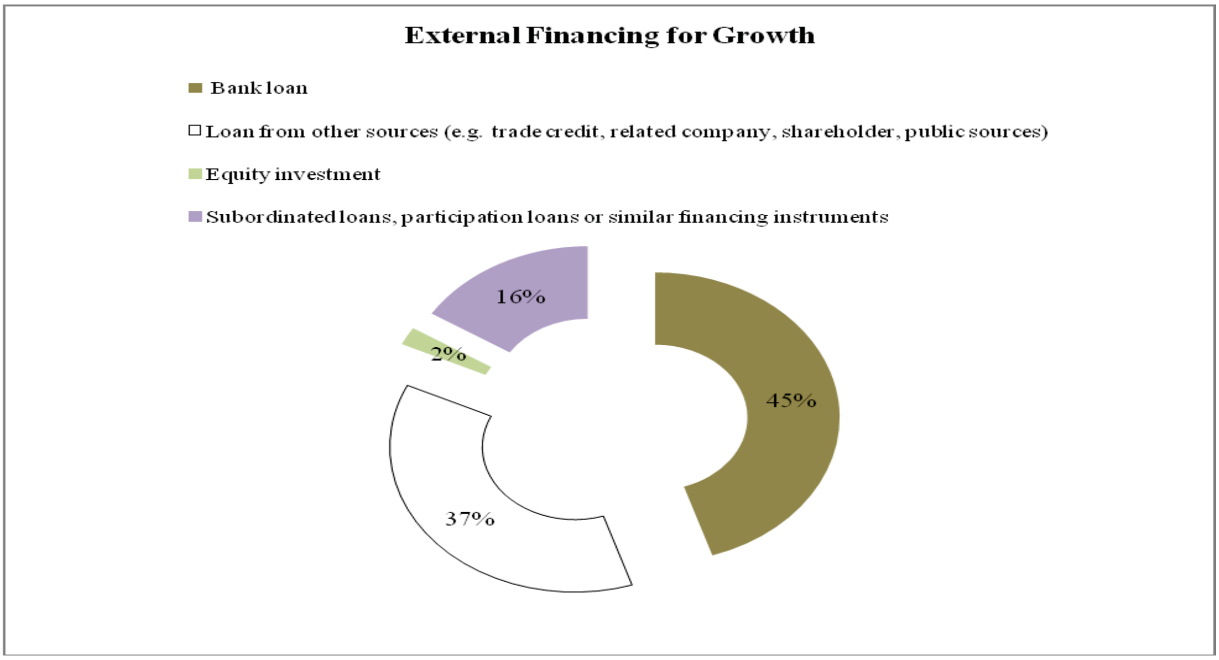


Source: Survey on Finance for SMEs Development in Ghana.

The figure 4.9 above describes how the SMEs feel confident to talk about financing from Bank and more precisely from the commercial banks to obtain desired results. 58 percent of the respondents do not feel confident to talk about financing from the banks. This means they cannot boldly proof that it support from the commercial banks that have let them reach this far of recommending it to other SMEs in need of such financing. On the other hand 42 percent said yes, they feel confident when talking about financing from commercial banks to obtain desired results.

