

ADDIS ABABA UNIVERSITY  
SCHOOL OF PUBLIC AND BUSINESS ADMINISTRATION  
DEPARTMENT OF ACCOUNTING AND FINANCE

ACCOUNTING PRACTICES OF SMALL AND MEDIUM SIZED ENTERPRISES AND  
ITS EFFECT ON ACCESS TO FINANCE IN ADDIS ABABA

By

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A thesis submitted to the school of public and business administration  
of Addis Ababa University in partial fulfillment of the requirements for  
the Degree of Masters of Science in Accounting and Finance



June, 2011

Addis Ababa

ADDIS ABABA UNIVERSITY  
SCHOOL OF GRADUATE STUDIES

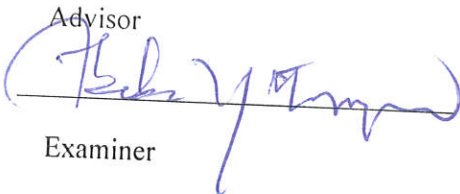
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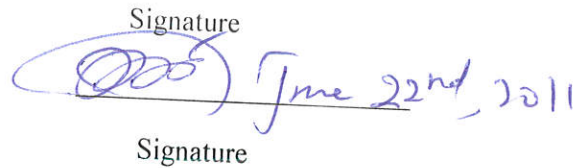
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## Acknowledgement

First and for most, I would like to express my heartfelt thank to my God for my life and abilities he put in me to successfully complete this thesis. My limitless thanks go to my advisor, Dr. Laxmikantham P. Department of Accounting and finance, University of Addis Ababa for painstakingly seeing me through the arduous task of MSC studies, and also for his unflinching support and relentless advice to ensure the completion of the thesis and my studies.

I would also like to thank small and medium sized enterprise manager for their cooperation in providing me all the necessary data for my study and also bank manager or concerned body for their willingness in providing me the necessary information.

My thanks extend to dear Kume for the support and encouragements I received from her, she strived to ensure the completion of this project by inspiring me to effectively complete this tasks. All my family members, for their moral and financial support throughout this study deserve thanks.

Lastly I am grateful to my friend Jaleta Gezahegn for all his cooperation in dealing with him about my study and sharing me all constructive idea for the completion of this thesis.

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## List of Acronyms

- CVP- Cost volume profit
- CSA-Central statistical agency
- GC- Gregorian calendar
- GDPs- Gross domestic products
- GNP- Gross National Product
- IASB- international accounting standard board
- ILO - International Labor Organization
- MSMEs- Micro, small and medium sized enterprise
- NICs-New Industrialized Countries
- OECD- Organization for Economic Cooperation and Development
- OLS-Ordinary least square
- Plcs-private limited companies
- SMEs- small and medium size enterprises
- UK-United kingdom
- UNDP- United Nations Development Programme
- US\$/ USD - United States dollar

### *Abstract*

*This study seeks to examine the accounting practice of small and medium sized enterprises and its effect on access to finance in Addis Ababa. It identifies the sector as the key to unlocking the economic potentials of the country. However, the sector is constrained by a number of factors which include among others minimum or poor accounting practice and difficulty in accessing credit facilities. For the achievement of the objective of the study quantitative research approach particularly survey design were used and the data obtained were analyzed using descriptive statistics and ordinary least square regression.*

*The study revealed that the majority of the studied firm has no formal accounting practice. The study also revealed that the major sources of finance available for the establishment and expansion of SMEs in Addis Ababa are personal saving, microfinance, money from friends or relative, iqub and less from banks. The result of ordinary least square regression evidences that variables such as capital, manager education level and age of the firms are the significant determinants of firms' accounting practices whereas the problems significantly associated with access to bank credits are the demand for collateral, accounting practice or formal accounting information and age of the firm.*

## CHAPTER ONE

### INTRODUCTION

#### 1.1 Background

Small and medium sized enterprises are an important ingredient for stable and equitable growth in any national economy. Ethiopia takes the development and expansion of SME's as the main way to solve many of the social problems. Addis Ababa (capital city of Ethiopia) is a city with alarming socio-economic problems. The unemployment rate is estimated to be about 21.4% of male 36.1% of female. The total average of unemployment is 28.75 % (C.S.A 2006). There is various housing shortage and investment has been low. At present various reforms and development activities are being carried out. One of these is the promotion and development of SME's in the city. The program has been started seven years (2002/03 G.C) ago to enhance the promotion of the sector, emphasizing on employment creation through the development of SME's (Addis Ababa city trade and investment office 2010). Yet despite specific global efforts to strengthen the SME sector, these businesses face a number of stifling financial and regulatory barriers, particularly in developing countries. In Ethiopia one of the main problems of SME's may be their access to finance and accounting practices.

Since the 1960s to date, SMEs have been given due recognitions especially in the developed nations for playing very important roles towards fostering accelerated economic growth, development and stability within several economies. They make-up the largest proportion of businesses all over the world and play tremendous roles in employment generation, provision of goods and services, creating a better standard of living, as well as immensely contributing to the gross domestic products (GDPs) of many countries (OECD 2000). Over the last few decades, the contributions of the SMEs sector to the development of the largest economies in the world have beamed the searchlight on the uniqueness of the SMEs; and this have succeeded in overruling previously held views that SMEs were only “miniature versions” of larger companies (Al-Shaikh 1998).

