Access to Finance and Its Challenge for Small Business Enterprises

Case of Addis Ababa City

Study conducted in partial fulfilment of the MSc in accounting and finance

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LIST OF ABBREVIATION

AEMFI- Association of Ethiopian Microfinance Institutions

FF&CBAs- Family, friends, and close business associates

GDP- Gross domestic product

IFC- International Finance Corporation

ILO - International Labour Organisation.

MoFED – Ministry of finance and economic development

OD-overdraft

SEDF- South Asia Enterprise Development Facilities

VCs- venture capitalists

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ABSTRACT

Small-scale enterprises have become an important contributor to Ethiopia's economy. The sector contributes to the national objective of creating employment opportunities, training entrepreneurs, generating income and providing a source of livelihood for the majority of low-income households in the country, accounting for material amount of GDP (Eshetu and Mammo, 2009). Improving access to finance for small business is an important devilment tool, because it helps these business sectors, in addition to strengthening the forward and backward integration to and from different sectors, to create employment for the unemployed and increases their income and consumption.

The purpose of this paper was to bring to light one of the major prerequisites, namely access to finance aspects, of the small scale enterprises which are foundation in accelerating economic growth. The main objective of the paper is to identify the challenges that small businesses in Addis Ababa (selected sub cities) face in accessing finance from financial institution through identifying the dominant means of financing small businesses and factors influence the extent of accessing finance. The study was conducted by taking into account the demand side aspect.

The most pressing problem identified, from response of small businesses and from responsible officers interviewed, was accessing fund to finance working capital and in fixed investment. The basic factors aggravated the problem for small business are loan covenants need by financial institution, lack of collateral, level of cost of financing and availability of other financing instruments. In addition; as it was confirmed from the research, luck of credit history with the financial institutions, willingness of banks and suppliers to provide credit and the firm's specific outlook about sales and profitability have contributed to the problem.

Key words: *Access to finance, Small business enterprises*

CHAPTER ONE

1. INTRODUCTION

There is no universally accepted definition of small business enterprises (Ayyagari, Beck and Demiruc-Kunt, 2007); in fact it is not possible, because it depends not only on investment level and number of workers but also on technologies and technical complexities of production, degrees of skills demanded from workers and managers, end use of products, economic level of the country in which they operate, low of the land and so on, which varies from country to country.

As it was observed by Paul and Frederic (2000), most growth theories imply that industrialization is a carrier of economic growth. Nonetheless, for a developing country such as Ethiopia, whose economy is still predominantly agrarian, the emphasis on industrialization should not be stressed by undermining the role of other sectors in the economy, rather a complementary balance has to be established between these sectors to reap the relative benefits accruing to each other, resulting in acceleration of the economic growth. Strong forward and backward linkages between agriculture and other sectors of the economy in supply of raw materials and, in turn, facilitate market for the output goods and services and the existence to which small business enterprise make easy the integration very relevant (Eshetu and Mammo, 2009). While pursuing the industrial development efforts, the major objectives and strategies are focused on optimum utilization of resources, creating employment opportunities and catalyzing the growth of production and exports. In any case, it is now recognized that the small businesses are playing an increasingly important role as engines for economic growth and employment in many regions of the world. Therefore, policies and initiatives to develop small businesses and to increase their competitiveness are a priority for these countries (Ogujiuba, Ohuche and Adenuga, 2004). As indicated by Bartholdy and Mateus (2008) the role of small scale businesses can be as instruments of employment and income generation, human development and poverty alleviation, export promotion, import substitution, stimulation of private ownership, competition and entrepreneurship and hence the driving forces behind the growth of a vibrant industrial market economy, has generated considerable interest among the policymakers, academics, business circle and the international donor agencies in recent times. Nevertheless, the small scale enterprises including the cottage industries are of special consideration as these industries mainly serve the domestic market. As it was tried to be displayed by Gebrehiwot and Wolday(2006) the role of the small business enterprise sector in employment creation, economic growth and poverty alleviation (as opposed to being viewed as marginal and unproductive, tax evader, and with limited contribution to economic growth) has received the recognition it deserves, as explicitly stated, for example, in the Poverty Reduction Strategy, the Small Enterprises Development Strategy, and the Federal Food Security Strategy. To have strong follow up and periodic improvement of policies established for these sector need to be properly studied but not yet in Ethiopian context.

Small firms comparative advantages lie in manufacturing especially items that involve a greater share of value added from labor particularly semiskilled and skilled labor and in the developing countries context even unskilled labor (Kojima and Ozawa, 1985).

The focus of this paper is to evaluate access to finance that these small scale industries are having and the factors that hinder them not to properly raise fund is going to be assessed. Investment in any productive sector is very much essential for the growth of industry and increased facilities in obtaining finances can enhance that growth. Finance is needed at the opening phase of a business as well as at the continuing phases. As indicated by Jesmin and Rubayat (2008). The entrepreneurs require mainly three types of finances, namely- (i) equity capital - to finance assets at the start of a business; (ii) debts – to refinance assets; and (iii) working capital – to maintain the day-to-day activities. However, access to financing is recognized as the leading obstacle to small businesses growth in Ethiopia, alike most other developing and under-developed countries. The small businesses, in most cases, as indicated by Haftu et al,(2009) manage to start a business with resources from informal sector, but find it extremely difficult to survive and expand without further financial assistance from the institutional lenders (Haftu et al., 2009)

Although the economy of Ethiopia is agrarian in nature, the contribution of the small businesses in both agriculture and industrial sector to the country's gross domestic product (GDP) is continuously increasing. Some of the well-recognized strengths and importance of the small businesses, in developing countries as indicated by Jesmin and Rubayat (2008) are:

- source of new employment opportunities
- more flexible in terms of internal organizational structure
- comparatively flexible in adopting, more rapidly and readily, innovations and new technologies
- able to provide favorable environment for development of entrepreneurial skills and business culture
- closer to the ultimate consumers and can respond to their demands more rapidly and efficiently
- in some cases, generator of higher competitiveness on the market
- primarily focused on domestic demand and the local market

Weakness of these small scaled businesses indicated by Jesmin and Rubayat(2008) follows

- due to difficult access to financing, a great part of the small businesses are engaged in activities which are characterized by higher labor intensity than invested capital and, thus, leading to sub-optimal use of resources
- a substantial part of the entrepreneurs do not have sufficient marketing, financial, accounting and legal knowledge, which hinders smooth-running of their business and reduces the efficiency of the enterprises
- low access level and disregard of the real needs for information and consultation
- underestimating of the quality requirements and lack of knowledge on standard specifications
- some entrepreneurs are not well acquainted with the current effective international agreements and requirements

Small businesses which are considered as change agents, since 1960s (Klapper and Allende, 2006), are still in the 21 century being discriminated from the large business to access finance.

According to Jacob Levitsky and Ranga N. Prasad (1989) the reasons why small enterprises have limited access to institutional finance are well known. They are: (1) Lending to small enterprises is considered to be risky. The uncertainties facing small industry, the high mortality rate of such enterprises and their vulnerability to market and economic changes make banks reluctant to deal with them, and there is a parallel reluctance on the part of small-scale enterprises to borrow from banks. (2) Banks and financial institutions are biased in favor of lending to large corporate borrowers. In some countries there are links between banks and corporate borrowers that take the forms of joint directorships, joint ownerships, and various other joint financial dealings. (3) The administrative costs (specifically transaction costs) of lending to small enterprises are high and cut deep into the profitability of such loans. (4) Small enterprises seeking loans are unable or unwilling to provide accounting records and other documentation required by banks, or to provide securities or collateral for the loans.

Generating an entrepreneurial idea is one thing but accessing necessary finance to translate such ideas into reality is another. Many new and considerably attractive commercial ideas have been known to die simply because their originators could not finalize them and banks could not be convinced that they were worth investing in. To fund a business idea as indicated by (Tracy and Tracy, 2009) two major sources can be accessed: internal and external finance. Internal finance is concerned with sourcing funds though savings and those of friends and relatives. However as the firm grows its financing requirement may go beyond personal savings and other internal financing instrument ability to finance the operation and expansion of the business.

The next source is external finance. External funding is based on merit according to the evaluation of financial institutions, which is considered as challenge for small firms by researchers (E.g. Gebrehiwot and Wolday, 2006; Haftu el al., 2009; Rubayat, 2009; Tracy and Tracy, 2009). There are two notable variants of external finance: debt financing and equity financing. Debt financing involves the procurement of interest bearing instruments such as loans overdrafts, letters of credit and accounts receivable etc. They are secured by asset-based collateral and have term structures, that is either short or long term. The equity component of external finance gives the financier the right of ownership in the business and as such may not require collateral since the equity participant will be part of the management of the business (Berger and Udell, 2002).

As shown by Gebrehiwot and Wolday (2006) friends or relatives, suppliers credit, and Iqub(rotating saving and credit associations) and also Idirs are the most important sources of finance for small scale business operating in Ethiopia. The research conducted by the aforementioned two professionals has depicted that trade credit appears to be used as a substitute for bank loans. But the problem is that trade credits are mostly for short time period means this financing instrument does not even stay with the businesses for a month or two month.

1.1 STATEMENT OF THE PROBLEM

Small-scale enterprises have become an important contributor to Ethiopia's economy. The sector contributes to the national objective of creating employment opportunities, training entrepreneurs, generating income and providing a source of livelihood for the majority of low-income households in the country, accounting for material amount of GDP (Eshetu and Mammo, 2009). Had this sector been provided proper emphasis, the sector has a high potential for contributing to meet the objective they were envisaged for. Yet the majority of entrepreneurs in this sector are considered uncreditworthy by most formal credit institutions as per the report of

World Bank's (2009) and by Abebe, Million and Andrew (2009) about businesses and their access to finance in Ethiopia. While there are a number of constraining factors obstacle development and emergency of small firms the basic and the one that seek attention is access to finance (Ayyagors, Demirguc-Kunt and Maksimovic, 2006)

Improving the availability of finance facilities to this sector is one of the incentives that have been proposed for stimulating its growth and the realization of its potential contribution to the economy (by establishing saving and credit institutions) but the need of small scale business for finance became complicated when they grow and involve in innovative activities. Despite this emphasis, the effects of existing institutional problems, especially the lending terms and conditions on access to credit facilities, have not been addressed. In addition, there is no empirical study indicating the potential role of improved lending policies by the financial institutions in alleviating problems of access to finance. Knowledge in this area, especially a quantitative analysis of the challenges small business are facing in access finance is lacking for the financial markets of Ethiopia.

Although informal credit institutions have proved relatively successful in meeting the credit needs of small enterprises in some countries (example Indonesia), their limited resources restrict the extent to which they can effectively and sustainably satisfy the finance needs of these entrepreneurs (Nappon and Huddlestone, 1993). This is because as small enterprises expand in size, the characteristics of loans they require become increasingly difficult for informal credit sources to satisfy, yet they still remain too small for the formal lenders (Aryeetey, 1996). To meet the objective for which these small enterprises are established, this challenge should be alleviated. Therefore the researcher wants to see the following main issues:

1. What are challenges that small business enterprise are facing in accessing finance?
2. What are the factors determine participation of small business entrepreneurs' in credit markets?
3. Is (Are) there measures that the government is taking to minimize these problems and are these measures alleviating the problems?

1.2 OBJECTIVE OF THE STUDY

The overall objective of the paper is to evaluate the access to finance that small businesses have in sub cities selected from Addis Ababa.

The specific objective are

- Identify the challenges through spotting the factors influencing small business's access to finance.
- Identify dominant means of financing small business and the reason why this financing is preferred over the others.
- To evaluate the action of the government as a facilitator to alleviate the problem of access to finance and recommend action to be taken.

1.3 SCOPE OF THE STUDY

The study focus on small business in city of Addis Ababa and challenge they face in the process of accessing finance. The total number of small businesses registered in the city is over 1350 out of which the 136 were selected for the research purpose. Even though access to finance can be measured through both the supply side and demand side, the scope of the research is limited to the demand side only. This, on the other hand, is to say that the supply side needs further research which is the mainly concerned with financing technology financial institutions use to satisfy their users.

1.4 LIMITATION

One of the basic limitations that the researcher faced is that recklessness of small business owner managers in responding to the questions in the questionnaire. The other limitation was again with respondent's perception about the objective of the research project; they consider it as the research is being conducted for some other reason behind the main objective of the research.

CHAPTER TWO

2 METHODOLOGY

The purpose of this paper is to bring to light one of the major prerequisites, namely financial aspects, of the small scale enterprise sector in the backdrop of pursuing rapid industrialization strategy keystone acceleration of economic growth. In addition to the assessment of the access to finance provided to the small scale enterprise in the country, this paper aimed to focus on various other financial aspects and recommendations was provided. For this purpose, extensive survey of literature was made and relevant publications, previous studies and various initiatives taken by the stakeholders (including the government and the development partners) are going to be consulted.

A research method can be either qualitative or quantitative. This research uses the qualitative and quantitative approach to address the research questions qualitative and to some extent quantitative.

2.1 DATA TYPE AND DATA SOURCES

Both primary and secondary data were used to conduct the research. The primary data the researcher used were data from target group means the owner managers of the small scale enterprises and the employees having access to the issue relevant to the research objective. And the officers in small business development bureau were the basic source of information.

The secondary data that the researcher used were from varies secondary sources. In addition the periodic government body's publications and report of development partners was the other main source to see the extent to which the small businesses are accessing credit facilities.

The data pertaining to the issues core to the research were collected using questionnaire incorporating appropriate questions in respective categories. The questionnaires, after translated to Amharic, were distributed to small business owner managers operating in five sub cities which consisted of Addis Ketema, Gulele, Kolfe, and Yeka in Addis Ababa on the basis of judgmental sampling. Data used (mainly primary type) was collected through questionnaire. The researcher distributed questionnaires to judgmentally selected 136[1] small businesses operating in Addis Ababa of which 115 were collected back (Gulale 42, Addis Ketema 39, Yeka 17 and Kolfe 38).

To achieve the first objective of the project, the challenges of getting access to credit small business enterprise, questions indicating the most popular source of finance these businesses have been using, whether these businesses had accessed external finance before and if they have accessed the challenge they faced in the process of getting the finance, were requested. In addition to these the growth pattern of small businesses was assessed, by asking beginning capital and ending capital, to see whether these business's nature and type of finance needed to fund the operation and growth. The third objective, the most popular means of financing operation of small businesses, was tried to be addressed through question to owner operators of small businesses that indicate what type of financing instruments that the businesses were using and the which one they prefer to use.

[1] The number of questionnaires collected back are only 115

To attain the last objective which is about what government is doing to resolve the problem small businesses face, interview was made with officers of the Addis Ababa city administration small business development bureau. The interview type the researcher used was unstructured since it will let the interviewer to be flexible in asking question and to address the issue relevant to the research objective. The interview of two times approximately 25 minutes was made with Addis Ababa city administration small business development bureau officers.

2.2 SAMPLING TECHNIQUE

The populations that the researcher indentified to conduct the research on were the small scale businesses in capital city, Addis Ababa. Form the purposive sampling techniques the researcher was interested in judgmental sampling technique. The reason was that it improves representativeness of the sample. From the total number of small businesses in the city 136 were selected judgmentally out of 1350 small businesses access from the database of the city administration and questionnaire was distributed to them. Not to incur much cost the researcher used proximity of the small business in distributing the questionnaire.

2.3 ANALYSIS AND INTERPRETATION

The analysis method that was used by the researcher was descriptive. After all the relevant data were collected, data preparation including editing, coding, and data entry was made. This step include activities that ensure the accuracy of the data and their conversion form raw from to reduced and classified forms that are more appropriate for analysis. Preparing a descriptive statistical summary was another preliminary step that the researcher conducted to carry out that lead to an understanding of the collected data. The coded data by assigning symbol to responses of the population, to group into limited number of categories; data entry was made to Microsoft Office Excel. Statistical instrument like measures of central tendency and measure of variability were used.