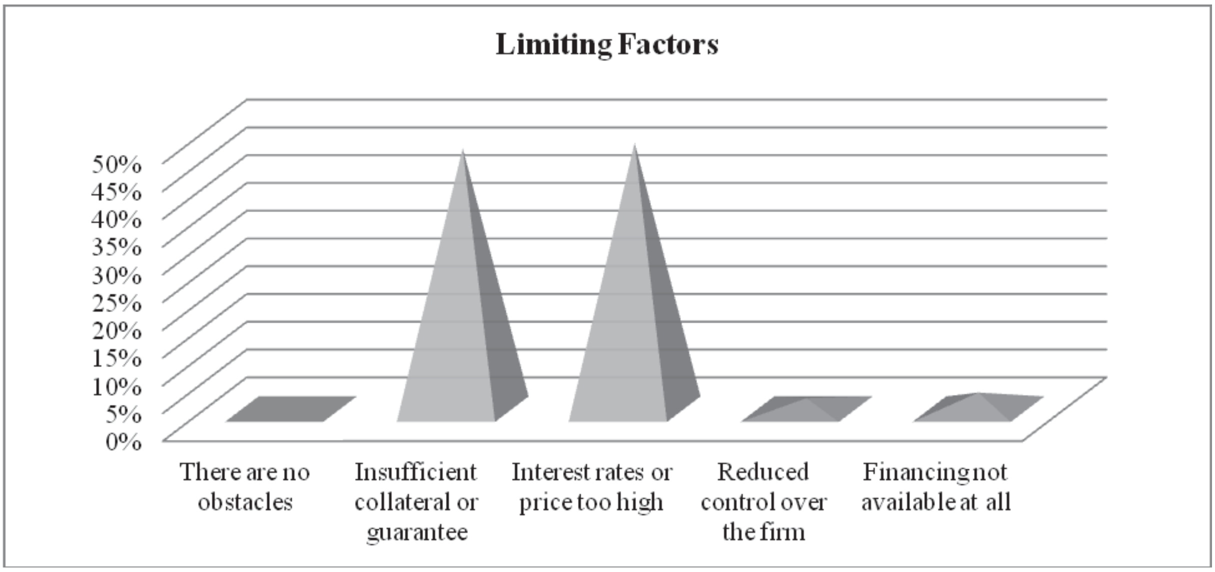
The figure 4.10 below also tells about the reactions of the interviewees on external financing to realize their growth ambitions. The pie chart below shows that the majority to the tune of 45 percent stated Bank loans. Better still the response could be better than recorded and based on the previous responses, it looks more like SMEs lost confidence in the commercial banks as a source of their finances for development. 37 percent stated that they would prefer loan from other sources for instance trade credit, related company, shareholder, public sources. The remaining 17 percent said they would prefer equity investment, subordinated loans, participation loans and or similar financing instruments. Thus loan from commercial banks, instance trade credit, related company, shareholder, and public sources are the most preferable options for SMEs to realize their growth ambition. Mechanisms are therefore needed to make the commercial banks the dominants force therefore putting much confidence in the banking system.

Figure 4.10: External Financing for Growth



Source: Survey of Finance for SMEs Development in Ghana.