However, it appears that considering the enormous potentials of the SMEs sector, and despite the acknowledgement of its immense contribution to sustainable economic development, its performance still falls below expectation in many developing countries (Arinaitwe 2006). This is because the sector in these developing countries has been bedeviled by several factors militating against its performance, and leading to an increase in the rate of SMEs failure. These factors include the unfavourable and very harsh economic conditions resulting from unstable government policies; gross under capitalisation, strained by the difficulty in accessing credits from banks and other financial institutions; inadequacies resulting from the highly dilapidated state of infrastructural facilities; astronomically high operating costs; lack of transparency and

corruption; and the lack of interest and lasting support for the SMEs sector by government authorities, to mention a few (Oboh 2002, Wale-Awe 2000).

Despite the importance of financial reporting, management accounting and control practices, it is unfortunate to find that these practices are often inadequate and lacking among SMEs. Except for yearly taxation returns and some form of profit and loss statements, other statements such as balance sheet, cash flow statement, fund statement, production report, variance report, are infrequently used. These rather limited usage of financial and management accounting reports could be attributed to SMEs' inability to employ professional managers with functional specialization especially in the financial area due to their limited financial resources. Without adequate, effective and timely financial reports and analysis, the SMEs are losing out on the benefits from those practices such as improved monitoring of financial health and progress, improved ability to anticipate fortunes or failures, better assessments of financial risks and greater ease in financial planning and control. Most importantly, in the context of SMEs requiring extra capital to grow, regular financial reports can provide indications on their ability to produce steady cash flows and to service debt. It has been established that the use of appropriate financial reporting and management accounting practices could be one of the determinants of company survival particularly SMEs (Gorton, 1999; Holmes, 1991). To ensure the contribution of SME's to the economy the enterprise should perform efficiently, which is effective through practicing accounting system and having an access to finance. In Ethiopia these enterprise may not practice accounting or not practicing

formal accounting system and has no well developed access to finance. The aim of this paper is to examine the accounting practice of SME's and its effect on access to finance in Addis Ababa.

## **1.2 Statement of the problem**

It appears that considering the enormous potentials of the SMEs sector, and despite the acknowledgement of its immense contribution to sustainable economic development, its performance still falls below expectation in many developing countries (Arinaitwe 2006). SMEs frequently lack access to institutional credit (World Bank 1978), causing them to encounter high financing costs and high failure rates (Byron & Friedlob 1984).

The possible reasons for SME failures include among others 1) the poor management and/or administrative skills of the owner/manager, 2) insufficient capital invested by the owner, 4) an over-reliance on external borrowings, and 5) poor record-keeping, and etc. (Brooks, Collings & Gonzales 1990). Poor record keeping and inefficient use of accounting information are a major cause of the above according to Berryman (Berryman 1982 quoted in Siop 1997, Walton 2000, Wichmann 1983, World Bank 1978). The inefficient use of the accounting information to support their financial decision-making and the low quality and reliability of financial data are part of the main problems of SMEs (Ubonratchat hanee University 2000).

Accounting information signals that decisions are needed, and provide information useful to making decisions (Gibson 1963 quoted in Thomas & Evanson 1987; Report of the study group on the objectives of financial statements, American Institute of Certified Public Accountants, 1972 quoted in Lothian 1976). Accounting information is used to assess the profitability of alternative courses of action, measure performance, and evaluate the position of enterprises in term of profitability, liquidity, activity and leverage. It can be used to improve SME performance, especially financial decisions. Different capital structures cause different degrees of financial risk. Different alternative financial plans affect SMEs' performance differently. Thus, proper accounting is a key to small business success (Wichmann 1983).

SMEs lack of access to capital and high interest rates charges are partially the result of incomplete (or no) accounting records, and the inefficient use of accounting information. Poor record keeping and accounting information make it difficult for financial institutions to evaluate potential risks and returns, making them unwilling to lend to SMEs (World Bank 1978). As a result, SMEs pay high interest rates or fall back on the middlemen or moneylenders, whose loans are costly and often restrictive (Institute for Small and Medium Enterprises Development). The misuse and inaccuracy of accounting information causes SMEs to inaccurately assess their financial situation, and make poor financial decisions, as well as leads them to face with the high failure rate (Byron 1976).

While the performance levels of small businesses have traditionally been attributed to general managerial factors, such as manufacturing, marketing and operations, accounting systems may have a strong impact on small business survival and growth. The literature on financial and accounting practices is scarcer than long term investment and financing decisions (Howorth, 1999, 2003; Peel and Wilson, 1996), yet it occupies the major share of a financial manager's time and attention (Gitman, 2000). A large number of business failures have been attributed to inability of financial managers to plan and control properly the current assets and the current liabilities of their respective firms (Dodge and Robbins, 1992; Ooghe, 1998). In particular, the small firms may face serious problems due to the operating conditions and specific characteristics.

The main factors that contribute to success or failure of small business are categorised as internal and external factors. The external factors include financing (such as the availability of attractive financing), economic conditions, competition, government regulations, technology and environmental factors. The internal factors are managerial skills, workforce, accounting systems and financial management practices. SMEs often face problems with regard to access to finance which is associated with accounting practices. The problem the enterprises faces are that associated with accounting practices includes; it is very difficult to give information on their income and expenses (they do not know whether they have lost or profited from their business activities), in presenting their financial position, management decisions and this leads problem on access to finance.

These problems evidence the need to undertake extensive research on the accounting practice of SME's and its effect on access to finance.

### **1.3 Objective of the study**

The general objective of the study is to construct an empirical study of the accounting practice and its effect on access to finance of SME's in Addis Ababa.

#### **1.3.1 Specific objective of the study**

Specifically the study has the following aims:

- Determining Whether SME does maintain formal accounting practice.
- Examine the determinants of the accounting practice of the SME.
- Examine the determinants of the access to credit of the SMEs.
- Identify the source of credit available to SMEs and the types of finance used.