To visualize the data frequency tables, bar graphs and pie charts were used. These instruments have used to facilitate interpretation process of the research. Finally from the premises indicated in the analysis and discussion the research derived finding and conclusion which in turn helped to recommend the possible action to be taken.

CHAPTER THREE

4. LITERATURE REVIEW

Even though there is no universally accepted definition for small scale business, countries define this business sector in a manner it reflect the economy of the country, the law of the land and other factors relevant to be taken into consideration including technology. In Ethiopia small businesses are defined as 'businesses with paid up capital of birr 20,000 to birr 50,000 and number of employees 10 to50' (ILO, 2005), which is different from for any other country. For example World Bank defined small businesses as '10 up to 50 employees, total assets of up to $3 million and total sales of up to $3 million' and EU defined small businesses as 'Small enterprises: 10-49 employees with maximum turnover up to 7 million Euros.' (Dasanayaka, 2009)

3.1SOURCE OF FINANCE FOR SMALL BUSINESS ENTERPRISES

When implementing a new business concept and expanding or financing operation, only one definition captures the real essence of capital: "It takes money to make money." From the aspiring entrepreneur designing a new office furniture product in a home office to an executive of a multinational corporation looking to expand foreign distribution channels for new product introductions, launching any new business concept requires capital, or money, as a basis to execute the business plan (Rodriguez, 2003). Before a business sells its first product or delivers a service to the market, it needs financial resources for product development, sales, marketing and promotional efforts, administrative support, the company's formation, and countless other critical business functions. Capital is not only perceived as just the amount of "cash on hand" but rather the amount of financial resources available to support the execution of a business plan. While financial resources come in countless forms, types, and structures, two main basic types of financial resources are available to most businesses: debt and equity.

As indicated by Tracy and Tracy (2009) for small scaled business enterprises source initial or additional capital needed to conduct business can be:

i. Family, friends, and close business associates (FF&CBAs) have been one of the primary capital sources to launch new business concepts since the beginning of time and will most likely continue to fill this role in the future. This is the main source of finance in Ethiopia and any other developing country (Gebrehiwot and Wolday, 2006). The range of capital-raising options from FF&CBAs stretches from the founders of a business tapping their own credit worthiness or resources (savings, home equity, or credit cards) to Mom and Dad or a trusted business associate stepping up with the needed seed money to launch the company. Generally, this type of capital tends to be for lower dollar amounts, geared toward equity as opposed to debt (given the uncertain nature of the business and higher risks present in terms of generating cash flow), and provided to closely held and/or family operated businesses.
ii. As indicated by Tracy and Tracy(2009) in the business world, a large number of private capital sources are available and include such sources as venture capitalists (VCs), investment bankers, angels or white knights, and similar types of private investment groups. Private capital sources come in a variety shapes, sizes, and forms, but all tend to gravitate towards a common set of criteria: The dollar size of the capital commitment is generally much larger and these groups tend to be more risk-based capital sources and look for higher returns from equity driven transactions.
iii. Debt capital sources including banks, leasing companies, government-backed programs (microfinance in our country's context), asset-based lenders, factoring companies. For almost any debt-based need, some type of lender is readily available in the market. These

groups, similar to private sources, tend to look for a common set of characteristics when extending capital in the form of debt: Security of some sort — an asset or personal guarantee, for example —must be present and Debt providers tend to look for more stable business environments where a company has been in business for an extended period of time and has a proven track record.

iv. A company generates positive internal cash flow and reinvests this asset internally as needed.

v. A company utilizes creative forms of unsecured financing from vendors, partners, customers, and so on to provide a real source of capital.

vi. A company looks for gifts. Governments, universities, and nonprofit organizations have resources available in the form of grants, low interest rate loans (with limited downside risk), incentive credits, and so on, which are intended to be used for special interests or purposes. The general idea is to provide this capital to an organization that will use it in the best interest of the general public.(Tracy and Tracy, 2009)

In today's business world where consumer's credit and other types of credits being offered by banking sectors in developed and developing countries, it is amusing to see the small scale business, change agent, suffer from luck of access to finance in these country. As known an important role of banks is to provide relationship lending services that help resolve problems in providing external finance to informationally obscure small businesses (Berger and Udell, 1994). However, a number of factors may affect the banking system's ability to provide credit to small businesses. Banking industry consolidation creates large banks that may be oriented toward transactions lending and providing capital market services to large corporate clients. These institutions are also often headquartered at great distances from small business customers and may have difficulty processing locally-based, and often less quantitative, relationship information (Berger, Klapper and Udell, 2001).

The issue of credit availability to small firms has garnered world-wide concern recently. Models of equilibrium credit rationing that point to moral hazard and adverse selection problems (e.g., Stiglitz and Weiss, 1981) suggest that small firms may be particularly helpless because they are often so informationally unclear. That is, the informational wedge between insiders and outsiders tends to be more discriminating for small companies, which makes the provision of external finance particularly challenging. Small firms with opportunities to invest in positive net present value projects may be blocked from doing so because potential providers of external finance cannot readily verify that the firm has access to a quality project (adverse selection problem) or ensure that the funds will not be diverted to fund an alternative project (moral hazard problem) (Barger, Klapper and Udell, 2001)

It is important to clarify from the outset that the researchers focus here on the vast majority of small firms whose access to external finance is nearly entirely limited to internal financing and FF&CBAs. In our country's context recently micro finances are institutions handling the micro and small business sector (Camilleri, 2005). These are firms with very high growth potential, often in knowledge-intensive high tech industries, who principally access the banks and other financial institutions for early-phase financing. Because these high risk firms generally require large injections of external funding relative to insider financing, have little in the way of tangible assets that may be pledged as collateral, and are subject to significant moral hazard opportunities to change projects, they are ill suited for bank financing and thus tend to have low levels of leverage (Barger, Klapper and Udell, 2001).

3.2 ACCESS TO FINANCE AND DEVELOPMENT

Finance is at the core of the development process (World Bank, 2008). Backed by sold empirical evidence, development practitioners are becoming increasing by convinced that efficient, well functioning financial systems are crucial in channelling funds to the most productive uses and in allocating risks to those who can best bear them, thus boosting economic growth improving opportunities and income distribution and reducing poverty. This is the reason why the World Bank and other international institutions are awarding the Microfinance and other financial institutions, for their good deed in developing countries.

In the World Bank's report published in 2008 it is indicated that improving access and building inclusive financial system is goal that is relevant to economies, at all level of development. The challenge of better access means making financial service available to all, there by spreading equality of opportunities and tapping the full potential in an economy. But as per the researcher's perception the challenge is greater than ensuring that as many businesses or firm or individual as possible access to basic financial service. The challenge of access to finance in developing countries includes where, who, when and under what condition that business are accessing credit. This means on the other hand low of the land, the policies and procedures of the institution providing credit service matter. This article of World Bank indicate, what the researcher strongly support that the challenges are as much about enhancing the quality and reach of credit, savings payments, insurance, and other risk management products(World Bank, 2008). Here, even though, it is very challenging if not impossible to apply the credit facilities developed countries are using the modern technology oriented instrument; we can make use of the traditional finance oriented instruments by blending them with the modern engineered financial facilities

Most theoreticians have long reasoned that financial market frictions can be the critical mechanism for generating present income inequality or poverty traps (this idea is supported by the World Bank too) without inclusive financial system poor individual and small enterprises need to rely on their personal wealth or internal resources to invest in their education, become entrepreneurs or take advantage of promising growth opportunities (for e.g. Barger and udell, 1994; Fama, E. F., 1970; Neave, E. 2009; Soros, G. 2000; F.J. Fabozi and P.P Drake, 2009)

A more effective and sustainable development approach would directly address financial market imperfections, without causing adverse incentive effects. Most retribution policies create disincentive to work and save although the economic magnitude of disincentive effect are subjected of intense debate. As Demirguc-Kunt and Levine (2007) argue this tension vanish when focusing on financial sector reforms. Reducing financial market imperfections to expand individual opportunities creates positive not negative incentive effect on. Even though those arguments are very consistent with modern development theories yet emphasizing to put financial sector reforms that promote financial inclusion is at the core of development agenda.

3.3 MEASUREMENT INDICATORS OF ACCESS TO FINANCE

As per report produced by World Bank (2008), financial inclusion or broad access to financial service is defined as an absence of price or non price barriers in the use of financial services. But this does not mean that all firms should be able to borrow unlimited amount at prime lending rate or transmit funds access the world instantaneously. In addition the report specify that, even if service providers are keenly competitive and employ the best financial technology, prices and interest rates charged and the size of loans and insurance coverage on offer in a market economy will necessarily depend on the credit worthiness of the customers.

It is obvious that improving access means improving degree to which financial services are available to all at a fair price. It is easier to measure the use of financial services, since use can be observed, but use is not always the same as access. Therefore accesses indicate that supply of their financial facilities on the other hand use indicate both the supply and demand side of the market. These means to access is the availability of financial institutions in the market where as the use is whether the financial facilities are being accessed properly by the users. (World Bank, 2008)

On the World Bank's report (2008) under the title "Finance for all" indicate that wealth customers in advanced financial systems will choose not to use some financial services. Some moderately prosperous customer's especially ordinary individuals or households may not have and wish to borrow money; even if offered a loan at a favourable interest rate. The World Bank classified access and use as follows

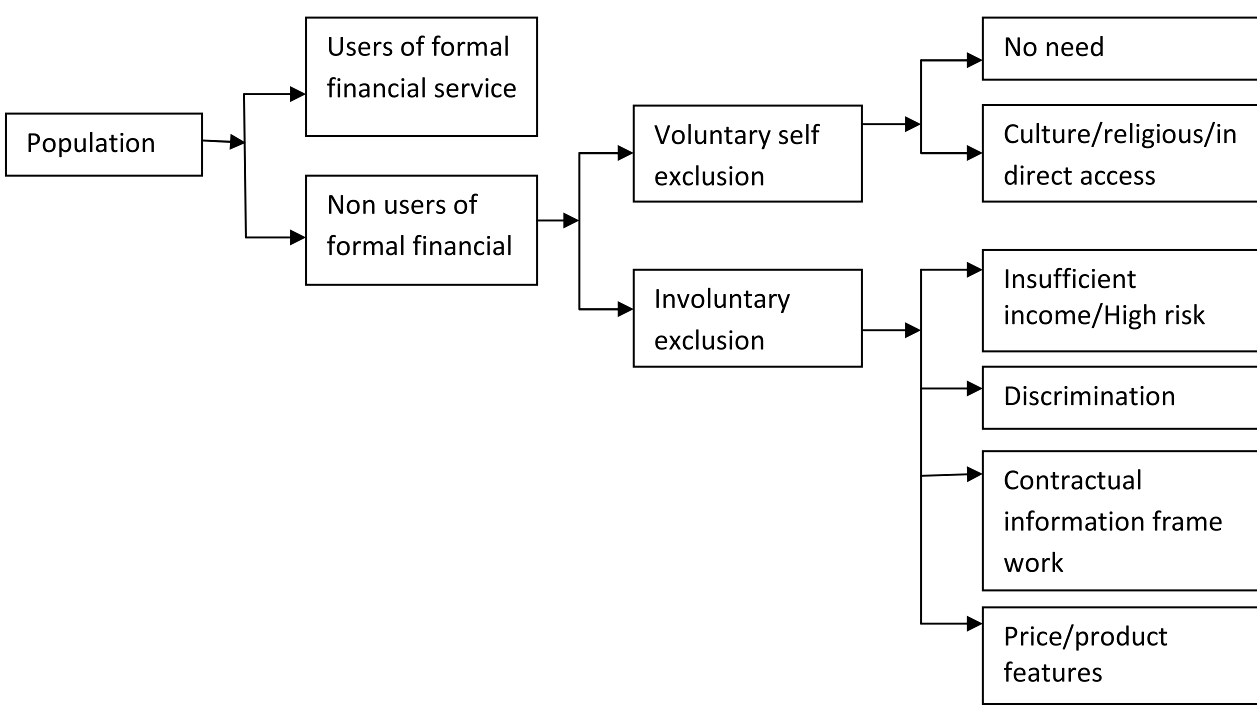

Figure 3.1: Access to finance vs. use: voluntary and involuntary exclusion (Sources: World Bank report- finance for all- pp- 29)

In the diagram population indicate the household, small business enterprises and others that do have the right to access financial service and the World Bank classified those groups into two: user of formal financial service and non users of formal financial instruments but the not users are two types: voluntary self exclusion those who do not want to (luck of demand to the financial facilities). On the other hand the involuntary excluding are those who do have the demand by no access because of rules and regulations, discrimination, conceptual information frame work because of high price of financial service.

3.4MEASURING ACCESS TO AND USE OF FINANCIAL SERVICE

World Bank measured access to credit with census data on the number and characteristics of households that have a bank like financial institution. The report indicate that in the absence of census data, one would at least like to have survey based measures that are represent five of the whole population and of important subgroups again collecting information about the types of financial service they are consuming, in what quality and at what price as well as complementary data on other characteristics of the household that might affect or be affected by their service.

One basic method that Caskey, Ruiz Duran and Solo (2006) have used to measure access to finance is target group surveys. The aforementioned authors in their research conducted in India, Colombia and México give insight into the information that can be obtained from such survey instruments beyond simple measures of use of financial service. As per the finding household surveys are necessary to obtain detailed information on who uses with financial services from which types of institutions including informal ones.

Beck et., al (2007) complete loan and deposit account data though surveys of bank regulators for a cross –section of countries and documents the large variation in those indicators across countries. This was made though computation of GDP per capita.

On the other hand access to finance can be measured as to outreach of banks and financial institutions. Ethiopian microfinance institutions have reached over 1.8 million borrowers, representing an outstanding loan portfolio of birr 3.1 billion (AEMFI, 2009).

Similarly, indicators of financial use show a positive but imperfect correlation with indicators of financial depth such as credit to the private sector divided by GDP(World Bank,2008). This correlation shows that access really is a distinct division; financial systems can become deep without delivery access to all.

3.5 BARRIERS OF ACCESSING FINANCE

Understanding only the actual use of financial services, not complete by itself but access across its different dimension is important too. Collecting indictors of and briers to access and comparing them to usage and other country characteristics will enable researchers and policy maker close the gap. The quantity and quality of access is important. Barriers indentified as main by Haftu et al(2009) as Ethiopia's small business enterprise access to finance are religion, problem of forming group, high interest rate and the willingness to receive loan from financial institution (owner managers are pessimist) are the basic.

The World Bank's report(2008) indicate that, service may be available but may not be customized to different needs, or points of delivery may be too few or delivery may take a long time.

The study of Beck, Remirguc-Kunt, and Martinez Peria(2007) sponsored by the world Bank, indicated that barriers as availability of location minimum account and loan balances account fees, fees associated with payments documentation requirements and processing ties are found to vary significantly both across banks and across countries. Indicators of access barriers are also found to be negatively correlated with actual use of financial services, confirming that these barriers can exclude individuals from using bank services. Geographic access is the most important finding of (Beck , Remirguc-Kunt and Martinez Peria, 2007). As an example they have compared Ethiopia where 1 branch of bank is for 100,000 people and in Spain 1 branch is for 1000 people. They recommended technology as solution for this problem which did not take into account the capacity of banks and the risk that these banks will face when making use of for example ATM.

The other basic barrier is lock of documentation most developing countries like Ethiopia to have a bank account, an individual is required to have at least three documents, identity card/passport, wage slip, recommendation letter proof of domicile. Given high degree of informalities in these developing countries, only small portion of the population can produce most of this document (Beck, Remirguc-Kunt and Martinez Peria 2007).

In addition to the above mentioned barriers affordability barrier is one that need emphasis. The study indicates that in most developing countries, the cost of giving checking account is very high. In Cameron for example an individual needs to have $ 700 to open a checking account, which is above to average per capita GDP of the country (Beck, Remirguc-Kunt and Martinez Peria, 2007).