Figure 4.11: Limiting Factors

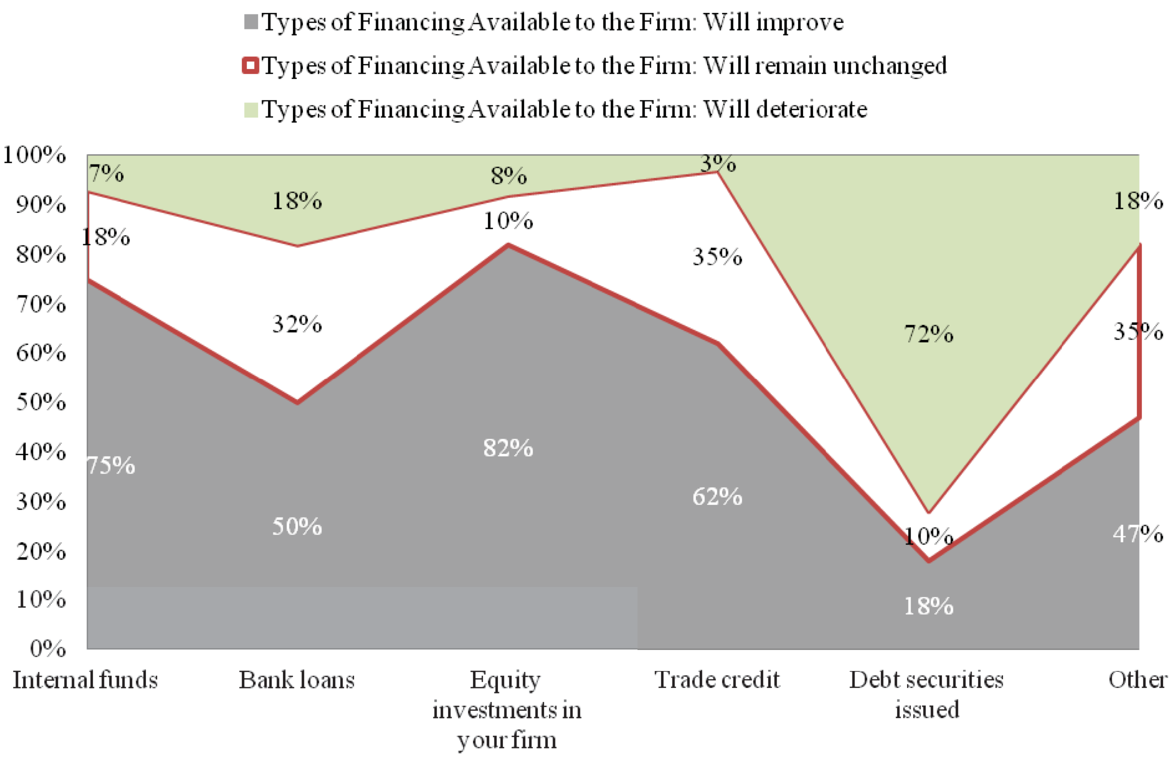


Source: Survey on Finance for SMEs Development in Ghana.

The figure 4.11 above summarizes the findings on the view about the most important limiting factors to get financing from the commercial banks. As shown in the above figure, no one admit that there no obstacles so far as acquisition of finance to support SMEs is concerned. 47 percent shows that the most limiting factor is insufficient collateral or guarantee, while 48 percent said it is interest rates or price too high but the rest 5 percent said it is about reduced control over the firm and financing not available at all. The demand for collateral security, guarantors and high interest are the major factors hindering the finance availability for SMEs and ability to remove these barriers and other institutional rigidities would cause SMEs to develop therefore promoting general economic development.

Finally the figure 4.12 below is also the summary of the outcome from the respondents' reaction as to the types of financing available to their firms, that would either improve, deteriorate, or cause no change to your business. 47 percent to 82 percent representing the majority stated that internal funds, for example from retained earnings and sale of assets, bank loans, equity investments in the SMEs, trade credit, and other forms of financing, for example loan from a related company or shareholders, excluding trade credit, loan from family and friends, leasing and factoring are expected to improve the profitability of the business. 10 percent to 35 percent indicated that the factors mentioned before would not really cause a change to the life of the business, however 72 percent stated categorically that debt security issue are expected to deteriorate the performance of the business.

Figure 4.12: Types of financing and their expectations



Source: Survey on Finance for SMEs Development in Ghana.

4.5 Interview with a Credit Officer

To begin with, the researcher found out about the roles and duties of the officer which he answered as follows. He said as a loan officer, he serves as an intermediary between his institution (lending institutions) and borrowers. He solicits loans, represents creditors to borrowers, and represents borrowers to creditors. He helps individuals and businesses obtain funds from lenders. He added that as a Loan officer, he specialized in commercial, consumer and mortgage loans. With regards to whether his bank provides credit loan to SMEs he answered yes.

Though the bank does not have a special project for SMEs, he believes handling them fall in line with the Corporate Finance Operation which focuses on innovation as the hallmark of a service oriented bank. The Corporate Finance Department meets the banks clients' growing demand for financial advisory services. The Bank's Corporate Finance Team provides a wide range of services to clients, including advice on mergers and acquisitions, corporate divestitures, recapitalizations, restructuring, joint ventures and strategic partnerships. The bank continuously leverages its expertise in investment banking to provide a comprehensive array of corporate advisory services. He said the investment professionals bring extensive capital market experience to structuring innovative financing solutions to fit clients' needs. The hallmark in Corporate Finance, he said, is therefore quality analysis, guided by client interests and the demands of the Ghanaian market. The Bank also advises on and executes the following: Company valuations, sourcing of local and foreign debt and equity financing, loan syndications project analysis and evaluation, target market identification and identification of potential investor's research sector studies and investment analysis.