### **1.4 Significance of the study**

Taken as a whole, this study examine the accounting practice of SME and its effect on access to finance, in order to provide meaningful insight and contribute to efforts aimed at expanding SME in the city and transforming small enterprises to medium sized enterprises. Therefore it believed that the study performed will have the result of strengthening the relationship between SME's and banks by specifically identifying the

main barriers between them, provide knowledge to SME about the importance of accounting practices, it fill the research gap in the area and provides the basis for further research.

### **1.5 Scope of the study**

The study is delimited to the Addis Ababa city SME's accounting practices and access to finance of the firm. The scope of this study spread across SMEs in Addis Ababa specifically business included are service, retail and wholesale.

### **1.6 Limitations of the study**

During the study time some of the limitations were faced by the researcher. To cite the limitations; absence of complete and organized information about the enterprise from sub-city, shortage of time to carry out research, difficulty to get the address of the enterprises to be studied and there was many challenges to get the required data from some firms.

### **1.7 Organization of the paper**

The rest of the paper is organized as follows; Chapter two reviews of the literature, chapter three is research methodology, chapter four provides some results and discussion

of descriptive analysis. Chapter five is all about econometric estimation, regression results and discussions. Chapters six concludes and provides recommendation.

## CHAPTER TWO

### REVIEW OF THE LITERATURE

The previous chapter presents the background of SME's and the objective of the paper, which is to examine accounting practices of SME and its effect on access to finance. This chapter presents the theoretical literature including definition of SME's; empirical evidence on accounting practice of SME's and access to finance and research gap.

#### **2.1 Theoretical perspective**

Development strategists have advocated the progressive use of small and medium enterprises (SMEs) to accelerate the pace of economic growth especially in the developing countries of the world (Daodu, 1997). Most African countries are basically agrarian societies with the majority of the populace engaging in agro-related activities such as farming, livestock rearing, agro forestry and fishing (Osinowo, 1997). With little capital to invest, it seems obvious that the process of industrialization should be based on the development of the SMEs to link agricultural production with manufacturing activities. This requires specific incentives to assist in the development of the SMEs sub-sector, which include among others easy accessibility to credit, provision of infrastructural facilities, industrial extension services and development of production capacity based on locally developed or adapted technology and locally designed equipment and spares (Ekpenyong, 1992; 1997).

The need to promote a vibrant industrial sector has continued to be a major concern of most governments worldwide especially the developing countries like Ethiopia. The reasons for this are centered on the prospects that a developed industrial sector will boost manufacturing production, increase employment generation and efficiency in the sector. Similarly, modern manufacturing processes are characterized by high technological innovations, the development of managerial and entrepreneurial talents and improvement in technical skills which normally promote productivity and better living conditions of the people. The effect of this is that productivity level will be enhanced, a sustainable level of economic growth will be achieved with the prospect of economic diversification and increased exports. The economy will have the potential of being competitive in the global market (Olorunshola, 2002).

The Small and Medium Enterprises play a critical role in both developing and developed countries. The East Asian countries miracle was partly as a result of a vibrant SMEs sub-sector, which triggered the up-surge in exports and subsequent development of the industrial sector ( Stiglitz 1996). For example, the New Industrialized Countries (NICs) like Singapore, Taiwan, South Korea, Malaysia, Indonesia and China among others, were able to achieve economic growth through the activities of SMEs which later contributed to the transformation of the Large-Scale enterprises. The Republic of China over the years, despite her large population, has been able to generate employment and income for her teeming population through the activities of the SMEs.

The importance of SMEs sub-sector cannot be overemphasized. The sub-sector contributes significantly in achieving various socioeconomic objectives, which include employment generation, contribution to national output and exports, fostering new entrepreneurships and providing a foundation for the industrial base of the economy (Inang and Ukpong, 1992). In low income countries with Gross National Product (GNP) per capita of between US\$100 and US\$500, SMEs account for over 60 per cent of GDP and 70 percent of total employment; in middle income countries, the SMEs produced close to 70 percent of GDP and 95 percent of total employment; and in OECD countries, SMEs constitute the majority of firms and contribute over 55 percent of GDP and 65 percent of total employment (Basu, et. al., 2005).

In attempting to conceptualize SMEs in Ethiopia, some points need to be stressed. First, there is no generally accepted definition of small or medium. Secondly, small businesses are generally quite responsive to their environment and our environment changes fast. Changes in the environment therefore affect what constitutes a small business at a particular point in time. Thirdly, what the definition aims at is to set some limits (lower and upper) that will assist in achieving the set purpose. Such limits can be in terms of level of capitalization, sales volume and number of employees.

A clear definition may be useful in a particular national context but it may not be practical to attempt a universal definition. An attempt is made to present some definitions of SMEs to demonstrate the divergence in definition across countries.

Therefore there is no universal definition of SMEs since the sector is diverse and flexible that resists any narrow categorization. The definitions given to SME's and applied vary from country to country and also mean different things to different people, even within the same country. The definition of SME is based on five main parameters; labour, capital, loan size, fixed asset and annual sales turnover. Organizations often use one criterion to define SMEs. The size limit is one of the most common definitions in developing countries. Some countries use one criterion to define this sector while others may have definitions with multiple criteria. For example South Korea defines SME on the basis of 'capital or assets', while Canada defines this term on the basis of 'number of employees' and 'gross sales or taxable income'. This also appears to be true in the case of Ethiopia. This lack of consistent definition has eventually led to be confusion and failure to distinguish between one segment and another and has significant implications on the structure of interventions and promotional support that could be provided to the section.