Lack of appropriate product and service for small scale enterprises is another important barrier to access financial service. As per the world bank's report (2008), the main problem in delivering credit are linked to risk management and high transaction cost of processing, monitoring and enforcing small loans, which increase break even interest rate for these loans. The risk includes those arising out of information asymmetries. These asymmetries can result from adverse selection that is the inability of the lender to distinguish between high and low risk barrowers or from moral hazard, that is the tendency form some borrowers to divert sources to projects that reduce their likely hood of being able to repay the loan and the inability of the lender to detect and prevent such behaviour.

Berger and Udell (2004) argued that the differences in the financial institution structure and lending infrastructure may significantly affect the availability of funds to different types of Small business enterprises. However, small business enterprise need finance to undertake productive investment in order to expand their business to introduce new product to market the products as well as to loop up with temporary financial problems. But most of the small businesses in Ethiopia face challenge from banks and other financial institution in accessing finance.

Most of the recent works of small businesses access to finance focuses on the comparative advantage of different types of financial institutions in using transactions lending approaches, based on hard quantitative data that may be observed and verified at above the time of the credit originations versus relationship lending approaches based significantly on soft qualitative information gathered through contract over time with the small businesses and often with its owner and members of the local community. Berger et al., (2005) found that large institutions have comparative advantages in relationship lending to informationally unclear small businesses based on soft information.

Most commercial banks are so reluctant to provide loan to small businesses because of high risk and supervision cost associated with this type of investments. Hossain (1998) and Sia(2008) identified in Bangladesh that banks are shy to lend to small business activities, as they do not consider them as attractive and profitable under takings. And small businesses are considered as high risk borrowers because of the nature of their operation, low capitalisation, and insufficient assets to be used as collateral. Here in Ethiopia access to finance by small business more on suppliers credit, equipment leasing (Gebrehiwot and Wolday, 2006) but the problem is aggravated because non existence of international institutions that facilitate the access to finance for example small business Department of International Finance Corporation(IFC), a World Bank group. For example IFC has extended the small and medium scale businesses financing facilities to Bangladesh through South Asia Enterprise Development Facilities (SEDF) along the local states of the country. (Siddiquee et al., 2006) IFC provide not only fund for small business but also term loans, leasing industrial hire purchase, for asset acquisition, business expansion, overdraft (OD), revolving credit, Factoring, letter of credit and etc.

3.6 LOWERING FINANCIAL BARRIERS IS ESPECIALLY BENEFICIAL FOR SMALL FIRMS

Finance does not just raise aggregate firm performance uniformly; it also transforms that structure of the economy by affecting different types of firms in different ways. Small and new businesses have more difficulty obtain external finance than others. As financial access conditions improve in an economy, those that were formerly shut out have an opportunity to expand. Survey finding suggest that financing obstacles loom much on small business enterprises specifically Back, Demigruc-kunt and Maksimovic (2005) find that financial constraints reduce firm growth by 6% points, on average large firm, but by 10% points on average for large but by 10% firms in the case of small firms. While lack of financial access tends to hurt small firms the most in countries with underlying weaknesses in their institutional environment, empirical evidence also suggests the small firms benefits disproportionately interims of seeing their constraints relaxed as financial systems develop(Back, Demigruc-Kunt and Maksimovic, 2005)

3.7 WHAT ASPECT OF FINANCIAL SECTOR IS IMPORTANT FOR SMALL FIRMS?

As indicated before business organisations can access finance from different areas. Making credit from banks and other intermediaries that provide debt finance more widely accessible calls for two complementary approaches. On the other hand, the modern trend to transaction lending, weather based on assets or an automated credit appraisal such as credit registries. On the other hand neglect of relationship lending can mean that large part of the market are underserved where infrastructures are weak and economic activity more informal. World Bank (2008) in its report recommend the role of foreign banks in improving access but because of political reasons and other basic reasons, including low of the land, foreign bank are not allowed to enter into the financial market of developing counties. There are good reasons for thinking that each has its sphere of comparative advantage (Allen and Gale, 2000). As per the finding banks can effective in financing ventures not firms in sector where there is little dispute over the sector prospects and where firms can be relied up on pay back loans provided they maintain cost control and productive efficiency.

Debt financing is the other major external financing instrument that firms of all size use. Diverse technologies are employed for reaching different types of client in contrasting environments especially where client do not have conventional collateral or where collection of collateral is not secured. Berger and Udell (2004) have pointed out between transaction lending based primary on "hard" quantitative data (such as a credible set of borrower's financial accounts) or secured on assets and relationship lending, based significantly on "soft" quantitative information.

On the other hand Bergar and Udell (2004) pointed out that because of the time and effort evolved in understanding the borrowers business and financial needs. Relationship leading is costly for the lender and therefore requires either high spreads or large volumes to be viable. If the customer's creditworthiness is hard to evaluate then there may be no alternative to relationship lending. A point that must be provided emphasis is that relationship lending is at the core of the banking business continuing to give banks a comparative advantage over markets and nonbank financial institutions, even in developed country.

World bank report of the year 2008, in "Finance for all" booklet indicate that credit network that employ sustain a form of social capital through relationship lending have long been observed in different part of the world. These networks are often characterized by a common ethnicity of the participants although ethnic group membership does not automatically convey membership in the credit market. Biggs and Shah (2006) described credit net works observed in the response to enterprise surveys in sample African countries in the year 1990's. They showed that a common ethnicity greatly increases the likelihood of a trade credit relationship between any two firms and the lengthy specific relationship history between the two firms involved in the credit transaction is not required: network membership seems to be sufficient.

3.8 DETERMINANTS AND IMPLICATIONS OF ACCESS TO FINANCE

It is true that firms finance their operations and growth in many different ways. Their financing choices are influenced by the preferences of each firms entrepreneurs and more important by the option that are available to them, World Bank's report (Finance for all, policies and pitfalls in extending access) indicates that in what form, from whom, how successfully and at what cost small firms are financed thus depends on wide range of factors both internal and external to the firm. As per the report financial resources available to the firm's entrepreneurs and other insiders are of course important, which is strongly supported by the pecking order theory of Myers (1984) and Myers and Majluf (1984). But this internal financing instrument has limitation with regard to the newly being established business where there is no internally generated net income in addition businesses who have started operation and incurred loss during start up period will have no choice. Not only are those the basis for most start ups but they can lever themselves with external finance, that is, finance from outsiders. But given information and agency problems, external financing also depends on the firm entrepreneurs' own ability to project a credible financial proposal, their willingness to share control, the nature of their business plan and the uncertainty and risks involved in implementing it. Factors external to the firm matter a lot too, which includes the economic conditions, financial environment and other macro economic factors (Ed Vos et al., 2005). Moreover world business environment survey by Beck, Demirguc-Kunt, and Maksimovic (2005) made on 10,000 firm in 80 countries indicates that the basic constraints of development in business are corruption, legal and finance. Of these three basics financing constraints lead to the greatest reduction in firm growth.

3.9 BANKING AND NON BANKING SECTORS IN FINANCING SMALL FIRMS

Small businesses like the repayment schedule that banks provide in Ethiopia (Haftu et al., 2009), bankers are not interested in providing loan to small business because of the loan immateriality which increase the transaction cost banks incur and high mortality rate of small businesses (Ogujiuba, Ohuche and Adenuga, 2008). The type of fund that a business organisation raise can be publically placed bonds and term loan from financial institution manly banks. It is obvious that term loan are better in many ways form the public placement, since public placement needs well structured financial market, which is unthinkable in our country's current situation and form the view point of business small in size and newly being established. The other main advantage of term loan than public placement is that they can easily be negotiated for rearrangement at the time of financial in capability to pay back. In addition their transaction cost is by far less than that of the publically paced bonds. This basic role is in the hand of banks and financial institutions in our countries context.

3.10 ACCESS TO INFORMAL FINANCE

Informal financing instrument are dominant more in Ethiopia where more of traditional way of living is practical. To be sure, informal financial services still do represent a significant part of the financial dealings of poor people, especially but not only in developing countries, although reliable quantisation on this point is not readily available (Rutherford, 1998). In Ethiopia formal finance has not yet superseded in formal largely because the current working practices of formal financial intermediaries are not adapted to providing service in small packets at a cost that makes them affordable to the poor. Technology- financial and physical – as well as an improved overall infrastructure, can help bring costs down to realistic levels, but only if the management of formal institutions chooses to focus on the potential for doing profitable business and read to accept risk (Haftu et al., 2009)

3.11 MICROFINANCE INSTITUTIONS AND THEIR ROLE IN FINANCING SMALL BUSINESSES

These days the number of micro finance- institution has grown at a rate which is said to be good. Most micro credit movement and literature has focused on production credit movement and has focused on production credit for house hold enterprise or microenterprises. But even if lock of financing is fundamentally the only constraints for poor micro enterprise as it asserted by Muhammad Yunus, founder of Grameen Bank and winner of the 2006 Nobel peace prize, they do also face numerous practical challenges.

3.12 GOVERNMENT REGULATION AND DEVELOPMENT OF ACCESS TO FINANCE

It is known that regulation government impose on economy has got two broad effects: positive and negative. Here history and research revealed that access to finance has both the two effect aforementioned. One experiment is that in year 1977 to 1990 the Indian government has imposed policy indicating that commercial banks are allowed to open one new branch in a district that already had a bank presence only after it opened four branches in areas without a bank present. This policy led to the opening of 30,000 new rural branches over this period. Burgess and Pande (2005) have indicated in their finding that this branching regulation resulted in fast development of non agricultural products, products, poverty decline faster, while the opposite was true before and after this period of regulation. It is obvious that this regulation might have negative impact on some commercial banks.

The case of US is another typical example branching deregulation implemented by different US states over 20 year period from the mid 1970s to the mid 1990s following Toyarone and Strahn (1996) a large literature has evaluated the effect that easing restrictions on intra and interstate branching had an income growth, banking sector restructuring and entrepreneurial activities.

3.13 CREDIT SCORING FOR SMALL BUSINESSES

Credit ratings are intended as relative assessment of expected loss. They are not intended to capture a particular default probability over a particular horizon. Simple inspection of the data indicate that within a rating category; default rates rise and fall over time, and sometimes quite significantly. Credit scoring is the process of assigning a single quantitative measure, or score, to a potential borrower representing an estimate of the borrower's future loan performance (Feldman 1997). While credit scores have been used for some time in the underwriting of consumer loans and residential mortgages, this technology has been routinely applied to commercial credit only since the mid-1990s. This is because commercial loans were thought to be too heterogeneous and documentation not sufficiently standardized either within or across institutions (Rutherford, 1998). However, credit analysts ultimately determined that the personal credit history of small business owners is highly predictive of the loan repayment prospects of their businesses. Thus, personal information is obtained from a credit bureau and then augmented with basic business-specific data to predict repayment. Eisenbeis (1996) presents an overview of the history and application of credit scoring techniques to small business loan portfolios. Frame, Padhi and Woosley (1995) describes how the leading model of credit scoring for small business lending—the model originated by Fair, Isaac and Company—was developed.

The introduction of credit scoring may have profound effects on small business credit markets, including borrower-lender interactions, loan pricing, loan risk, and credit availability. First, credit scoring allows lenders to underwrite and monitor small business loans without actually meeting the borrower. This development contrasts with the perceived importance of a local bank-borrower relationship for small business lending (e.g., Petersen and Rajan 1994; Berger and

Udell 1995). In fact, because of scoring systems, borrowers can obtain unsecured credit from distant lenders through direct marketing channels. Indeed, empirical evidence suggests that the distance between small firms and their lenders has increased in recent years (e.g., Petersen and Rajan 2002) and that credit scoring increases the probability that a large banking organization will make small business loans in certain areas (Frame, Padhi, and Woosley 2004).

Small business credit scoring may affect the price of credit, although the direction of any change may depend on how a lender uses the technology. While credit scoring is a less-expensive way of underwriting loans (providing downward price pressures), it is not always used as a substitute technology. Indeed, if a lender generates credit scores to complement its usual underwriting approach, total costs may actually increase (providing upward price pressures). Furthermore, depending on the lender's perception of the quality of the information set, borrower risk may change. Empirical evidence by Berger, Frame, and Miller (2005) suggests that the net effect of small business credit scoring is higher average loan prices, especially for those lenders using the technology as a complement to traditional underwriting. The authors also find that the loans funded by scoring institutions are classified as higher risk, on average, consistent with increased lending to riskier marginal borrowers. Credit scoring should increase credit availability for small businesses. Cheaper or better information about the repayment prospects of a small business applicant makes it more likely that a lender will price the loan based on expected risk, rather than denying the loan out of fear of charging too little. Empirical studies have found a positive relationship between small business credit scoring and credit availability (Frame et al., 2001; Frame et al., 2004; Berger et al., 2005). In Ethiopia, it is only banks and financial institution who, rate their customers by using their own bench marks. Lack of this independent institution has contributed towards the gap of access to credit.

One way in which most banks and other financial institution evaluate credit risk is through the use of credit scoring. It involves the numerical evaluation of each applicant. An applicant receives a score based on his or her answers to a simple set of question. This score is then evaluated according to a predetermined standard, its level relative to the standard determining whether credit should be extended. The major advantage of credit scoring is that it is inexpensive and easy to perform. The techniques used for constructing credit scoring indexes rage form the simple approach of adding up default rate associated with the answers given to each question to sophisticated evaluation using multiple discriminate analyses (MDA). MDA is a statistical technique for calculating the appropriate importance to assign each question used to evaluating the applicant. Edward Altman in his model, 1961, blended the multiple discriminate analyses and the traditional ratio analysis to score credit which he called Z score model.

Credit registries are important tools for the expansion of transactions based lending technology (Powell et al., 2004). Credit registries ease for the lender the routine task of verifying aspects of the repayment record the routine sometimes the outstanding indebtedness) of the applicants borrowers and increase the cost of delinquency; thereby reducing moral hazard. These also help in building data in building database helpful in the financial market.

The use of credit scoring for small business lending often based on data collected for credit registry purposes in growing in developing countries as well (Powell et al., 2004), although it has year to reach many countries: this is banking at what is currently a very active frontier. The more financial data that financial institutions have in credit register, the more useful it is in selecting out the risky borrowers without reducing overall access to credit. It is not only the lenders, who will benefit from the credit registry as per study conducted by Powell et al., (2004) in Argentina, but the credit information sharing also benefit stockholders including the borrowers.

On the other hand Brown, Jappelli and Pegano (2006) find out positive association between the quality of the credit registry and the ease of external financing, in their study made across 24 transaction economies. While public credit registries may have some potential advantages such as the power to compel lenders to share positive information the experience in Ethiopia is almost nil. Means the financial institution consider this information as the greatest role but nothing has yet been carried out to have such an environment.

3.14 ROLE OF GOVERNMENT FACILITATING ACCESS

World Bank in its report (2008) pointed out that given the evidence financial access varies widely around the world and the expanding access remains an important challenge even in advanced economies, it is not enough to say that the markets will provide. Market failure related to information gaps the need for coordination on collective action and concentrations of power means that government everywhere have an extensive role in supporting regulating and sometimes directly intervening in the provision of financial services. But one has to bear in mind that not all government action is quality effective, however and some policies can be counterproductive. Complex systems responses can make will intentioned policies misfire, so successful policy design must be context specific. Governance issues are important: policy success can depend on institutional quality. Measures that are effective in environments that already enjoy strong institutions may fail elsewhere, at the sometime, a well functioning financial system itself is likely to contribute to strengthening national governance.

Researchers(E.g. Burgess and Pande, 2005) have tried to identify specific policies to facilitate financial access indicated government can achieve additional impact in the short to medium terms by taking action specifically directed at facilitating financial market activity that help access. Beyond the overall legal structure and its protections, an important practical question is that extents to which contract enforcement in finance need to be supplemented by specific laws restricting and classifying and there by offering more reliable protection to; certain types of financial business more generally. (World Bank, 2008)

In Ethiopia where access to credit is rated to be very low, the government has got role of creating credit registries, or private sector can play a greater role in forming credit registries. Even where the operation and ownership registry is left to the private sector, government actions strongly influence the ability of registries to function.

The rapidly evolving technologies based on the internet (e-finance) and cell phone (mobile phones or m-finance) can be powerful engines of access (World Bank, 2008). But lack of legal clarity may impede the adaption of these technologies.