He said a substantial portion of the SMEs do not have the security required for conventional collateral based bank lending, nor high enough returns to attract formal venture capitalists and other risk investors. In addition, markets may be characterized by deficient information (limiting the effectiveness of financial statement-based lending and credit scoring). This has led to claims of an "SME finance gap". In addition are lack of satisfactory business plans, accounting and other information; inadequate assets for use as security, and insufficiently high levels of profitability, gearing, liquidity, stability, and other business-financial performance criteria on the part of funding applicants. The researcher went further to ask why the bank provides finance to its clients. He said in order to help businesses grow and also increase profitability. SMEs are facing greater problem than just finance for development. There is the need for government also to intervene in order to remedy the information gap.

CHAPTER FIVE

SUMMARY OF FINDINGS, CONCLUSIONS AND RECOMMENDATIONS

SMEs finance is perceived as a financially sustainable instrument, and is meant to reach significant number of small businesses of which most are not able to access financial services because of the lack of strong retailing financial intermediaries. Access to financial services is imperative for the development of the informal sector and also helps to mop up excess liquidity through savings that can be made available as investment capital for national development (World Bank- Africa Region, 1999).

Small and Medium Scale Enterprises (SMEs) tend by their very nature to show a far more volatile pattern of growth and earnings, with greater fluctuations, than larger companies. According to Organization for Economic Co-Operation and Development (OECD) policy brief report on SME development in 2006, Financing is necessary to help Small and Medium Scale Enterprises (SMEs) set up and expand their operations, develop new products, and invest in new staff or production facilities. The characteristics of the banking system in emerging markets frequently inhibit SME lending. Many countries assert that a financing gap exists, partly due to complaints from the SMEs about the availability finance.

Small and Medium Enterprises (SMEs) in Ghana constitute a greater percentage of the economy of Ghana. There are, however, several constraints to the development of SME's especially, the lack of access to resources and financial markets (Aryeetey et al 1994). The study has employ qualitative research techniques where respondents, has been interviewed and data collected has been examined in that perspective. Qualitative research analysis is believed to reveal in many cases the reality on the ground that could serve as impetus for further studies. In order to achieve this, questionnaires has been explored and the researcher actively participated in the investigating process in order to draw the respondent mind on the subject matter. The results were later analyzed and conclusions and recommendations have been drawn as shown in the sub-chapters below. The study has engaged both the officers of the Banks and their clients so as to make concrete analysis for the study.

5.1 Summary

The first objective of the study was to determine the alternative sources for financing SMEs in Ghana. Results of the analysis revealed that, among the various financing options (Internal funds, Bank overdraft, Trade credit, Leasing or hire-purchase, Debt securities issued, Equity issuance, and Loan from Bank) available to the entrepreneurs, only trade credit, bank overdraft and bank loans were the major sources of financing for SMEs in Ghana. Even among the three, trade credit and bank overdraft were prominent sources with trade credit being the most preferred and commonest source of SME financing among the study participants. Besides, they also used loans from friends that are arranged based on the good relation one has with the lender. Again, the study also showed majority of the participants got their most recent loans from sources such as microfinance institutions (23%) and banks (29%); this implies that majority (52%) got their most recent loans from sources other than private individuals. This finding seems at odds with Okraku and Croffie's (1997) conclusion that Ghana SMEs rely primarily on personal savings of owners, business profits, family members or friends for their financial needs. They have little or no access to external credit. This is because the study provided evidence that SMEs also depend on some form of external financing including trade credit and bank overdrafts. This may also be due to the reforms that have been undertaken in the banking sector that may have increased the number of banks and non-banking financial institutions (such as micro-finance institutions) that can offer borrowers such facilities.

Notwithstanding, the study also revealed that the SMEs were less likely to be granted access when they applied for some loans, particularly from the traditional commercial banks. Indeed, it has been reported that in Sub-Saharan Africa, most small businesses fail in their first year due to lack of support from government and traditional banks (Biekpe, 2004). However, the situation in Ghana has changed with the influx of micro-finance institutions that provide access to the needed credit. Accessing credit from the traditional banks and the increasingly micro-finance institutions is expensive. For instance, the study revealed that the participants reported high interest rate as one of the constraints on getting loans from the commercial banks. As a result, actual use of the loans is on the decline. This may explain why, for instance, 38% of those who took the loans withdrew due to the cost of borrowing (in terms of the interest rates).