To see some of the definition as an example; to support and develop these businesses, the European Union has introduced a new definition of SME valid from January 1, 2005. SMEs are defined by three main criteria: the number of employees, annual turnover in millions of Euros and total value of assets in millions of Euros.

**Table 2.1** European Union division of SME's

Size	Number of employees	Turnover in EUR	Balance sum in EUR
Medium enterprises	50 -249	Max. 50. mil.	Max. 43 mil.
Small enterprises	10 -49	2 mil.-10 mil.	2 mil.-10 mil.

Source: <http://www.czechinvest.org/definice-msp>

Together with these indicators a SMEs should also fulfill a criterion of independence, which means that no other subject should participate in its basic capital or voting rights by more than 25 percent. Differences between a small and a big enterprise are as a rule defined not only by the above mentioned quantitative criteria, but also by qualitative criteria. The borderlines between small and large enterprises also depend on different conditions in individual regions and they also change with time. Basic differences between a small and medium enterprise and their interactions can be traced in several spheres. The differences are in:

- (1) Organizational and legal forms and in-house structures,
- (2) Relation between owners (entrepreneurs) and companies management,
- (3) Possibilities of sales and application of marketing strategies of small and large companies
- (4) Capital availability and approach to outer sources of financing.

In the developed or industrialized countries like United State of America and Canada, small business is defined in terms of annual turnover and the number of paid employees. In 1987 for example, the manufacturing sector of the United State of America has as small scale business when the number of employees is between 20 and 49, while the medium employ between 50 and 499 employees in the manufacturing sector. In the UK that same year, small business is said to employ between 1 and 99 employees and medium scale 100 to 499 employees in the manufacturing sector. In 1990, Japan level of employment in the small scale ranges between 20 and 49 and medium as 50 to 499 in the manufacturing sector (Ekpenyong, 1997).

In the New Industrialize Countries, the definition of SMEs also varied and is mostly based on the number of employees and the value of assets. In Taiwan, the small scale business was defined as a business with less than 5 employees and the medium as the business with between 10 and 499 employees in 1991 in the manufacturing sector. The South Korea defined small scale enterprise in 1988 as any business that employ 5 to 19 and medium scale enterprises as employing between 20 and 199 without sectoral specification. In Bangladesh a micro firm employed less than 20, while small firm employed from 20 to 99 in the manufacturing sector without mentioning of medium scale enterprises in 1986. In Bolivia, a small scale employed 1 to 9 and medium scale 10 to 99 employees in 1992 (Hallberg, 1999).

In Philippines, small industry is defined qualitatively, in terms of employment or asset size. Qualitatively, small scale industries are manufacturing and/or industrial service enterprises in which the owner manager(s) are not actively engaged in production but perform the varied range of tasks involved in guidance and leadership without the help of specialized staff. The employment size is 5 to 99 employees and the asset size of p250,000. In 1986, the definition was drastically changed to cover all enterprises except agricultural farms which have assets of p500, 000 to p5million (US\$25,000 to US\$250,000) (Ekpenyong, 1995).

In Ethiopia there is no clear definition of SME's. Only paid up capital is used for the categorization of business as micro, small and large. Small size enterprises are those enterprises with paid up capital of above Birr20, 000 and not exceeding Birr 500,000 excluding high tech constancy firms (Manufacturing enterprises) and other high tech establishments(Addis Ababa MSME'S 2010). But there is no categorization of business above small scale enterprises as medium and large enterprises in the country. For the purpose of this paper the working definition by International Labor Organization (ILO) and United Nations Development Programme (UNDP) for SMEs and large enterprises is used. The working definition by ILO and UNDP for SMEs and large enterprises indicates that: employing less than 5 employees including the owner is a micro enterprise; employing 5 to 20 employees is a small enterprise; employing 21 to 99 employees is a medium enterprise; and employing above 99 employees is a large enterprise (UNDP, 2001).

The size distribution of firms in today's developed economies is very different from that in developing ones. In the poorest countries, on average almost two thirds of workers are employed in very small (micro) enterprises that is, enterprises with less than five employees and most of the rest work for large enterprises with more than one hundred employees. Small- and medium-size firms have little presence in these economies and together employ less than 10 percent of the total workforce. By contrast, in the richest countries more than two thirds of all employees work for large enterprises, the bulk of the remainder work for SMEs, and only a very small fraction for micro enterprises (Snodgrass and Biggs 1996). Although large firms account for the lion's share of aggregate economic activity in developed countries, SMEs play a more significant role in these economies than their proportion of total employment might suggest. Not only do they make up the vast majority of firms, but they dominate many sectors of economic activity and have been an ongoing source of new products and of technological innovation more generally.

One possible explanation for the relative absence of SMEs in poor economies is the difficulty of obtaining access to finance. Large firms in these countries can secure financial assistance because they have assets that can serve as collateral for loans, because their directors also serve on the boards of financial institutions, and/or because they receive special government backing. Other enterprises, however, have to rely largely on their proprietors' financial resources, which are likely to be limited, and on retained

earnings, which, given the general poverty of the populations that they serve, cannot be large. Without outside sources of funds, therefore, such firms are condemned to start and remain very small.

Financial inclusion, or broad access to financial services, is identified as an absence of price and non price barriers in the use of financial services. Improving access, then, means improving the degree to which financial services are available to all at a fair price. It is easier to measure the use of financial services since data of use can be observed, but use is not always the same as access. Access essentially refers to the supply of services, whereas use is determined by demand as well as supply.

As SME's are important ingredients for stable and equitable growth in any national economy, mostly in developing countries these businesses are with many problems and their contribution is not such much as that of rich countries. One of the main problems is poor accounting practices. Therefore the researcher is also motivated to examine the problem of poor accounting practices of SME's in Addis Ababa.