Regulations are required to be designed by government to fever disadvantaged groups in the economy.(World Bank, 2008) policies to promote competition in the banking system can help restrain the exercise of market power that could be damaging to access and Procedural regulation has also its own contribution. The contracting of credit often associated with systemic banking crises hits the poor as well as the rich-sometimes more so- and the poor are less able to bear losses (Honohan 2005). Here an important point that should not be forgotten is that regulation can fever the economy and harm the economy too. For example Borth, Coprio, and

Levine (2006) have addressed this issue with regard to banking. They collected detailed information about the powers and conduct of bank supervisors in over 150 countries in 1997to 2001. Based on regression analysis linking measures of national regulatory style to financial access and other economic out comes at the individual firm level, the authors concluded that relying too much on discretionary powers given to government official to keep the banking system safe sound and efficient may be misguided.

In the process of expanding access, it is important to build long term institution. The emphasis in recent literature on the importance institutions – the "rule of the game" for economic development and the parallel role these intuitions are thought to play in financial development suggests that the mechanisms of finance are at the heart of the complex process that lead to accelerated economic growth in a way that is still far from being fully understood (World Bank, 2008). As such, adjusting institution in direction that clearly helps improve the functioning of finance is likely to be a highly effective pro-growth strategy and the government's role in were is very vital. Here the strategy is long term but the short term on which the long term relay is not being provided emphasis. In other words building these institutions is typically a long term and diffuse endeavour and it necessarily involves a key role government. Government is the natural-many cases only provide some the key organisations that support good institutions such as efficient: speedy and fair courts. Government may also need to provide some or all of the needed registries of credit information, liens and property ownership.

According to Green (2003) cited in the World Bank's report government involvement in creating a credit guarantee company is often rationalised by the obscuration that small and medium scale enterprise commonly do not have the kinds of collateral that bankers require. Means given that financial markets are not perfectly efficient; a decision by the government to step in where private financiers have not formal it profitable to do so need not necessarily involve subsidy and fiscal outlay- although typically it does.

CHAPTER FOUR

4. DATA ANALYSIS AND DISCUSSION

Small business enterprises are considered as change agents during 1980s (Klapper et al., 2001) and they are becoming key role player in the development of Ethiopia through creating employment opportunities and through assisting the large business organisations in accessing the end users. As per Ministry of Finance and Economic Development of Ethiopia the contribution of the Small business enterprises to the GDP of the country is on average 1.7% during the decade ending and the growth when compared with large businesses still lower, which is 5.6% on average where as 7% for the large and medium enterprises. The contribution of small business is not as much an amount that the country should have generated from the sector. The figure below indicates the growth trend for the last ten years by comparing the sectors.

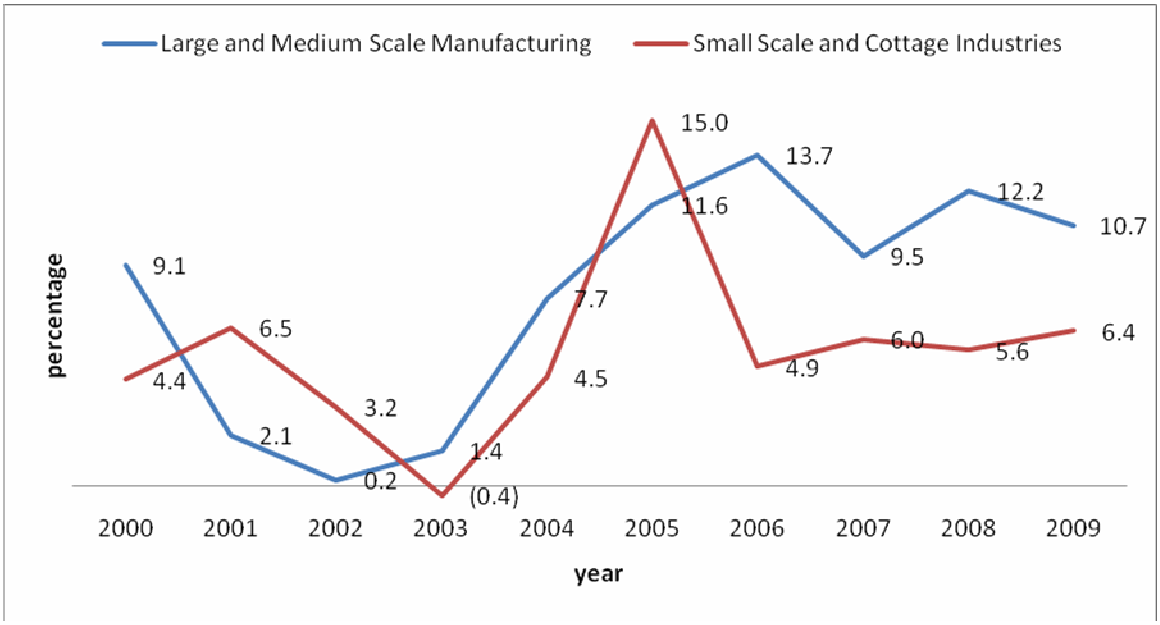

Figure 4.1: comparison of small& cottage industries and large & medium scale business in terms of contribution (constant price) to GDP of Ethiopia[2]

Source: MoFED's annual report- prepared by the researcher as convenient.

In the process of fostering conducive environment for businesses in Ethiopia small business should be given a priority. Sufficient access to finance for business in Ethiopia is crucial for growth of the companies. It helps to foster entrepreneurship, competition and innovation. The purpose of this paper as indicated in the objective section to see challenges hindering the possible access that small businesses in Ethiopia specifically in Addis Ababa. It is undeniable that sufficient access to finance is crucial for the growth of companies in Ethiopia or any other developing country– it helps to foster entrepreneurship, competition and innovation. Nevertheless, survey conducted – in Addis Ababa – showed that a considerable proportion of small businesses in city did not have enough financing to enable them to complete their projects.

In detail this study examined small businesses

- Past, current and future states: their financial situation, growth, innovative activities and need for external financing
- Use of financial instruments, distinguishing between external and internal financing

[2] Selected from growth rate of GDP by Economic Activity at Constant prices (%)

- Experiences when applying for various types of external financing and reasons why they have not applied for such types financing
- Use of loan s as source of financing, the popular providers, size and purpose of recent loan and
- The plan small businesses taken into account to loan from external fund providers and the institution they prefer to provide them loan.

Type and age of the businesses

The type of businesses on which the research was conducted were three consisting of 1) Merchandising 2) Manufacturing which composes of (Metal work industry, wood work industry, textile and leather product including bags and footwear. 3) Hotels and Restaurants. The total numbers of small businesses studied were 115.

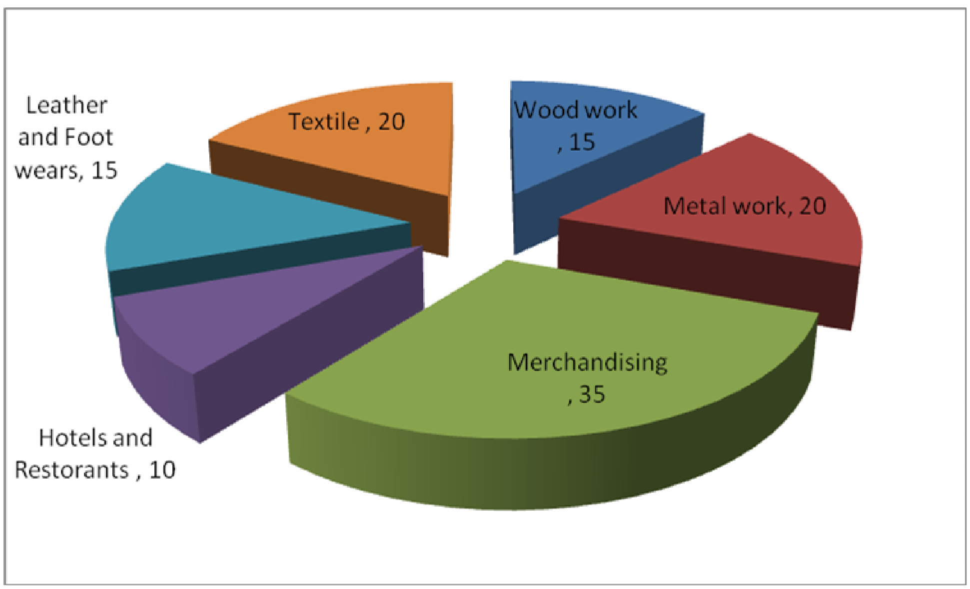

Figure 4.2: The type of businesses on which the study was conducted

From the response of the small business's owner operators it was possible to indentify that the total number of the businesses under the study having age of less than 2 years were 17% and 50% have stayed in the market for 2 to 5years, in addition 33% of them have more than 5 years existence in the businesses environment.

4.1 CURRENT STATE OF THE FIRMS

In this study, managers of small business enterprises were posed questions about the initial capital and their current capital to see whether there is change on the size of the businesses and whether these businesses have introduced new product or innovated during the period under consideration.

4.1.1 SMALL BUSINESSES GROWTH PATTERN

The number of businesses having initial capital of birr less than 10,000 were 55 and those having initial capital in between 10,000 to 50, 000 were 47, which has completely changed currently.

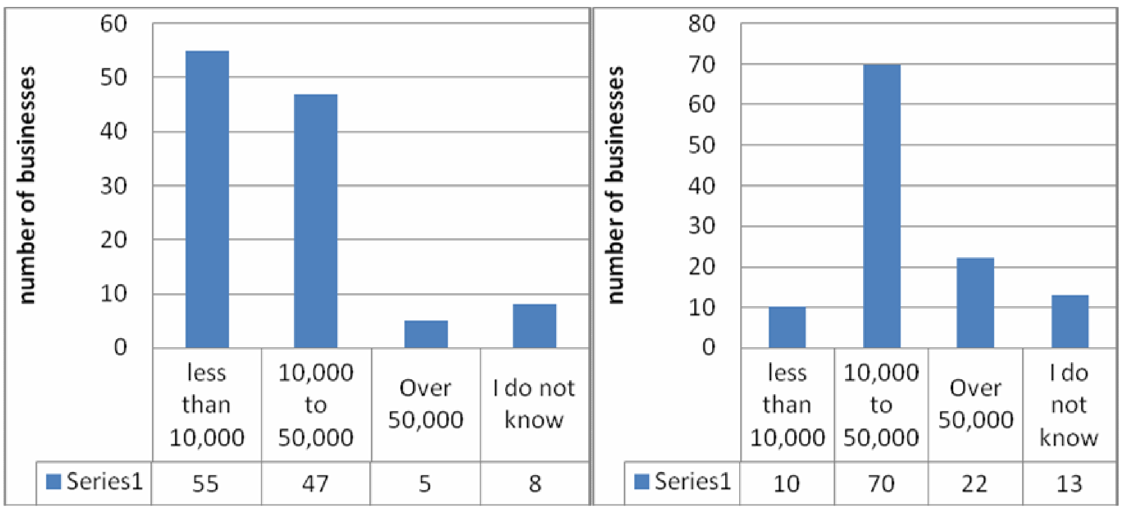

Figure 4.3: Small businesses growth trade in terms of capital

The current trend, as it can be seen from the above figure is that the capital of the business has increase. The number of small businesses in the second range has increased third range has increased (see figure 4.3). As it can be seen from figure 4.3 the number of small businesses within the first range (less than 10,000) has decreased from 55 to 10 which implies the small businesses showed change in their capital which in turn indicate the growth of the small businesses. The same thing was observed from the small businesses which had capital of over 50,000. Initially they were only 5 but currently the number those businesses are 22, which is by far greater than those who indicated as their initial capital.

4.1.2 INNOVATION AND GROWTH

Innovative businesses (i.e. those that had introduced innovation in at least one area – products or services, marketing, production and management) need finance more than those who do not. As per the response of the small business owners more than 80% indicated that they have introduced new or improved products to the market, new organization and management system, new or improved production process and new way of selling their product or output. Disaggregating the data by sector, innovative nature the business is higher in metal and wood work industry around 91% of wood and metal work operators introduced new or improved product for the market. But relatively small owner managers of hotel and restaurants indicated that they have innovated (5%) and 16% of textile manufacturing indicated that they have innovated.

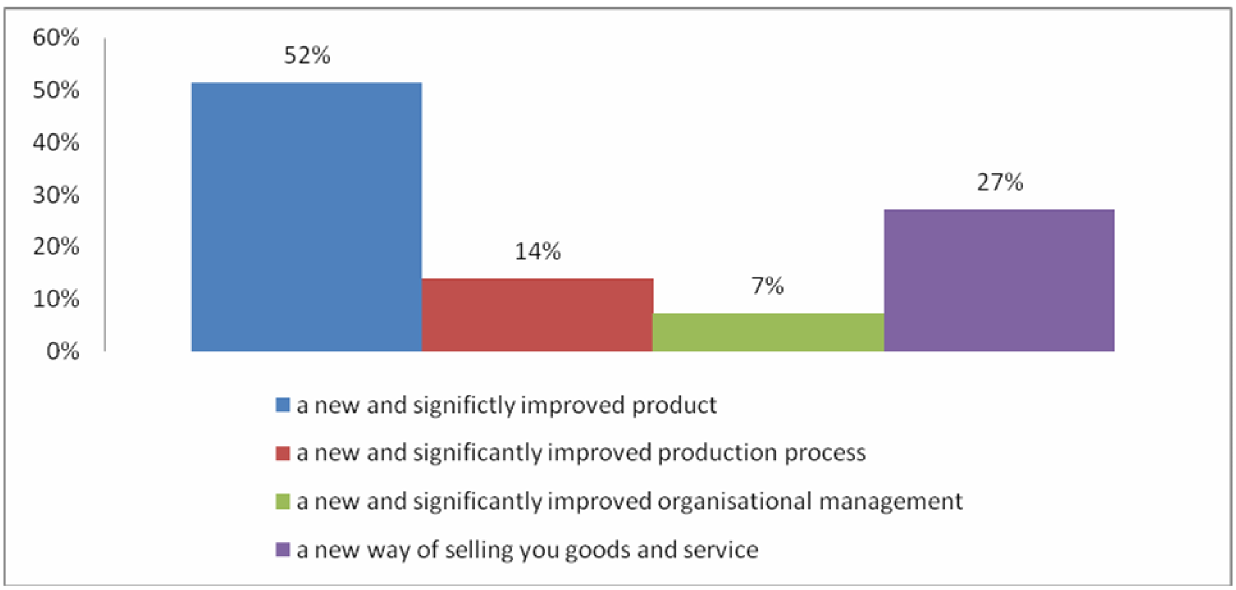

Figure 4.4: Firms nature of innovation.

As indicated in figure 4.4 the number of small business engaged in innovating new products are larger than those who do not. Around 52%[3] of the total respondents indicated that they have introduced new and significantly improved product to the market and around 27% of them replayed that they have introduced new way of selling their product means for example through bazaars.

[3] The percentage indicated is of the total number innovative firms

Involvement in innovation, as measured by these four activity categories, was high in these small companies and a company needs to have money in the process of improving itself and meeting the need of its customer. Focusing solely on innovations in bringing new or improved products or services to the market has its own impact on the need for finance, since innovation needs money and resources.

Product innovation is reported highest in wood and metal work industry because of the nature of the industry. The unique need of customers forced firms in wood and metal industry to innovate. In most of the sectors in this study, the most popular type of innovative activity was linked to bringing new products or services to market proceed by new way of selling goods and services, while organizational innovation was the least popular.

4.2 FINANCIAL SITUATION OF THE FIRMS

In this section the income generating power of small businesses including change in cost of production, the debt to asset ratio of the small businesses and the most pressing problem were indentified

4.2.1 INCOME GENERATION INDICATORS

To make use of internal financing instrument a business must be profitable and to be profitable the entity has to minimize its cost and increase their revenue as well. Significant part of business organization's expense are labor cost, material and energy cost and other expense; and it was indentified that the cost of production has increased in general without proportionate increment in their revenue.