The finding that high interest rates discourage borrowing by entrepreneurs studied is consistent with Stiglitz and Weiss (1981), high interest rates lead to adverse selection of loan seekers that affect loan repayment. In Africa, loan repayment performance has been poor. For example: 14% to 20%, for commercial banks in Tanzania (Bagachwa, 1996), and about 45% for small agricultural loans in Ghana (Aryeetey & Nissanke, 2000). In the case of Ghana and other African countries, there is evidence of poor supervision and monitoring by banks (Lassort & Clavier, 1989; Aryeetey et al, 1994). Loan misapplication and its consequences for loan repayment has been recognized by several authors. It is a phenomenon that can be described as moral hazard.

5.2 Conclusions

This section comprises the conclusion from the analysis done in the previous chapter. This also addresses the research questions posed in Chapter One. This study sought to answer the following questions:

- What are the alternative sources of raising capital for SME's in Ghana?
- Are the alternative financial gaps accessible to the SME's in Ghana?

In the ensuing subsection, conclusions based on the specific research questions are presented.

5.2.1 Alternative sources of raising capital for SME's in Ghana

It was demonstrated that, majority of the respondents showed that access to finance is their most pressing problem they face as business owners; lack of finance restrains growth of most SME in general. This problem coupled with increase in input cost like labour, material, electricity, water bills among others hinder profit making since the mark up is eaten up by other incremental costs. Thus despite the SMEs' turnover increased over time there is no incentive to make profit thus hold back development.

It was also indicated that, the major sources of finance for SMEs are trade credit, bank overdraft and bank loans. The internal sources of finance and leasing or hire purchase are the minor source to which only few entrepreneurs resort to. In addition, trade credit and bank loans were identified as the external sources of finance for SMEs that saw improvement over the past six months of their operations. With regard to source for fund outside the business, trade credit was highly applied for, followed by Bank loan, then bank overdraft. This could be due to the fact that suppliers give credit to the wholesalers or retailers as a form of pre-financing their business in order to increase patronage for their products. Bank loans are the next resort because it attracts interest and allows some time to pay. While bank overdraft gives the opportunity to the client to overdraw his or her accounts at a particular time, it is repayable within a short time with interest. Not to forget about the private lenders who are another source of external finance and the terms arranged based on just guarantees. The availability of external financing depends on various factors for instance, general economic outlook, access to public financial support including guarantees, firm-specific outlook with respect to their sales and profitability or business plan, firm's own capital, firm's credit history and willingness of commercial banks to provide loan.

When it comes to loan or advance application, it was realized that only few Bank clients applied for either loan, trade credit or other external financing and get all. Majority applied and got part of their required finance level. The increment in the terms and conditions as observed depicts the fact that SMEs are facing financing difficulty especially with regard to the increase in the interest rate, charges, fees, commissions, loan covenants, required guarantees, information requirements, procedures, and time required for loan approval. The former are factors that really influence the level of finance demand by an entity or individuals.

5.2.2 Accessibility to alternative financial gaps

The investigation on the recent loan acquired and who actually provided it, shows that most SMEs get loan from private individuals and relations than from the commercial banks. However they invested the finance obtained in working capital, land, buildings, equipment, vehicles and acquire new business. In addition the majority of the SMEs lost confidence in the banking sector. Among other limiting factors are insufficient collateral or guarantee, and interest rates. Many SMEs believe that access to internal funds, for example from retained earnings and sale of assets, bank loans, equity investments in the SMEs, trade credit, and other forms of financing, for example loan from a related company or shareholders, excluding trade credit, loan from family and friends, leasing and factoring are expected to improve the profitability of the business.

On the other hand, SMEs do not have the security required for conventional collateral based bank lending, nor high enough returns to attract formal venture capitalists and other risk investors. In addition, markets may be characterized by deficient information (limiting the effectiveness of financial statement-based lending and credit scoring). This has led to claims of an "SME finance gap". In addition are lacks of satisfactory business plans, accounting and other information; inadequate assets for use as security, and insufficiently high levels of profitability, gearing, liquidity, stability, and other business-financial performance criteria on the part of funding applicants.

In effect, SMEs are unable to access the alternative sources of financing available. This is due to the number of reasons enumerated, including lack of collateral security and discouraging high interest rates.