## **2.2 Empirical evidence**

Researches have been carried out on the accounting practice and the access to finance of the SME's. So this part of the paper presents the empirical evidence on the idea of the paper. The empirical evidence below is presented consecutively based on the concept of evidence.

### 2.2.1 Accounting practices

The empirical evidence about the accounting practice of SME is organized in terms of evidence such as: record keeping, financial accounting, financial management and cost and management accounting.

**Record keeping:** A study involving more than 1,000 SMEs in Australia, found that majority of the respondents (85.7%) has a computer-based in-house general ledger accounting system (McMahon 1998). Larger enterprises tend to statistically use more of computer-based general ledger accounting system compared to smaller enterprises.

Study examined private limited companies in the UK found that 57 per cent of the respondents had a computerised accounting system and 25 per cent had a partly computerised system suggesting moderate level of sophistication of accounting system (Collis and Jarvis 2002). Similarly other study found that SMEs that are concerned with procedural controls activities and use financial plan as part of their preparation for startup are more likely to employ computerized accounting system (Gorton 1999). In addition to their internal accounting staff, SMEs often employ outside professionals to provide accounting advice. It has been found that the most frequently form of outsourced accounting services are for taxation purposes and preparation of accounting reports (Collis and Jarvis 2002, McMahon 1998).

Studies conducted in Nigeria and UK with a sample size of forty-five (45) questionnaires each between the UK and Nigeria and conducted two (2) Semi-structured interviews each between the UK and Nigeria. Out of the forty-five (45) questionnaires administered each in the UK and Nigeria, thirty five (35) was returned in the UK and thirty (30) returned from Nigeria. The study conducted by having the variable that was measured with the question: "Do you agree that Poor Accounting and Book Keeping practices lead to SMEs failure in your country?" and the results showed that 68 percent and 57 percent of the respondents in the UK and Nigeria respectively agreed that it influenced SMEs failure. This reflects that in both countries, the respondents quite agree that poor accounting and book-keeping practices influenced SMEs failure, Kamla-Raj (2009).

**Financial accounting related:** In Australia, there have been a large number of empirical studies conducted on SMEs such as (McMahon and Davies 1994), (McMahon 1998). These studies investigate the types of financial reports produced by SMEs, the frequency of their preparation and their perceived usefulness for management purposes. The findings indicate that financial reports for SMEs are prepared predominantly by external accountants at annual intervals, and they normally comprise just the balance sheet and the profit and loss statement. The content and presentation of financial reports appear to be greatly influenced by taxation and corporate statutory reporting requirements.

Other Studies were conducted in various countries to examine the usefulness of accounting reports within the context of SMEs, for examples McMahon (1998) in

Australia Collis and Jarvis (2002), Gorton (1999) and Nayak and Greenfield (1994) in the UK; and Hopper et al. (1999) on SME Japanese companies. These studies found evidence that financial reports are not considered particularly useful for decision making purposes by SMEs owner-managers. These studies also found that there is limited usage of financial and management accounting reports by SMEs. In addition, it has been argued that accounting reports produced by SME's are usually limited to a few types of simple reports comprising mainly profit and loss account and balance sheet. The studies using a postal questionnaire to small private limited companies in the UK, found that 82 per cent of the companies use monthly or quarterly management accounts, 87 per cent of the companies prepare profit and loss statement and 78 per cent prepare balance sheet (Collis and Jarvis 2002). On the other hand, SMEs consider the most frequently used sources of information are the periodic management accounts, cash flow information and bank statements, to a lesser extent budgets, the state of order book and the additional annual accounts (Collis and Jarvis 2002).

Similarly studies conducted in Malaysia SME, for financial accounting reports all respondents (100 per cent) prepare balance sheet and profit and loss account, cash flow statements, fixed asset record, tax returns and inventory analysis.

**Financial management:** There are a number of reasons that explain the different approach to financial management practices of small firms. Some studies showed that they are driven by the personal motivation of the owner-manager, business life cycle

model; resource poverty while a dynamic view of the financial management process reveal that change may be brought about as a consequence of experiential learning of the owner managers.

A review of the literature on the financial management practices of small firms, revealed that owner-managers' personal and business goals dictate partly their approach to short-term financial management of their businesses (Collins and Jarvis, 2002). There is also theoretical justification that the business life cycle model lends support to the evolutionary approach to financial management practices of small firms (Lewis, 1983; Scott and Bruce, 1987).

Based on a literature review on financial management practices of SMEs in North America, McMahon and Holmes (1991) concluded that "the state of knowledge about financial management and the exercise of financial controls and techniques remain inadequate in small businesses." Study conducted on 200 manufacturing firms employing less than ten people in the U.K. which provides evidence that only one third of business formally monitored profits and applied any form of budgeting Nayak and Greenfield (1994).

The literature on financial and accounting practices is scarcer than long term investment and financing decisions (Howorth, 1999, Peel and Wilson, 1996), yet it occupies the major share of a financial manager's time and attention (Gitman 2000). A large number of business failures have been attributed to inability of financial managers to plan and

control properly the current assets and the current liabilities of their respective firms (Ooghe, 1998).

The main factors that contribute to success or failure of small business may be categorized as internal and external factors. The external factors include financing (such as the availability of attractive financing), economic conditions, competition, government regulations, technology and environmental factors. The internal factors are managerial skills, workforce, accounting systems and financial management practices. The accounting department is generally viewed as a service unit to support the firm's operations by providing information on costs and performance indicators.