By taking into consideration the past 12 month's operation small business managers and owners were requested to indicate whether the cost of material, interest, labor cost and gross profit has increased or not. 72 of the total of 115 have indicated that their gross profit has decreased and 103 of the total respondents have indicated that material cost and energy cost of their business have increased. In addition 87% of the total respondents have responded that labor cost has increased. Disaggregating the data by sector, in all sectors under consideration the cost of input has increased.

More than three fourth (87%) of managers of small companies answered that labor costs had increased in the past twelve months, and only 3 of the total respondents have responded that gross profit showed increment. Only a minority of respondents replied that costs had decreased: 9% saw a decrease in labor costs and 8% replied decrease in material and energy costs. The reason for the decrease in gross profit is that the small businesses faced increase in material and energy cost as well as increase in labor cost without increasing the selling price in proportion to the increase in selling price. Therefore increase in input price has seriously affected the profitability of these businesses. The increase in input price and decrease in profitability of the small businesses eroded the internal financing on which the small businesses are relaying heavily.

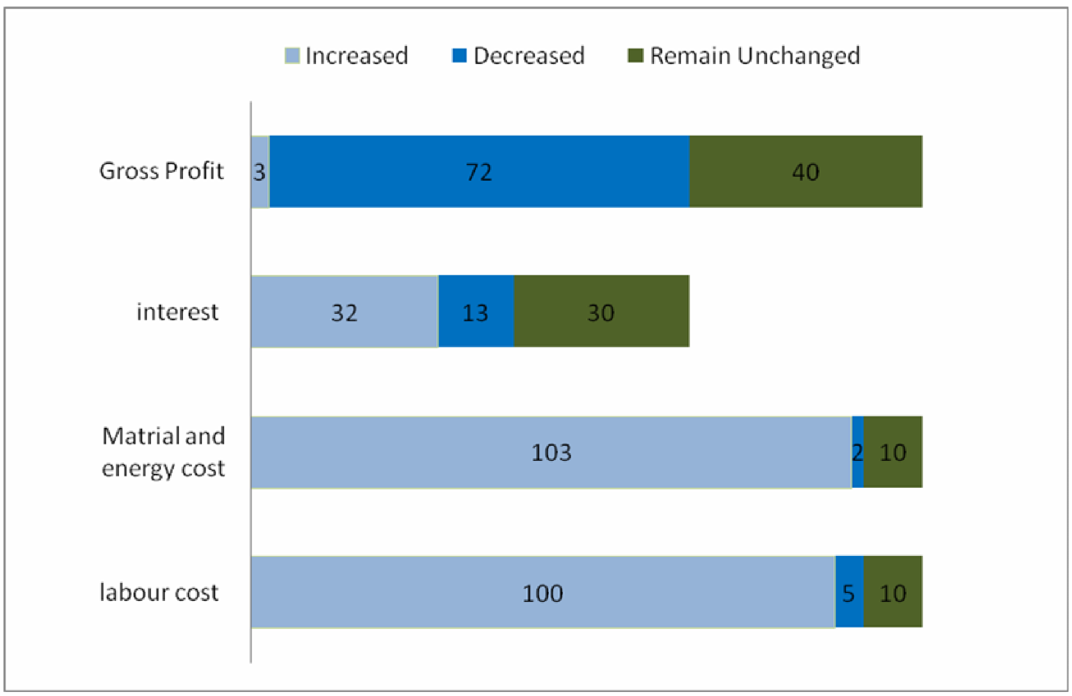

Figure 4.5: Indicators of income generating potential of the small firms

Managers or owners were also asked to evaluate their interest expenses; however, roughly one in three (35%) of the respondents could not answer this question. Nonetheless, the significant proportion of managers (26%) answered that their interest expenses had remained unchanged and around 27% replied it has increased.

4.2.2 CHANGES IN COMPANIES' DEBT-TO-ASSETS RATIO

It is obvious that debt financing is useful for small business in that it will strengthen the businesses in producing more and to become financially strong to compete with medium and large businesses.

From those small businesses who have used debt financing in their businesses around one-half answered that their company's debt-to-assets ratio – i.e. the ratio of total debt financing a company uses compared to its total assets – had increased in the past twelve months, while a similar proportion (15%) answered that there had been a decrease in this ratio. Around 37% of the debt user business managers said there had been no change in their company's debt-to-assets ratio. The proportion of non-leveraged companies – i.e. companies having no debt was larger (69%) when compared with those who have levered themselves.

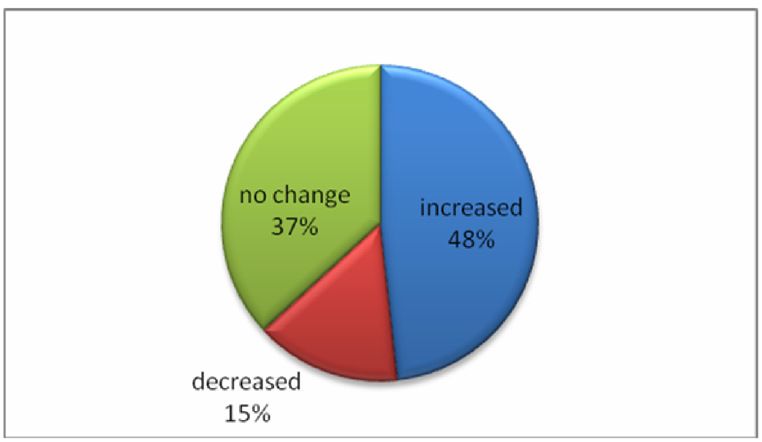

Figure 4.6: Debt situations of the small businesses

4.2.3 COMPANIES' MOST PRESSING PROBLEM

Result of the study indicated that 72% of the small business operators replied as difficult to sell their product. These, as replied by the small businesses owner managers, was because of quality problem, place to market their product, illegal business on the products and services these small businesses produce. The other basic reason was similarity of products produced by small businesses. Luck of market for products is higher in textile and leather and footwear manufacturing. Around 87% of the leather and footwear manufacturing and 82% of textile manufacturers indicated as market is the most pressing problem. The second most pressing problem for managers of small businesses was access to finance (indicated by 50% of the total respondents). This problem was aggravated by the luck of market for small business's output. Slightly more than a fifteen (18%) of managers were most concerned about competition and around 25% of the whole respondents mentioned cost of production has increased and it is the most pressing problem they have is costs of production. In addition the above mentioned problem around 7% of the respondents have indicated that the regulation problem is the main problem they are facing.

Finally, 11% of managers listed some other issue as the most pressing problem for their company; for example, issues such as luck of on time delivery of raw material, non-payment or late-paying customers and awareness of the customer.

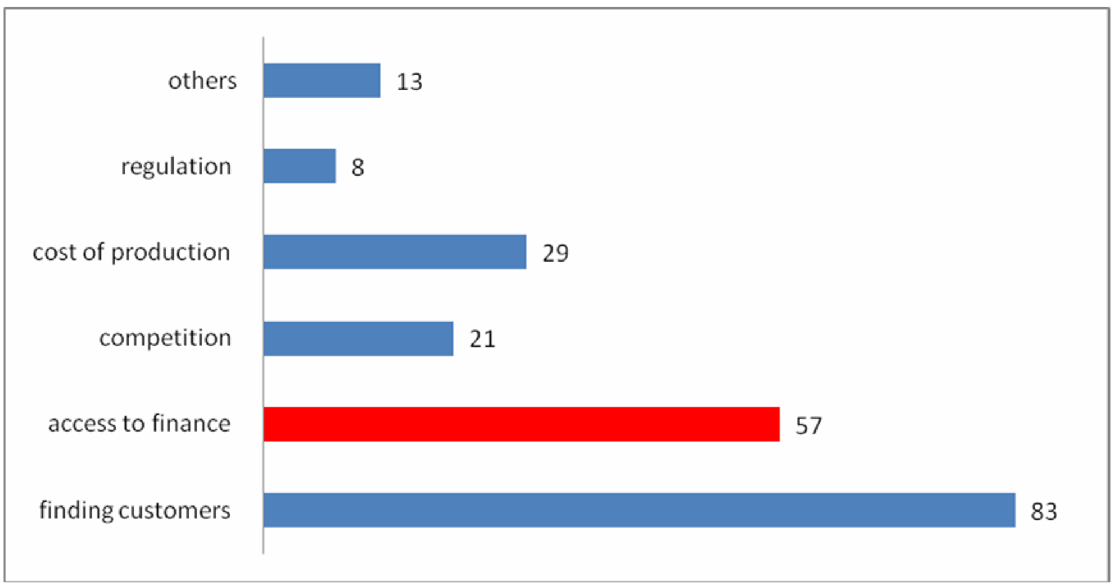

Figure 4.7: Pressing problem small businesses are facing

From the figure4.7 it is possible to read that financial aspect is the second most pressing problem of small business in sub cities under consideration. Ethiopian banks and financial institutions are known for the need of large collateral in providing loan to businesses which small business do not fulfill because of their size (Eshetu and Mamo, 2009). This imply that small businesses were relying on traditional and microfinance institution's loan, which is insufficient to finance the innovation and need for the working capital of these small businesses.

4.3 USE OF EXTERNAL AND INTERNAL FINANCING

4.3.1 USE OF DIFFERENT SOURCES OF FINANCING

Businesses can use internal funds or external sources to finance their operations, investments, etc. A firm can use one of these two financing sources only or, as is more often the case in practice, a mixture of them. Traditionally, internal funding, i.e. personal savings, retained profit and sales of assets, is an important means of financing for small businesses. In sub cities under consideration, of the total small businesses under consideration 100 (around 87%) of firms had used internal funds in the past twelve months. A slightly above 70% use spontaneous financing instruments including trade credit and tax payable to government. Around 62 out of the total number has indicated that they have been using lease financing, while 39% had used traditional way of financing including Idir and Equb. From the total small business under consideration only 28(24%) using bank and 0 of them had accessed bank over draft. The reason why they do not even want approach banks as source finance is mainly fear of being rejected and large collateral requirement by banks. Regarding trade credit (i.e. business-to business loans to allow, for example, for delays in payments when purchasing goods on account), around 32% which is greater than those who access bank credit.

From the discussion above it is possible to comprehend that internal financing is the most popular means of financing small business's operation which include retaining profit and money from family. The profit of small businesses from where the internal financing was eroded because of increase in cost of production without being compensated by the increment in selling price. This implies, these small businesses do shift from relaying on internal financing to search for external financing instrument.

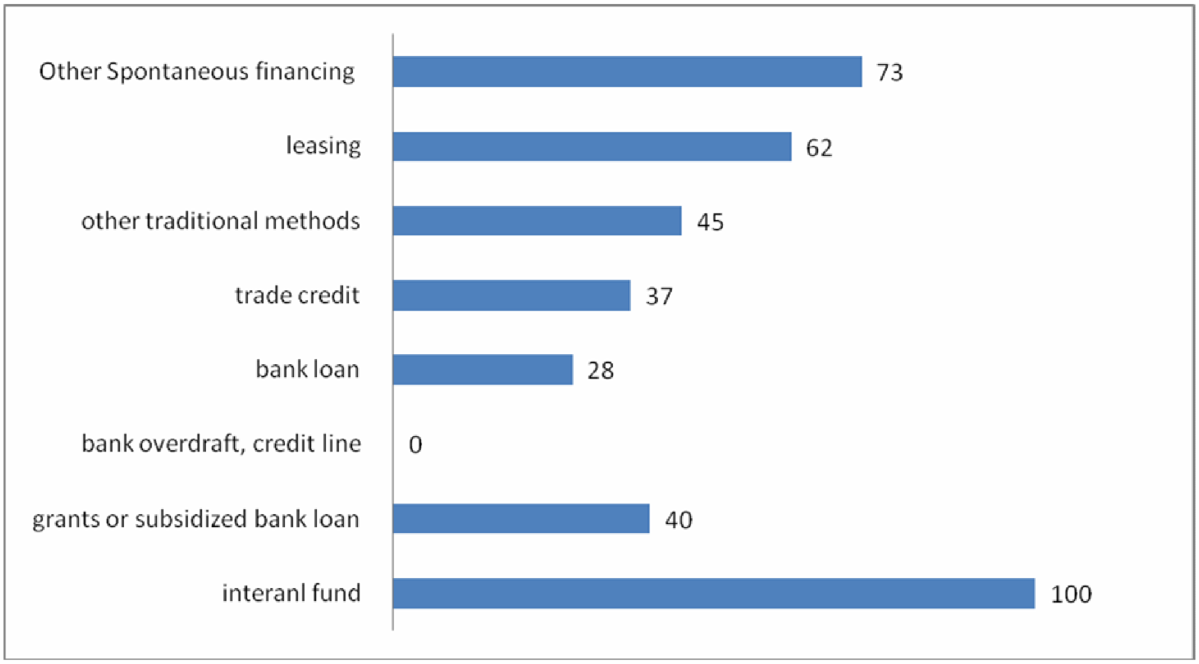

Figure 4.8: financing structure of the small businesses

4.3.2 APPLYING FOR VARIOUS TYPES OF EXTERNAL FINANCING

In this section the researcher has tried to indentify whether loan from different external parties improved, deteriorated or remained unchanged. According to the response collected from the small business's managers 70% indicated that access to loan from banks remained unchanged and 21% of the whole respondents indicated that access to loan form bank has shown improvement. On the other hand access to Microfinance has shown improvement as per the managers 90% of the respondent has indicated that the access they had to Microfinance has improved. The reason for improvement in microfinance was identified as government had taken action to bring together small business with microfinance institutions even at kebele level. Yet still significant number of respondents have approved that the access they had to loan from friends and family has shown improvement (35%)

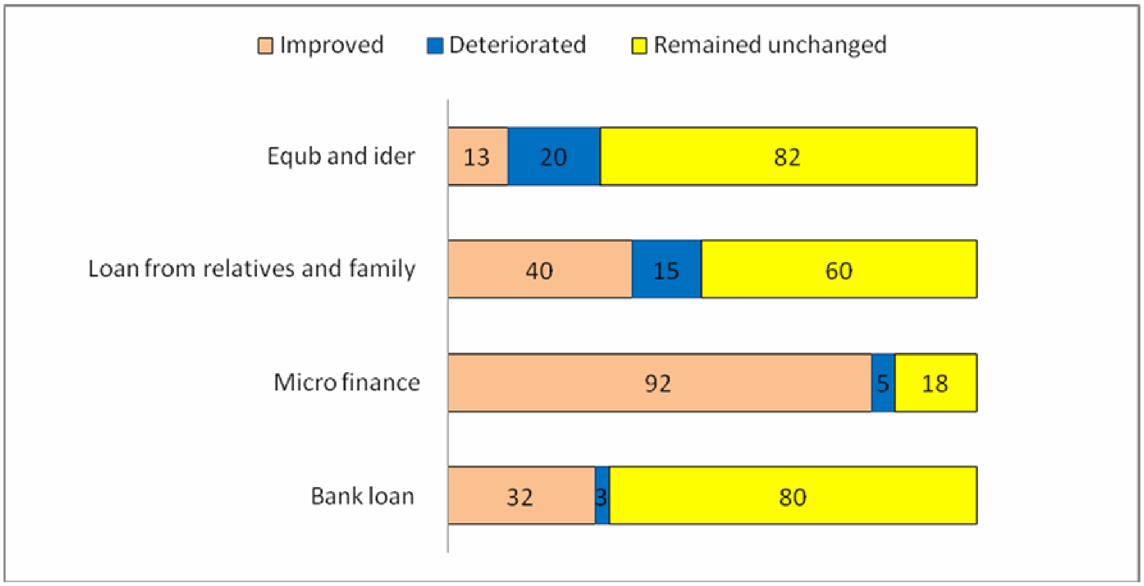

Figure 4.9: Availability of external financing for small businesses

4.3.3 EXTERNAL FINANCING NEED

Need for external finance increase as the internal financing instruments diminish (where there is need for finance). It was manifested that internal financing small businesses heavily rely was washed out by the increase in input price. Therefore external finance is the alternative with which these small businesses are left with.