5.3 Recommendations

Micro, small and medium enterprises are frequently hailed as the backbone of the economy. There is widespread consensus on their significant contribution to economic growth, employment creation, social cohesion, poverty alleviation and local and regional development. However, a lack of formal credit often hinders small firms from developing their potential. The credit limitation of small enterprises is mainly due to the high administrative costs of small-scale lending, asymmetric information, the high risk attributed to small firms, and their lack of collateral. The fact that small enterprises often receive less finance or face worse conditions than larger firms can put them at a competitive disadvantage and will seriously harm long-term growth and development through under-investment, a waste of entrepreneurial resources, a reduction of productivity and a lower growth rate. In order to address this problem, the following recommendations are made.

First, a Credit guarantee can be put in place as practiced in EU and other parts of the world. A Credit guarantees can be seen as a type of collateral because they provide the lender with a security which can be liquidated in the case of default. Just as collateral, the intension is to signal the borrower's creditworthiness and reduce the risk incurred by the lender. In contrast to collateral, however, they do not represent an effective threat mechanism for the lender since they are provided by an external agency. Alternatively, credit guarantees may be seen as a type of insurance whereby the guarantor insures lenders against default of borrowers and receives a fee for this service. There is some debate on whether credit guarantees are a form of collateral or insurance (Meyer & Nagarajan, 1996a). However, credit guarantees do not insure the borrower who, under normal circumstances, loses the assets he has pledged in the case of default. Credit guarantees are thus an incomplete form of both collateral and insurance. In recent years, efforts have been made to encourage private participation in guarantee schemes. Many schemes are now corporately managed by participating banks, chambers of commerce, or by the entrepreneurs themselves. Funds come from initial capital provided by the private owners or from public sources as well as donor contributions.

Secondly, governments should play an important role in supporting the SMEs sector, particularly where the system inhibits the provision of adequate financing on terms suitable for the SME's stage of development. Government measures to promote SMEs should be carefully focused, aimed at making the banking system work efficiently and at providing incentives for the sector to assume an active role in SME finance. Where necessary, banking systems should be reformed in line with market-based principles. Governments should also act to improve awareness among entrepreneurs of the range of financing options available to them from officials, private investors and banks. Micro-credit and micro-finance schemes play an important role in developing countries and efforts should be made to boost their effectiveness and diffusion.

In addition, policy makers need to ensure that the tax system does not inadvertently place SMEs at a disadvantage. They should also review the legal, tax and regulatory framework to ensure that it encourages the development of venture capital. At the same time, national policies should encourage diverse forms of institutional savings and institutional investors should be regulated flexibly. The market for corporate control should be allowed to function efficiently for both domestic and foreign entities.

Finally, risk can be controlled through character-based lending to entrepreneurs who have a good track record and close on-site monitoring. The cost of frequent monitoring can be minimized through greater decentralization of responsibilities for small loans provided local branch officers are adequately trained.

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APPENDIX

QUESTIONNAIRE

This questionnaire is to gather information about the financial gap for Small and Medium scale Enterprises (SMEs) in Ghana. This study is being conducted in partial fulfilment of the requirements for the award of a Master's degree in Business Administration (MBA) from the School of Management, Blekinge Institute of Technology. Answers given by respondents will be treated with confidentiality and used solely for academic purposes

SECTION A: EDUCATIONAL BACKGROUND

1. Educational Attainment: .... Middle School/J.S.S. [ ] S.S.S [ ]

Technical/Vocational [ ] Others Specify........................