Despite the increasing importance attached to small scale economic activities across the globe there appears to have little reported improvement in the financial management skills of small business owners (Jarvis *et al*, 1996). It is surprising to note that no specific research has been undertaken to tap the potential benefits that SMEs can reap by adopting a good framework of financial and accounting routines. This area has not received the same consideration as the many other areas, ranging from start-ups to schemes promoting the growth of the sector (Dewhurst and Burns, 1989; Johnson and Soenen, 2003). There is a substantial amount of literature providing detailed and carefully tailored advice to small business owners on financial management. But none of them have specifically looked into the benefits that firms can derive from formal accounting systems.

In view of their smallness, SME need continued support in the functional areas of their businesses. The often neglected area is the accounting and finance function of the small business and yet this has not attracted much interest from the support agencies. This being so despite findings from empirical studies showed the lower intake of working capital management by small firms and the absence of accounting systems to provide owner-managers with information about their business ( Dodge and Robbins 1992, Howorth and Westhead 2003). They identified five major management problems and inventory and cost controls was the most frequently mentioned problem and was more prevalent during the late growth stage of the business. The financial related problems were grouped into three major categories, where financial planning was found to be a more pertinent problem among the respondents (42%), followed by accounting systems and record keeping, which persist during all life cycle stages except early growth. Once the firm moves along the different stage of the organizational life cycle, accounting related issues become important for the owner-manager to consider seriously. These include recording, cash flow information, inventory and cost controls. A lack of such systems affects control of the business and finding sources of capital to finance daily operations become problematic (Dodge and Robbins, 1992).

Small firms make greater use of cash-based management information and this points to the importance that owner-manager placed on controlling cash found by (Collis and Jarvis 2002). A similar finding was found by Jarvis *et al.* (1996). The lesser use of published industry data, credit rating agency data and statutory accounts could be

explained by their relevance more to larger companies as small firms tend to have more close and personal relationships with their customers. They further noted that small firms use the services of external accountant for the preparation of the annual statutory accounts.

**Cost and Management Accounting:** A study found similarities between costing systems used by SMEs and larger companies (Hopper et al. 1999). The costing systems and cost management practices used by the SMEs were mainly for product costing and budget and less emphasis for decision making or performance evaluation. They also found that sophisticated detailed process of cost management was commonly used for engineering and quality control.

The management accounting reports studied include budgets and different types of budget variance analysis, production cost statement, cost volume profit (CVP) analysis and benchmarking report. The findings show that among the management accounting reports, majority of the respondents (92.1%) prepared budget, followed by production cost statement (82.9%), variance analysis (80.3%), CVP analysis (73.7%) and benchmarking reporting (57.9%). The findings might indicate that most of the SMEs are mainly utilizing a traditional management accounting techniques as compared to the more contemporary management techniques such as activity based costing or total quality management. Among the different types of budgets, cash budget is the most frequently prepared (93.4%), followed by sales budget (92.1%), expenses budget (86.8%) and lastly

production budget (85.5%). The least prepared management accounting report is benchmarking report (Che Ruhana Isa, Zakiah Saleh, Noor Sharoja Sapiei 2007).

To summarize others study, in spite of the importance of financial reporting, management accounting and control practices, it is unfortunate to find that these practices are often inadequate and lacking among SMEs. Except for yearly taxation returns and some form of profit and loss statements, other statements such as balance sheet, cash flow statement, fund statement, production report and variance report are infrequently used. These rather limited usage of financial and management accounting reports could be attributed to SMEs' inability to employ professional managers with functional specialization especially in the financial area due to their limited financial resources. Without adequate, effective and timely financial reports and analysis, the SMEs are losing out on the benefits from those practices such as improved monitoring of financial health and progress, improved ability to anticipate fortunes or failures, better assessments of financial risks and greater ease in financial planning and control. Most importantly, in the context of SMEs requiring extra capital to grow, regular financial reports can provide indications on their ability to produce steady cash flows and to service debt. It has been established that the use of appropriate financial reporting and management accounting practices could be one of the determinants of company survival particularly SMEs (Gorton, 1999; McMahon & Holmes, 1991).

### **2.2.2 Access to finance of SME**

There are two sources of finance available to SME which includes; internal and external sources (Chizca, 2002). Internal sources as the dominant source of finance for most small-scale businesses. A survey conducted by the World Bank (1995) on business environment in transitional economies showed that the share of internal funding is significantly lower in advanced reforming countries as follows: Estonia 33 percent, Poland 34 percent and Lithuania 37 percent. In the United States of America, the SMEs of less than two years old, internal finance constitute 54 percent of total financing. And for most businesses, internal sources of finance constitute retained earnings for the period including provisions made for depreciation which is essentially a book transfer.

The external sources of financing constitute bank finance and other forms of institutional credit. In India, the sources of external finance include informal channels, credit unions, and commercial banks which play an equally important role in the provision of external finance asserted by (World Bank 1995). These sources are certainly not dissimilar to the complement of sources of external finance available to most businesses in Ethiopia. External source of finance must also include public equity.

The financial sector has changed significantly during recent decades. Higher competitive pressure and a greater concentration of banks have diverse impacts on lending practices. Such changes in the financial environment may have substantial effects on the access to

finance of SMEs. Many financial institutions issue securitized debt on various asset classes.

Due to their relatively small size, SMEs face constraints in borrowing. After all, only certain forms of financing are available to SMEs. What is more, the higher default risk compared to large companies results in higher charges.