Working capital and fixed investments were the significant forces that required small businesses need for external finance. 74% of the total respondents have indicated that the need for working capital has increased and 65% of the 115 small businesses have displayed that the fixed investment including acquisition of plant asset and other fixed investment need has increased. On the other hand 20 of the small businesses responded as the need for inventory and working capital investment has remaining unchanged, while 28 of them have replied as no change on their need of external financing. External financing needs for inventories and working capital and fixed investment appear to have somewhat increased which is in line with the development of small business as indicated in the above section by looking at the change in the capital of the small businesses. Insufficient availability of internal funds, which was probably related to the decline in profit, had also increased the small businesses external financing needs over the preceding twelve months.

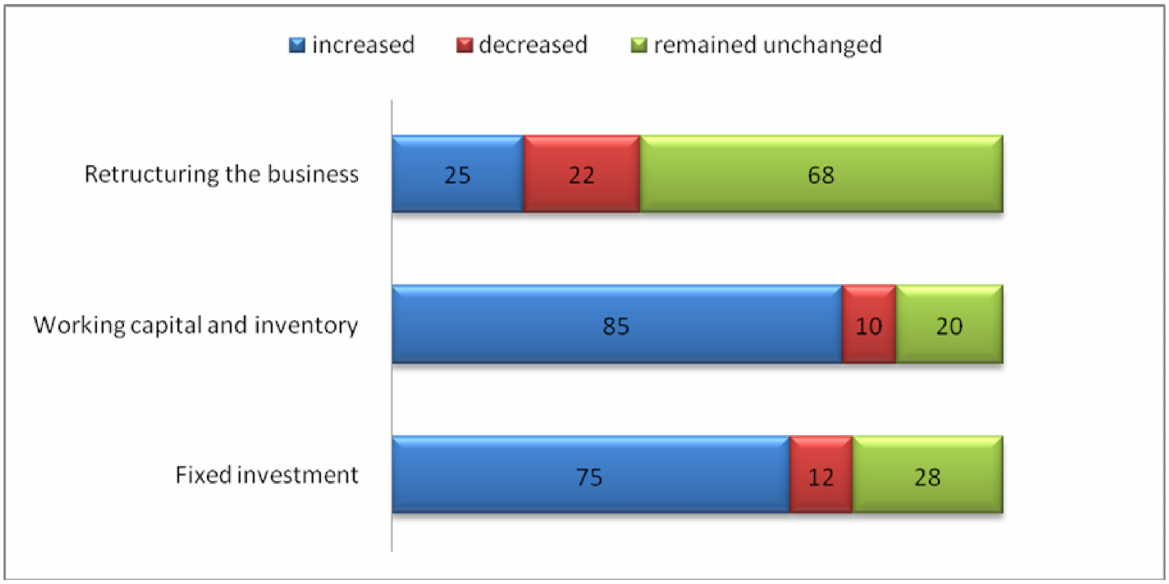

Figure 4.10: factors affecting external financing need for small businesses in Addis

In general, as tried to display in figure 4.10 fixed investment and working capital were regarded by small businesses in all branches of economic activity taken into account as the most relevant factors for their increased need for external financing during the previous twelve months.

4.4 EXPERIENCE IN APPLICATION FOR EXTERNAL FINANCING

As it can be seen from figure 4.11 most of the small business on which the study was conducted did not have experience of accessing bank loan because of the possibility of rejection (57%). Disaggregating the data, across the sectors in consideration almost all of the textile and leather industry operators had no experience of accessing bank loan and around 25% of hotel and restaurant operators had not experienced bank loan. This is because of the asset type these businesses were operating. Around 20% of the total respondents had not applied for bank loan because the small business had applied in some other financial institutions and because of large collateral requirement by financial institutions. 69.5% of the small business managers replied that they had applied to other external financing instruments which include micro finance institutions, friends and families and other traditional financing instruments. On the other hand 59 of small business owners responded that they had applied for trade credit and 31 of them have indicated that because of possibility of rejection they have not even applied for trade credits. Because of sufficient capital there were businesses who did not apply for external finance. It can be seen from figure 4.11 that 11% of the total respondents did not apply for bank loan, 4% did not for trade credit and 9% for the total respondents did not applied for other external financing sources including microfinance.

In general the reason why small business did not applying for loan from external financing were identified as possibility of rejection, because they have sufficient capital and alternative use of external financing for example micro financing institutions, family and friends etc. Considering the issue by sector, around 70% of wood work and metal work do have access to microfinance, friends and family financing.

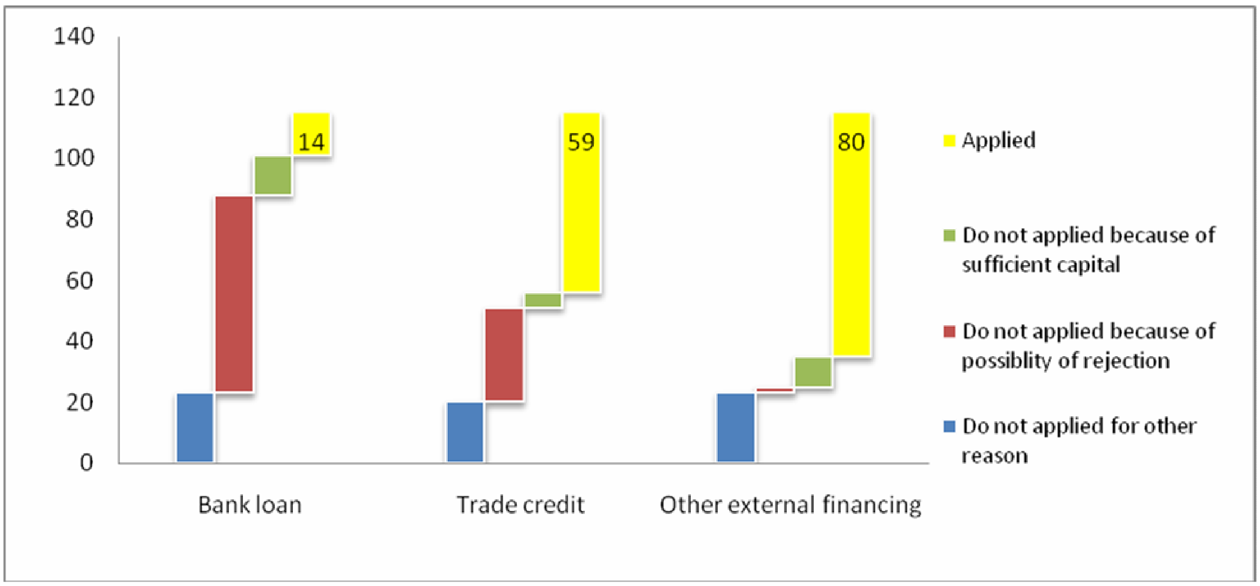

Figure 4.11: Application for external financing for small businesses

Out of those small businesses who applied for bank loan 42.3% were rejected and got no external financing. On the other hand only insignificant part, 15% of those who applied for other external financing instrument were rejected from accessing finance. Form the small businesses, who applied for trade credit, 71% had accessed the financing instrument. This implies that the dominant way of financing small businesses in Addis Ababa was microfinance institutions and other traditional way of financing.

4.4.1 AVAILABILITY OF EXTERNAL FINANCING

Respondents were also asked whether external financing showed improvement or not. As can be seen from figure 4.12, except for trade credit availability, other external financing instruments remain unchanged during the period under consideration. Around 61% of the respondents indicated that there was improvement in trade credit.

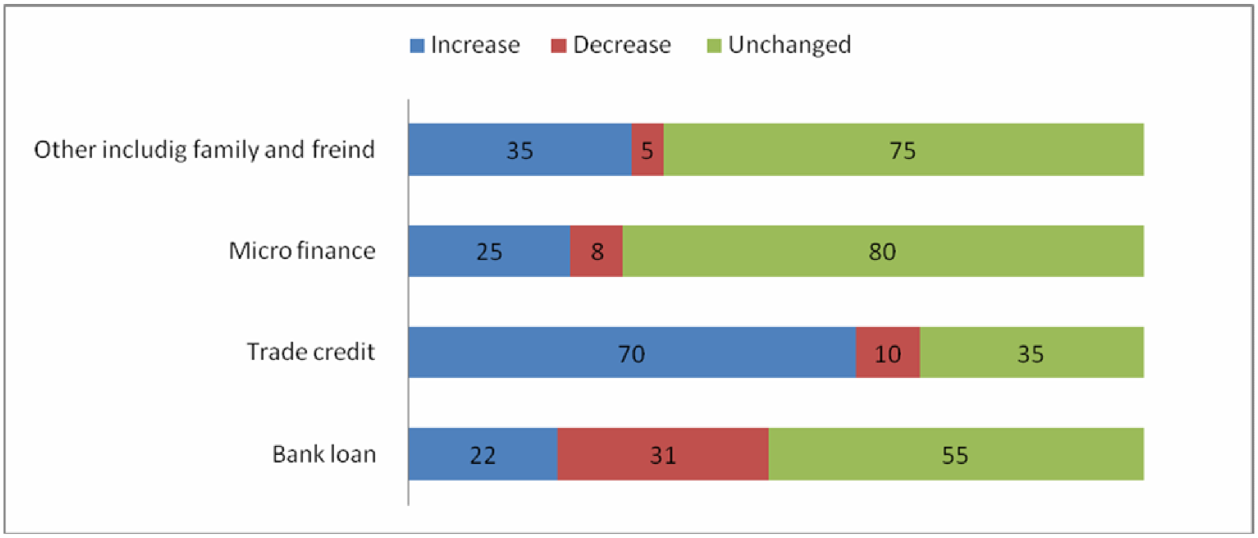

Figure 4.12: Availability of external financing for small business

4.4.2 CONDITION AND CHARACTERISTICS OF LOAN FINANCING

Managers of companies, who had applied for loan from external fund providers in the past 12 months, were asked to evaluate recent changes in the terms and conditions of external financing available to their company. It is obvious that factors like interest rate, level of the cost of financing, loan covenants and collateral requirements affect access to credit. 56 respondents of the total small business operators under consideration indicated that requirement for loan covenants and information requirement has increased and around 39% of them responded as collateral requirement of financial institutions specifically of banks showed increment.

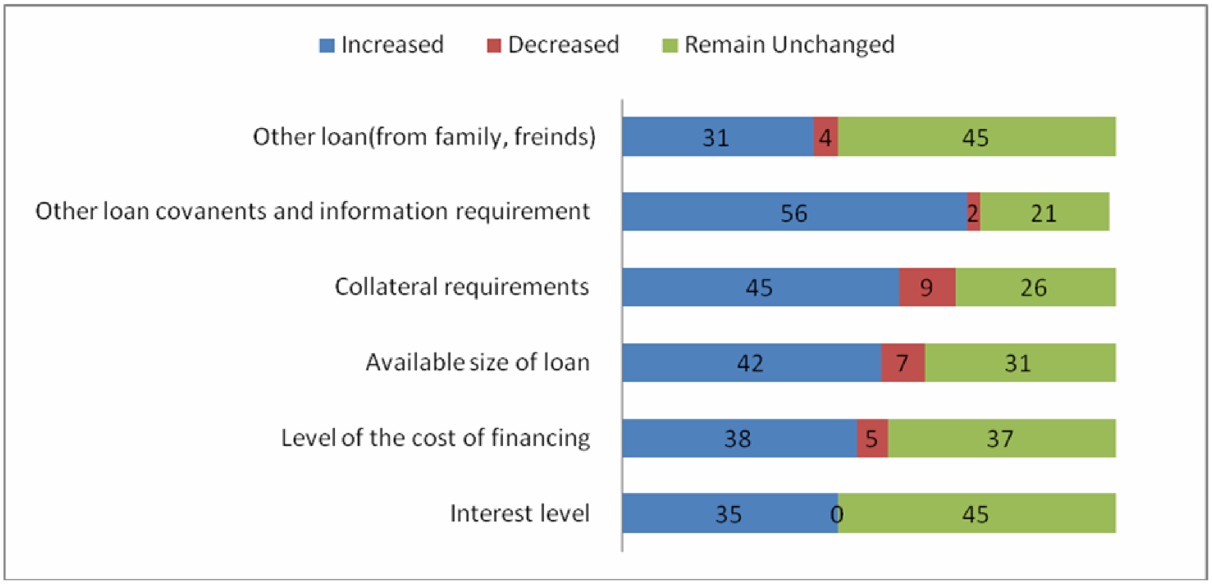

Figure 4.13: Change in terms of conditions of loan from financial institutions

Looking at the proportions of "increased" and "decreased" responses, however, it was noted that managers were more likely to say that the terms and conditions of financing institutions had deteriorated than they were to answer than these had improved. For example only 2 of total respondents have replied that the loan covenants and information requirement has decreased. On the other hand 39% of the total respondents indicated that collateral requirements has increased by banks and other institution and the availability of other financing instrument has remained unchanged as indicated by most of the managers(56.25%).

4.4.3 CHANGES IN THE GENERAL ECONOMIC AND FINANCIAL ENVIRONMENT

It is true that factors like economy of the country in addition to financial institutions willingness, performance of the businesses requesting loan, access to public financial support and grant, firm's specific outlook of profitability and credit history of the firm, has got significant influence on the access that a business will have to finance. A question was forwarded to owners of small businesses to see whether the availability of external financing depends on these various factors, which are in part related to the general economic situation. Finally it was found that it is true that the loan availability is dependent on the factors indentified

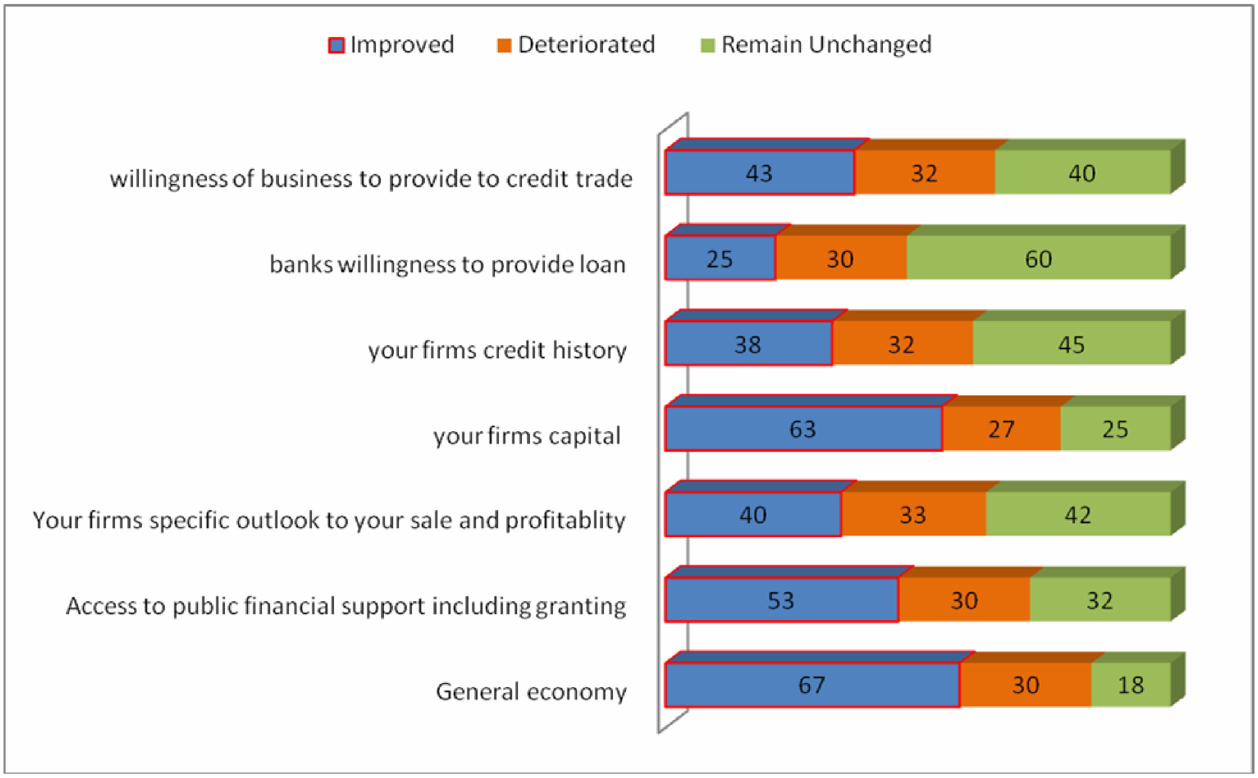

Figure 4.14: Factors impacting availability of finance for small businesses

As it can be seen from the figure above majority of the respondents have indicated that (67 of 115) the general economy of the country has improved. Respondents were more optimistic when evaluating changes in the financial situation of their own company.