SECTION B: CREDITS

2. How long have you been doing this business..............................

3. Have you obtained a loan before? Yes [ ] No [ ]

4. Which of the following lending agency did you obtained the loan.

A. Bank [ ] B. Microfinance Institution [ ] C. MASLOC [ ] D. Other [ ]

5. How much loan did you apply for ....

6. What was the amount approved? .... Principal .... Interest ......

7. Were you satisfy with the terms of the loan?

A. Strongly Agree [ ] B. Agree [ ] C. Neutral [ ] D. Disagree [ ] E. Disagree [ ]

8. Were you satisfied with the terms?

A. Strongly Agree [ ] B. Agree [ ] C. Neutral [ ] D. Disagree [ ] E. Disagree [ ]

9. When was the loan approved at the right time?

A. Instantly [ ] B. One Week [ ] C. Two Weeks [ ] D. Three Weeks [ ] E. One Month [ ]

CAPACITY OPERATION

10. State maximum output per working day ....

11. State actual (achieved) output per working day ....

12. What period does the actual result refer to? ....

13. Technology Type

Simple [ ] Intermediate [ ] Advance [ ]

14. Financial Capital

Amount! Owners' equity............................. Amount Borrowed.....................

15. What do you think of owing money general? Good [ ] Bad [ ] Indifferent [ ]

16. What do you think of borrowing from banks in general, if credit is available? A. Excellent [ ]

B. Very good [ ] C. Good [ ] D. Not Good [ ] D.

17. Timing of Release of loan

A. Very satisfactory [ ] B. Satisfactory [ ] C. Averagely satisfactory [ ] D. Not satisfactory [ ]

18. Did you have any visits from loan officials! Agency? Yes [ ] No [ ]

19. If Yes, was it

A. Once in 3 months [ ] B. Once in 6 months [ ] C. Once in a year [ ] Never [ ]

MANAGEMENT

20. Do you keep any records? Yes [ ] No [ ]

21. If Yes, what type of records are kept? Please tick all if applicable

A. Financial [ ] B. Transaction [ ] C. Clients [ ] D. Bookkeeping [ ]

22. Do you have a business plan? Yes [ ] No [ ]

23. Have you attended any workshop/seminar/training related to your business? Yes [ ] No [ ]

24. If yes, which year? Year ....

25. What amount and percentage of the loan has been paid back? Amount................................ Percentage................................. .

26. Which months and year(s) did you pay the amount? ....

27. What prevented you from paying the amount according to the agreed repayment schedule?

28. How old is the amount outstanding, (arrears) ....

SECTION C: FINANCIAL INSTITUTION

1. What type of borrowers do you deal with?

A. Small [ ] B. Medium [ ] C. Large Scale Enterprises [ ]

2. Which of the categories of borrowers above do you prefer most? A. Small [ ] B. Medium [ ] C. Large Scale Enterprises [ ]

3. Is there an opportunity cost associated with giving loans to each of the above? Yes [ ] No [ ]

4. If Yes, specify: ....

5. State the Breakdown of the loan recovery performance in the past few years of the

Small Scale Enterprises [ ] Medium scale Enterprises [ ] Large Scale [ ]

6. What (in your opinion) are the causes of the poor loan recovery performance?

A. High Interest Rate [ ] B. Poor Supervision [ ] C. Misapplication of the Loan [ ] D. Present Economic Situation not Favourable [ ] E. Bad Management

7. Do you think interest rates affect the repayment ability of burrowers? Yes [ ] No [ ]

If No, how? Please give reason(s) ………..

8. What factors do you use in determining your interest rate?

A. Risk of Portfolio [ ] B. Base Rate [ ] C. Credit Worthiness [ ] D. Collateral [ ]

9. Do you have any suggestion (s) as to how to improve on loan recovery performance?

A. Training [ ] B. Proper Supervision [ ] C. Lower Interest Rate [ ] D. Client Satisfaction [ ]

10. Do you sometimes fail to grant loans? Yes [ ] No [ ]

11. If Yes Why?

A. Not credit worthy [ ] B. Risk too High [ ] C. Collateral not sufficient [ ]

12. Do you ask for security against loans granted? Yes [ ] No [ ]

13. If Yes, what type of securities are preferred.

A. Property [ ] B. Investment Account [ ] C. Guarantor [ ]

14. What is the current lending Rate?

A. Base Rate [ ] B. Base Rate plus 2 [ ] C. Base Rate plus 3 [ ] D. Base Rate plus 4 [ ]

15. Do you charge different enterprises different lending rates for similar loan sizes and term?

Yes [ ] No [ ]

16. If Yes, why?

A. Rate of Risk [ ] B. Credit Worthiness [ ] C. Type of Enterprise [ ] D. Type of Security provided [ ]