The study carried out in Ethiopia indicates that access to finance is one of the crucial problems for the SME. Encouraging strides have been made in liberalizing the domestic financial sector; still it is a bottleneck for the rapid growth and development of the sector. In the study, 79% of MSMEs stated that getting credit finance from formal financial institutions is a key problem (Wole 2004). It is obvious that inadequate access to credit limits the expansion of firms, choice of technology, hiring suitable premises and the employment of skilled personnel. This hinders the potential to adequately meet the needs of consumers. Access to credit on favorable terms is essential for initiating new business ventures, fulfilling working capital requirements, as well as for expanding existing businesses. In this regard, the formal financial institutions are reluctant to avail credit facilities to the sector. Formal financial institutions such as commercial banks are reluctant to lend small amounts of money to small businesses because the cost of administering the loan exceeds the benefits accrued to them. Results from Pearson's chi-square tests of association have shown that the source of initial start-up capital ( $P=0.040$ ) and the amount of start-up capital ( $P=0.032$ ) are both significantly associated with

survival of business firms. An examination of the MSMEs in this study shows that the average registered start-up capital of starting a business was about \$3,000 (this figure actually varies with the type of firm). A large proportion (41%) of respondents started business with their own money, out of which 43.4% started business with inadequate savings. This was followed by money obtained from relatives and friends (18%), iqqub schemes (social capital) at 11.8%, microfinance institutions (9.2%), banks (8%), and private money lenders (7.2%). This indicates that although money raised from iqqub schemes (social capital) is not a major source of start-up capital, its contribution is quite significant. High rate of interest which is higher than the lending rate of formal banks and the small size of the loan (a maximum of 5000 birr = 400 USD) inhibit their effectiveness in addressing the financial needs of MSMEs according to (Wole 2004).

In 2001, a study identified poor access to finance as the most critical constraint on SME's in Nigeria. In fact, 50 percent of the surveyed enterprises received external finance while 79 percent indicated lack of financial resources as a major constraint (Guardian, 2001).

A similar study was made in Ghana which focuses on addressing the issue by ascertaining the various factors, which influence an entrepreneur's access to finance. These factors include location, size, initial capital, and level of debt, exports and socioeconomic factors. The SME survey in Ghana revealed that there was a 42 percent chance of an SME loan application to a formal financial institution being granted. However, there were variations in the success rate, which runs across the urban and rural

areas. Thus, location is an important determinant of firm's access to credit. *Ceteris paribus*, urban enterprises record a higher success rate than rural enterprises (Kimuyu and Omiti, 2000). Suppliers of credit are of the view that rural areas are less concentrated and more difficult to serve.

The size of an enterprise is important in accessing credit. Small firms in Ghana are more credit constrained compared to large firms; the study observed a positive relationship between size and access to credit report by (Aryeetey et al. 1994).

The level of initial start-up capital can also positively influence an SME's loan application. Firms with high initial capital appear to have a sound financial standing and this may influence the decision to grant credit. Firms with some level of debt are often seen as credit worthy and stand an improved chance of obtaining further credit. Credit risk and inflation risk are two major important variables affecting small business credit hence, lenders prefer granting credit to old firms who have established good credit records (Collier and Pattillo, 2000). Besides credit risk, inflation adds to the cost of credit.

In the world over, small businesses face more constraints at start up developmental phases than when established. In Africa, for example, the failure rate of SMEs is 85% out of every 100 companies due to lack of skills and access to capital (Fadahunsi, 1997). It is typical of SMEs in Africa to be lacking in business skills, lack record and collateral to

meet the existing lending criteria of risk averse banks (World Bank, 2000). This according to World Bank has created a "finance gap" in most markets between US\$50,000 to US\$1 million. The small businesses are able to source and obtain micro finance mostly from the informal sector like friends and relatives while large or medium enterprises, access these funds from banks. This unequal access to finance by SMEs and large enterprises has undermined the role of small scale business firms in the economic development of African countries at large.

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

In the traditional approach to SME development, governments have provided credit to SMEs through first-tier development banks, second-tier credit facilities channeled

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

Very little financial supports have been provided by the traditional financial institutions (the commercial banks) to the SMEs a study by (Ekpenyong 1997). The reasons are that small businesses have serious inherent structural defects that make them high risk borrowers, and the traditional banks are not structured to cater for the type of credit demanded by the small businesses owing to the nature of their credit assessment procedures (Hammond, 1995).

More than 50 percent of SMEs in Nigeria are sole proprietorships obtaining their start-up capital mostly from personal savings, family, and from friends and relatives. Usually the capital base of such companies hardly exceed N1 million, thus, making expansion in their investments difficult. Where there are partnerships or Plcs, the sole proprietor owns more than 60 percent of the capital stock. This clearly demonstrates that little institutional credit has been received by SMEs (Odetola, 1997). A study conducted on the sources of

investment financing for SMEs in Nigeria, found out that about 96.4 percent of the SMEs finance their enterprises through owner-savings, 2.92 percent through relatives and friends, 0.32 percent from banks, 0.94 percent from government institutions or agencies, 0.06 percent from cooperatives societies, 0.33 percent from money lenders, and 0.03 percent from NGOs in a total of 21,950 respondents (Odetola 1997).

In a similar study covering Northern Nigeria, Lagos and Western Nigeria, and Eastern Nigeria, the source of business finance from personal savings was 26.6 percent, 37.04 percent and 32.14 percent for the regions respectively (Odetola 1997). From friend sources it was 30.59 percent, 19.53 percent and 32.14 percent respectively. From bank sources it was 35.29 percent, 33.33 percent and 21.42 percent respectively. From government agencies it was 8.82 percent, 7.83 percent and 3.57 percent respectively; while trade groups and cooperatives was 5.88 percent, 11.02 percent, and 7.14 percent respectively.