- Although 35% of managers answered that their company-specific outlook with respect to sales, profitability or business plan had improved in the past twelve months, the proportion saying that it had been deteriorated was material too (29%). About 37% have responded that it was not changed totally.
- Although the proportion of managers who answered that their firm's own capital had remain unchanged in the past twelve months was significant than the proportion reporting remain unchanged (24% vs. 22%), the majority had seen increase in the past twelve months (55%).
- Almost a similar picture emerged when looking at companies' credit history, with 39.1% of managers reporting no change in the past twelve months. 33% had approved that their credit history improvement. Disaggregating the data by credit type, around 89% the small

business, whose credit history had improved, were those who use trade credit as financing instrument.

4.5 LOAN AS AN EXTERNAL FINANCING

4.5.1 MOST RECENT LOAN SIZE

From the small businesses who applied to financial institutions 70% had obtained a loan in the past two years. As per the response of the owner operators (57%) had loan less than birr 50,000. 11% of the small business had 50,000 to 100,000 and 16% indicated that they had 100,000 to 200,000. Finally 5% of them had accessed more than 200,000 and 11% not totally get loan in the past two years. Micro loan means less than birr 50,000 is the significant part of loan provided for the small businesses under consideration.

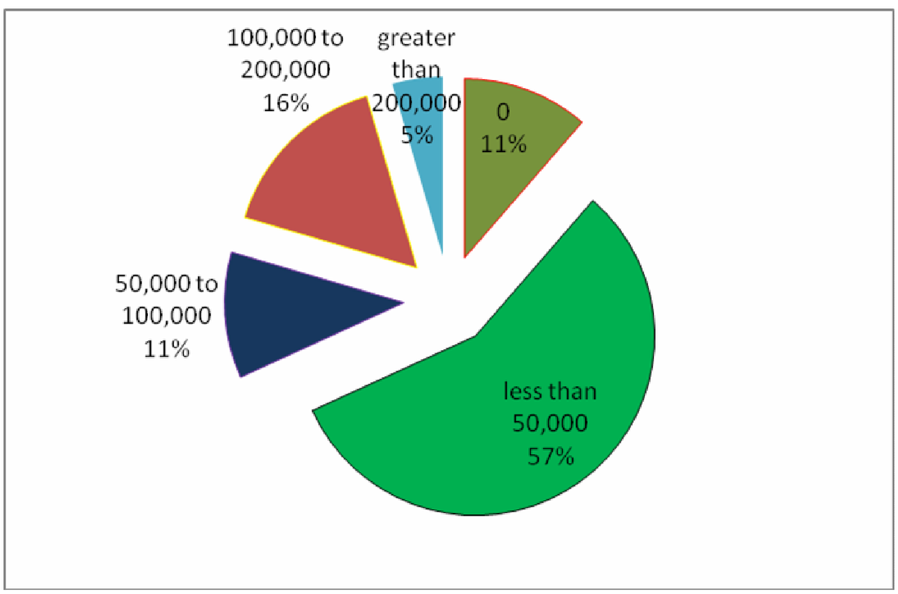

Figure4.15: The most recent loan size of the small businesses

4.5.2 MOST POPULAR PROVIDERS OF LOANS

Microfinance institutions were the most popular provider of loans for the small businesses operating in Addis; based on the response of owner operators around 50% of firms that had obtained a loan from microfinance in the past two years. 16% of the total small businesses had received a loan from a private individual, such as a family member or friend. only small number replied banks financed their operations which compose of 13%of the total respondents. From this one can read that small businesses are relaying on microfinance to raise fund. On the other hand the amount of loan that these businesses can access from microfinance is limited and the effective interest rate they were required to pay was higher relatively.

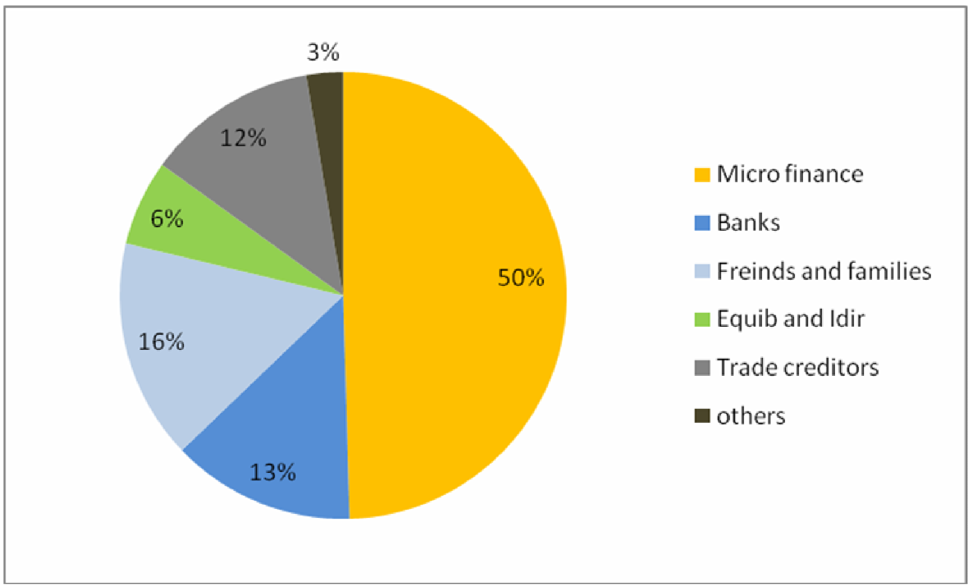

Figure 4.16: source of the most recent loan for the small businesses

4.5.3 PURPOSE OF THE MOST RECENT LOAN

Significant part of the small business owners (50%) indicated that they used the money to finance working capital of their business and 28% acquired plant asset with it. In addition there were small businesses used the loan for promotions on bazaars and other opportunities created by Kebeles and sub cities. These indicate that the significant part of the loan was used to finance acquisition of plant assets and working capital of the small businesses. Acquisition of plant asset need long term loan which microfinance cannot handle.

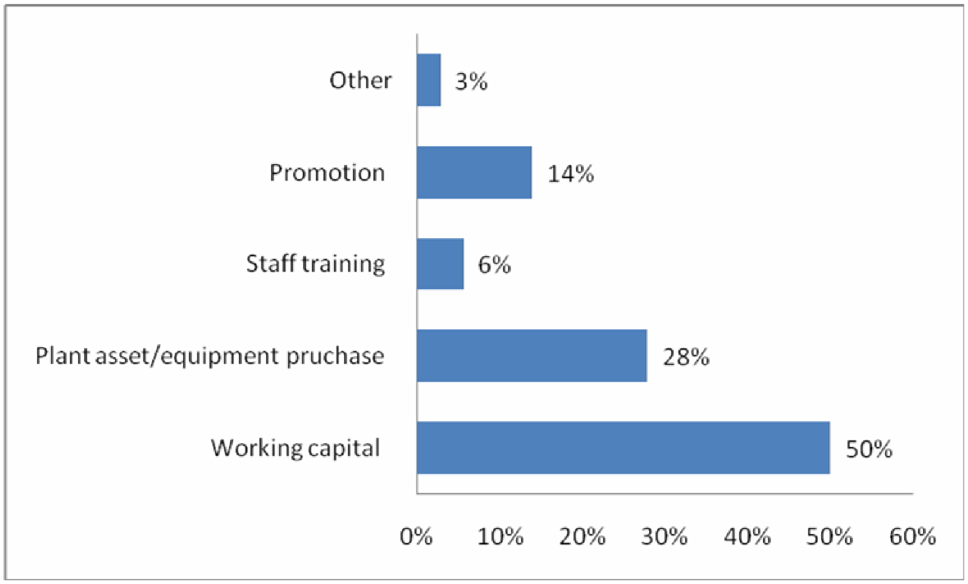

Figure 4.17: purpose of the most recent loan by the small businesses

In general from the discussion above it is possible to see that the small businesses access to finance is limited and the need for financing their working capital is increasing on the other hand. In addition those who do have access to external finance extremely relaying on microfinance institutions.

4.6 EXTERNAL FINANCING IN THE FUTURE

Managers who expected their company to grow in the coming years were asked questions about potential external financing that would be needed to realize these growth ambitions:

What would be the preferred type of external financing?

What amount of financing would they aim to obtain?

What would the most important limiting factors to get such financing?

4.6.1 PREFERRED TYPE OF FINANCING FOR FUTURE DEVELOPMENT

Preference of existing financial institution as indicated by the managers of small business is more in banks, around 56%. The reason why they prefer this institution was also asked and the response was that large amount of fund relatively when compared with microfinance and the fund can be used for longer period of time. In addition one can access finance from banks at fair interest rate than microfinance. Around 37% of the respondents indicated that microfinance is better for them since there is collateral requirement.

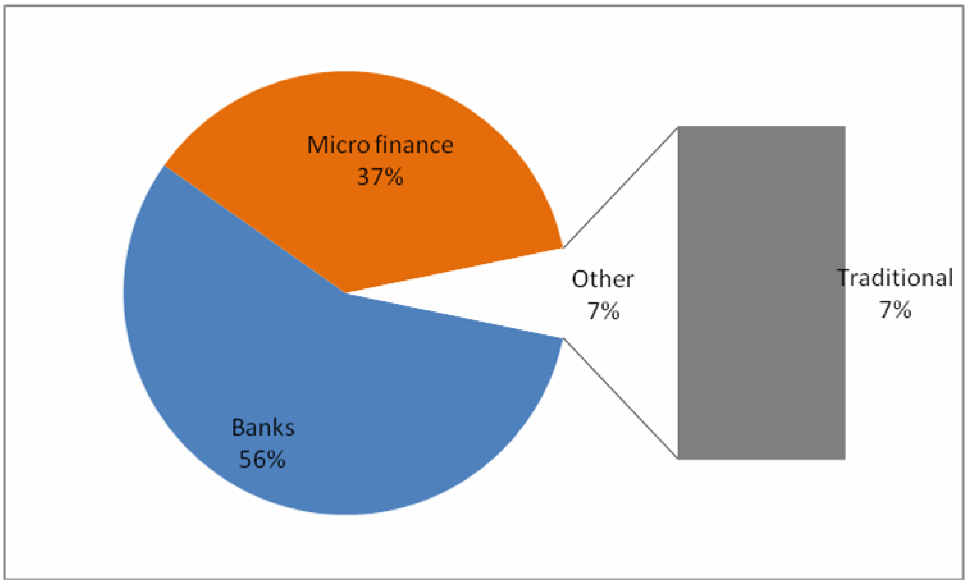

Figure 4.18: preferred source of external financing by the small businesses

In addition to the reason mentioned above the small businesses are preferring microfinance than banks in that it is easy to access and information needed in microfinance is not that much difficult to produce than banks. 7% of the small businesses have pointed out as their favorite is traditional way of financing the reason that they have portrayed are, one need not have to show collateral to get money from Equib, Idir and other formal and semi-formal ways of financing that can be obtained traditionally. The other basic reason why these small businesses prefer traditional way of financing is that easy to access and you do not need to provide information about the project you have on hand to get access to finance.

4.6.2 AMOUNT OF FINANCING COMPANIES WILL AIM TO OBTAIN IN THE FUTURE

Almost one fifth (20%) of managers of small businesses want to have birr 100,000 to birr 200,000 for their growth ambitions. A relatively large percentage (34%) of owner managers would aim to obtain between birr 50,000 and birr 100,000 of financing. Approximately 11% of small business managers would aim to obtain financing for more than birr 200,000, while a still significant proportion – 22% – would aim for financing of less than 50,000.

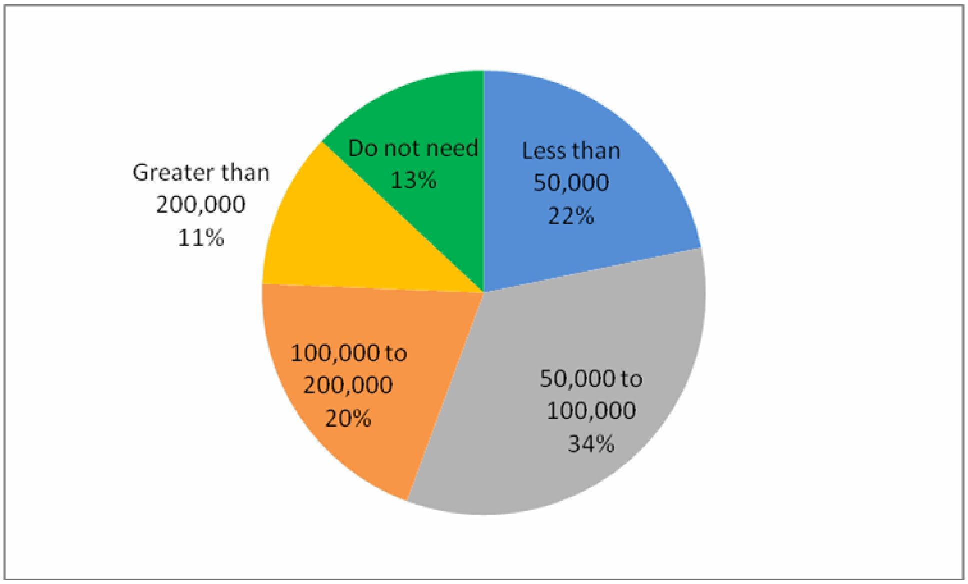

Figure 4.19: the amount of finance small businesses need in the future

Finally around 13% of the total population indicated that they do not want to have loan from the external financing. From the pie chart indicated above one can understand that around 56% of small businesses will remain as customer of microfinance while only 31% of them may access finance from banks

4.6.3 OBSTACLES TO GET EXTERNAL FINANCING

Those who want to have loan for their growth ambition in the future were asked to identify the possible problem that constrain them not to access finance. Accordingly 46% of the respondents indicated that insufficient collateral is the basic problem that they will face. Only 15% of the small business managers indicated that there will be no obstacle in accessing finances that they ambitioned to obtain. 26% of the respondents have indicated that the obstacles are others which include the financial institutions requirement and their expectation for the economy of the country and the impact that economic development will have on the purchasing power of the citizen. One out of ten respondents on the other hand has reasoned out that the finance is not available at all.

4.7 SUPPORT FROM GOVERNMENT BODIES

From the interview made with officer of micro and small business development bureau of Addis Ababa city administration it was possible to identify the following. Two times average of 25 minutes interview was made and the following finding were identified.

The city administration has taken measures assisting small business by providing industry areas where the business plant their workshop and from the responses of the officer it was possible to identify that in every sub city there are industry areas provided for the small and micro businesses.

The bureau has been organising relevant training for the business operators to assist them provide unique and new product for the market and provide consultation service about where to go for financial assistance and how to make use of the fund raised and also where to market their product. The other basic finding of the interview was that the bureau maintain database for the small businesses operating in different sub city but database consists of name and address but nothing about the initial capital and the periodic change in businesses operation and etc.

With respect to access to finance the bureau has opened office in each kifle ketema and through this offices contact the small business in each sub city and assist them in accessing loan from microfinance. As per the response of these officers even though it is on progress there are buildings constructed near to the main market areas of the city to assist the small businesses problem of reaching the market.

CHAPTER FIVE

5. FINDINGS

Access to finance is crucial for the growth of small businesses. It helps to foster entrepreneurship, competition and innovation. Nevertheless, there was no study made whether these types of business sectors had sufficient access to finance. This study conducted on 115 small businesses in Addis Ababa found out that small businesses did not have enough financing to enable them accomplish the objective for which they were established.

The government of Ethiopia is working with microfinance institution and regional government to improve access to finance for small businesses across the country. Microfinance institutions are providing loan for small businesses. For example, to facilitate the growth and development of small businesses, the government has set out a comprehensive system of financial policies and instruments to support small businesses with the appropriate sources through bringing together small businesses and microfinance institutions. But ambition for growth and increase in price of input let the financing need more complicated than the type of finance microfinance can handle.

In detail, the study examined small businesses: past, current and future states: their financial situation, growth, innovative activities and need for external financing, use of financial instruments, distinguishing between the use of internal funds and external sources of finance, experiences of applying for various types of external financing and reasons why they have not applied for such types of financing use of loans as a source of financing: the popularity of loans and the most popular providers, size and purpose of taking out recent loans perceptions about the availability of various types of external financing, and their views about changes in terms and their preferences and expectations for future financing.

The main findings of the research are:

Being one of the basic sectors that would have been contributed a lot to the GDP of the country not counting the employment opportunity that they create for the citizens, Ethiopian small businesses are lagging behind every other sector. Their growth is sluggish, marketability of their product is limited because of quality, competition, lack of market (deficient in place to market their product), the access that they have for input was limited and expensive in put price and their access as well as use of finance is extremely limited.

By comparing the initial capital of the small businesses taken into account with the current capital of these businesses it is possible to conclude the businesses have changed. The number of small businesses which had initial capital of birr less than 10,000 were 55 and those who had 10,000 to 50,000 were 47. On the other hand when looking at the current capital, the number of small businesses having capital of birr less than 10,000 are only 10 and those who reported as their current capital was 10,000 to 50,000 are 70 which is 49% greater those who have reported this range as an initial capital.

At least two out of three small businesses have innovated in the previous twelve moths which consist of introducing new product or service to the market, using new way of selling their product and new production process.

In addition to material and energy cost, labor cost had increased as indicated by most of the small businesses asked as income generating indicators. Around 87% of the owner managers come back with increase in cost of input in general and around 62% implied that the gross margin of their operation is decreased which was mainly because of increase in the input price.

Only limited number of small business had practice of accessing external loan. In the past twelve months only 41% of the total small business on which the research was conducted had accessed credit and of these businesses 48% indicated the credit has increased and 37% mentioned the debt to asset has decreased.

The second most pressing problem, next to market that these small businesses facing, was access to finance. The increase in cost of raw material, labor and energy cost forced them to increase their need in external financing. In addition the basic and first rated problem these firms faced is that they cannot find customers easily therefore the product or their output cannot be sold and it was not being converted to cash to make use of it. This result in slowdown in inventory turnover and fund to be tied up which in turn increase the need small businesses have for external finance.

As indicated by the owner manager's small businesses, the most popular form of financing that small business using were internal financing, which as indicated above was eroded by increase in input price and as a result reduced profitability. The other popular financing instrument that small businesses practiced were spontaneous financing instruments, which is for very short period of time and relatively smaller in amount. Most small businesses are not applying for bank financing because of possible rejection that result and requirements of banks. The other main financing source for small business is microfinance which was reported as improved in the last twelve month.

In addition to the above mentioned problems, because of expansion resulting, even though sluggish, the need for restructuring their business, acquisition of fixed asset and working capital financing small business were forced these businesses seek for external financing.

Factors that hinder accessing finance from the existing formal financial institution as listed by the owner managers were loan covenants and information requirement of the financial institutions, availability of loan size, their firm's sales and profitability, level of cost of financing, willingness of businesses to provide sales on account, financial institutions willingness to provide loan, the firm's capital, the economy of the country and availability of costless financing instrument that can easily be accessed.

Less than 50,000 birr was recent loan amount that most small businesses have borrowed mainly from micro finance institutions (50%). The other most popular loan providers were trade creditors, friends and families consisting of 29% of the total population. This most recent loan was used to purchase fixed asset and to finance working capital of the businesses. It was also for promotion and for staff training. But when the small businesses grow the need of finance will became larger and complicated for micro finances to handle.

Preference of small business indicates more in banks than microfinance and the reason was indicated as loan size, interest rate and time period. Around 37% of the total small businesses replied that their preference was microfinance since these institutions did not require collateral for loan provision, simple procedures and easily to fulfill and one can find them in Kebeles. Because of no cost of financing (interest and other transaction costs), around 7% of the small businesses have replied that the traditional way of financing as the best way to finance their operation.

As to the future ambitions of small businesses their needs for finance increase. As the response of small businesses studied indicated around 87% need finance for their growth ambition. Significant part of the respondent's need range from 50,000 to 200,000 which is around 54%. Financial institution they prefer to get the fund they aim is bank (56%) and microfinance (37%). The main challenge they face as per their response is that large collateral need by banks and other requirements by financial institutions as need for future plan as well as the requirement of not using the fund for reason not intended initially, even though it is not profitable. Again there are firms indicating that the financing is not available at all and the price and the costs are too high to afford. Unfortunately around 56% of the total small firm owner will remain customers' microfinance institutions because of the loan size they need.

CHAPTER SIX

6. CONCLUSION AND RECOMMENDATION

6.1 CONCLUSIONS

Small businesses are considered to have crucial role in an economy and are a key source of economic growth, dynamism and flexibility and can adapt quickly to changing market demand and supply situations. They are also deemed to generate employment, help diversifying economic activities and make a significant contribution to export and trade. It is not questionable that small business sector do have high relevance to developing countries like Ethiopia considering the small domestic market, weak and narrow based economy against volatile global environment.

However, an inadequacy in accessing finance is one of the key obstacles of small business growth not only when starting the business project but also when operating. Access to finance provides a range of instrument and information to help improve the survival rates, productivity and competiveness of small business and to address market failures and gaps in the supply of finance through public and public-private initiatives.

In addition to the above mentioned constraints of lack of access to finance for small business, the other basic findings of this research is the small businesses were extremely challenged by access to market, which in turn hinder these business not sale their output and generate revenue which was considered as the main source internal financing instrument. After manufacturing products and their product has to be sold to untie the fund in order to make use of the fund for further operation. But because of luck of market place to sale the product the business were unable to market their product and generate revenue. Most of the small business use internal financing as basic funding instrument; if these businesses can not convert their products to revenue from nowhere is the internal financing instrument and as a result mortality rate of this business will become high.

The past and present trends of the small business indicates that the small business of the sub cities of capital city are challenged to access finance when needed and the amount needed because of the long and tight procedure of financing institutions.

The growth even though sluggish, innovative nature of small business (to meet the unique need of customers and in search for market), forced the small business owner operators to have higher need for finance that could not be handled by internal (Because of law sales volume and lower gross margin as a result of high input price) and external financing instruments (luck of willingness and tight procedure). The price of raw material including energy and labour cost has increased, which in turn aggravated the need for the working capital financing and under some circumstances force them not to produce as much demanded output as possible for the market.

The assessment has shown that there exists a massive demand for financing of working capital and fixed investment and also restructuring the business. For the ambition of expansion, need for finance had shown tremendous increment. In general the insufficient availability of the internal funds (the popular financing instrument) and need for expansion as planned by small business increased the need for external finance.

Main internal financing instrument includes retained profit was highly affected by the change in input price and low price at which the products were sold. The dominant external financing were loan form microfinance, trade credit and other spontaneous financing instruments. The study indicated that most of the small businesses were not willing to apply to formal financial institution specifically bank because of the possible rejection and lack of appropriate collateral that banks require them to pledge. As to the availability of external finance small businesses have displayed that trade credit availability has increased during the past twelve months which cannot be used to finance fixed investment. The small businesses need.

As per the funding of the study the following were the basic aspects that hinder the small businesses not to access finance

- Loan covenants and information requirements
- Collateral requirements
- Available size of loan
- Level of cost of financing
- Availability of other loans(friends, family, Equb etc)

The study confirmed the factors that aggravated the level of access to credit market include 1) banks willingness to provide loan 2) lack of credit history with financial institution 3) firms specific outlook to sales and profitability 4) willingness of business to provide trade credit and 5) lack of access to public financial support. Even though insufficient the government has taken measure to improve the challenge of small businesses in accessing finance though assisting microfinance institutions.

6.2 RECOMMENDATIONS

It is absolutely fundamental that there is insufficient access to finance for small businesses. Affordable and appropriate finance enables business to operate efficiently and grow. It facilitates business start-ups, ensures that business is able to finance potentially viable investments, enabling them to expand operations to meet demand, provides funds for business to innovate, generating new technologies and new, more productive ways of operating, allocates resources in the economy to their most productive use, funds business growth, creating employment and wealth.

To resolve this basic problem that contributed significant role in the sluggish grow of small businesses, access to finance, the following possible actions are recommended to be taken by the government bodies as well as the small business owners operators.

I. In Short term

Small business owner managers are recommended to take action on the following basic issues

To control investment in fixed capital a manager advised to consider whether:

- All equipment held is really needed
- Plant or vehicles could be leased instead of bought
- Premises could be rented rather than bought

To control investment in working capital, the manager may consider how to keep it circulating rapidly and ensure that none is lying idle. In particular, the manager advised check:

- Since significant part of small business investment is in working capital and the raw material price control might be a short term way out
    - buying at best prices
    - keeping stock levels as low as possible
    - Delaying payment, to the extent possible without harming the relationship with suppliers.
- Concerning the work in progress, to prevent additional finance required in the process of rework and rejection from customers
    - improving productivity
    - Better quality control at an early stage to prevent further investment in rejects and waste.
- Faster distribution of finished goods to untie the fund in the finished good to make use of it for further operation in the business cycle of the small businesses.

The government on the other hand is recommended to take measures on the following basic issues.

To strengthen the capacity of microfinance institutions to let them handle not only micro businesses but also small and medium sized business too, since small business will not remain small they grow and micro business do became small business and the need for such finance will grow as it was also tried to be assessed in the analysis.

The city administration has database indicating the name, address and type of business they are engaged in. Including relevant data about financial position, achievements of small businesses and the credit history with the microfinance or other institutions in the database may assist the city administration. This database can be helpful as a credit registry or can be used to construct credit registry to let banks and other financial institutions provide fund for such businesses.

Taking an immediate action against the market place for small business that assists them to sale their product to speed up inventory turnover.

II. In long term

In long term the government is recommended to take action against the financial system of the country. Fostering conducive environment for development of well regulated financial market in order to create competitive financial environment. The development of stock market and bond market in the country force medium and large scale business to shift to these financing instruments to raise fund. On the other hand the markets for banks fall and this fall in market will most probable force banks to innovate and search for other market. To compensate the fall in market commercial banks will came down to small businesses. Therefore, action needs to be taken in creating conducive environment for financial market development.

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APPENDIX

Addis Ababa University
Faculty of Business and Economics
Department of Accounting and Finance
Post graduate Program

Dear Sir or Madam this questionnaire is designed to conduct survey research on challenges that worsen the small businesses access to finance. The researcher do believe that the outcome of the research is helpful in providing short term as well as long term solution for the challenges that these small business enterprises are facing. The data you business is providing will not be used for purpose other than intended and indicated here the questionnaire, so the researcher want you to be honest and truthful in replaying the question in the questionnaire. Thank you very much for your time and cooperation.

With best regards

1. What type of business is your business
   (a) Merchandise
   (b) Manufacturing

(c) Service
(d) Other ___________________________
2. For how long your business was in the market
   (a) Less than one year
   (b) Between 1 to 2
   (c) 3 to 5
   (d) More than 5
3. What was your start up capital
   (a) Less than birr 10,000
   (b) Between 10,000 to 50,000
   (c) Above 50,000
   (d) I do not know
4. What is the current capital of your business
   (a) Less than birr 10,000
   (b) Between 10,000 to 50,000
   (c) Above 50,000
   (d) I do not know
5. What is currently the most pressing problem your firm is facing?

____
____
____
____

6. During the last 12 months have you introduced?
   (a) A new or significantly improved production service to the market
   (b) A new or significantly improved production process or method
   (c) A new organisation of management
   (d) A new way of selling your goods or services
7. The following are indicators of income generation of your firm. Please tell me whether the following indicators have increased, remained unchanged or decreased over the past 6 months in your company

	Increased	***Decreased***	***Remained unchanged***
Labour cost			
Material and energy cost			
Interest expenses			
Mark up			

8. Would you say that the amount of debt compared to the assets of your company has(during the past 12 months)

◯ Increased ◯ remained unchanged ◯ decreased

9. With respect to the financing structure of your firm, you can use internal funds and external financing. For each of the following sources of financing; could you please indicate whether you used them or not during the past 12 months?
   (a) Internal funds
   (b) Gants or subsidized bank loan
   (c) Bank overdraft, credit line
   (d) Bank loan
   (e) Trade credit
   (f) Other traditional financing instrument(Idir, Equb, from family and friends)
   (g) Leasing
   (h) Other spontaneous financing instrument

10. From each of the following types of external financing please tell me if your needs increased, remained unchanged or decreased over the past 12 months

	Increased	***Remained unchanged***	***Decreased***
Bank loans			
Trade credit			
Loan from relatives family etc			
Equb and other traditional financing instruments			

11. For which of the following items, would you say that they have increased, decreased or had not impact on your firms needs for external financing over the past 6 months?

Item	***Increased***	***Decreased***	***No impact***
Fixed investment			
Inventories and working capital			
Restructuring or some other			

12. For each of the following ways of financing could you please indicate whether you applied for them over the past 12 months or if you did not apply because you thought you would be rejected because you had sufficient internal funds or you did not apply for other reasons?
   (a) Bank loan(new or renewal)________________________________
   (b) Trade credit ___________________________________
   (c) Other external financing___________________________
13. If you applied and tried to negotiate for this type of financing over the past 12 months did your receive all the financing you requested or only part of the financing you requested or only at unacceptable costs or terms and conditions so you did not take it or you have not received anything at all?
   (a) Bank loan(new or renewal)____________________________
   (b) Trade credit ____________________________________
   (c) Other external financing _____________________________
14. For each of the following ways of financing, would you say that their availability have improved, remained, unchanged or deteriorated for your firm over the past 12 month

	Improved	***Unchanged***	***Deteriorated***
Bank loan(new or renewal)			

Trade credit			
Microfinance			
Others(including loan from family, friend, Idir, Equb etc)			

15. Now consider the terms and conditions of the bank financing available to your firm. For each of the following items, could you please indicate whether they were increased, remained unchanged or were decreased the past 12 months

	Increased	***Remain unchanged***	***Decreased***
Level of interest			
Level of the cost of financing other than interest rate			
Available size of loan or other credit line			
Collateral requirements			
Other For example Loan covenants, required guarantees. Information requirements procedures, fine required to loan approval)			
Other loan(from family and friends)			

16. The availability of external financing depends on various factors, which are in part related to the general economic situation, your firm's specific situation and lender's attitudes. For each of the following factors, would you say that them have improved, remained unchanged or deteriorated over the past 12 month

	Improved	***Remained unchanged***	***Deteriorated***
General economic out look			
Access to public financial support including guarantees			
Your firms specific outlook with respect to your sales and profitability or business plan			
Your firm's own capital			
Your firm's credit history			
Willingness of banks to provide loan			
Willingness of business partners to provide trade credit			

17. What is the size of the last loan of any kind that you r firm has obtained in the last two years?

____

18. Who provided you this last loan?

____

19. What did you use with this last loan for?
    (a) Working capital
    (b) Land/building or equity/vehicles
    (c) Innovative activity
    (d) Promotion
    (e) Staff training
    (f) Other
20. Which of the following listed financial instrument do you prefer

(a) Banks
(b) Micro finance institution
(c) The traditional way of finance

21. Would you reason out why you perform the above indicated financial institutions?
____
____
____
22. And what amount of financing would you aim to obtain?
____
____
23. What do you see as the most important limiting factor to get this financing?
____