In Ghana SMEs rely primarily on personal savings of owners, business profits, family members or friends for their financial needs argued that (Okraaku and Croffie 1997). They have little or no access to external credit. The effect of this is inadequate fixed capital as well as working capital. The consequences of these are very slow growth rate and frequent failures among small businesses. At the regulation level, the problems identified are high interest rates charged by banks thus making bank borrowing very expensive.

### **2.3 Research gap**

As previously mentioned, SMEs are a significant component of developing country economy like Ethiopia and there is a lack of empirical evidence concerning their accounting practice and its effect in raising credit from banks and making investments of SMEs in Addis Ababa. Therefore, this study will examine SMEs accounting practice and its effect on accessing finance in Addis Ababa to provide empirical evidence of this gap.

## CHAPTER THREE

### DATA AND METHODOLOGY

Quantitative research approach was adopted to carry out this study particularly the survey design. The reason for the adoption of this approach includes; there is the cause and effect relationship in the study, to make generalization from a sample to a population, it is an efficient way of collecting information from a large number of respondents, Statistical techniques can be used to determine validity, reliability, and statistical significance, because they are standardized they are relatively free from several types of errors, they are relatively easy to administer, there is an economy in data collection due to the focus provided by standardized questions (Creswell 2002). The nature of the survey is the cross-sectional, because it is possible to obtain the desired information at one time.

#### **3.1 Sampling**

The firms in the sample were randomly selected from each sub-city database of firms. The sample was stratified by firm size class and economic activity. The number of firms in each of these strata of the sample was adjusted to increase the accuracy of the survey across activities and size classes.

The reason is that in Stratified random sampling specific characteristics of individuals (e.g both females and males) are represented in the sample and the sample reflects the

true proportion of individuals with certain characteristics of the population (Jfowler, 1988). The sample sizes for each economic activity were selected to ensure sufficient representativeness across the three major activities: retail, wholesale and services. The purpose of stratifying firms in this form is to draw representative sample from each stratum. From SME's in Addis Ababa, population for this study are firms exist in ten sub-city. The size of the population in general is 2240 of SME's (Addis Ababa revenue and customs authority 2010). Hence by applying 5% in each stratum, sample size is 112 of SME's. The reason for sampling only 5% of the population is that researcher believes this size represents the population because the population have the same characteristics by many factors such as; involve in the similar activity, government policy for them is similar, the access to finance they have are similar and accounting practice they have is also related.

From the list of the population every 20<sup>th</sup> of the enterprises was selected from each stratum. In addition from the bank side six banks are purposely selected to obtain the necessary information in relation to provision of loan to SMEs.

### **3.2 Instrument and data collection**

Both primary and secondary data were used for the achievement of the study objective. The primary data for this study was gathered through distribution of structured questionnaire for the owner or management of the enterprises and other separate close

ended question were developed and used for the face to face interview of the banks management or other concerned body questions related to precondition for the provision of loans to SME's as one can see from appendix 1. Both close ended questions were developed by the researcher. The reason for selecting face to face interview is primarily it is impossible to apply other means of interviewing in our country because it is difficult to get their telephone, it very costs interviewing through telephone and additionally face to face interview helps to make clarification about the question to interviewee.

The bank manager selected and interviewed are manager of commercial bank of Ethiopia, Awash international bank, Oromia international bank, Dashen bank, Cooperative bank of Oromia and construction and business bank of Ethiopia. Reasons for selecting these banks are; they are banks providing service for the large user, they provide special service for such business (e.g Oromia international bank) and banks with modern service. Therefore it is believed that they represent the other banks in the country.

The secondary data was obtained by reviewing five years (2006-2010) financial records particularly balance sheet, income statement and other non financial records of SME's. The reason for using the record of this periodic interval is it is reasonable that the paper emphasis more on the current situation of the firm. Therefore the latest data was preferred. Data collection was carried out in the month of April 2011.



### 3.3 Theoretical framework

In this section, the study considers the theoretical background of modeling the variables of our interest depending on the explanatory variables that determine them. In this regard, as our variables of interests are accounting practices and access to finance, the theoretical framework of modeling them is dealt with as follows.

#### 3.3.1 Accounting practices

A number of variables are expected to give an insight into the sample firms approach to accounting practices, in particular the accounting practice in place to provide financial information. These include; age of the business, capital of the firm and manager's education level.

Accounting function of an organisation may be regarded as a service of accounting department whereby the department capture transactions, process same and formulate report to the user to facilitate the decision making process.

**Measurement of accounting practices:** Simplified financial reporting standards should be adopted or set for SME. Entities, which do not fall into the definition of public interest entities, will fall into the SME category. There is international acceptance that SME require simplified financial reporting standards fitting their reduced size and narrow

stakeholder base. The International Accounting Standards Board is in the process of setting simplified accounting standards, which can be adopted or adapted for the small and medium enterprises in Ethiopia.

According international accounting standard board SME at least should report the following financial statements (IFRS 2005):

**Balance sheet:** Each enterprise should determine, based on the nature of its operations, whether or not to present current and non-current assets and current and non-current liabilities as separate classifications on the face of the balance sheet.

At a minimum, the face of the balance sheet should include line items presenting the following amounts:

- (a) Property, plant and equipment;
- (b) Intangible assets;
- (c) Financial assets (excluding amounts shown under (e) and (f));
- (d) Inventories;
- (e) Trade and other receivables;
- (f) Cash and cash equivalents;
- (g) Trade and other payables;
- (h) Tax liabilities and assets;
- (i) Provisions;
- (j) Non-current interest-bearing liabilities; and

(k) Issued capital and reserves.

Additional line items, headings and subtotals should be presented on the face of the balance sheet when such presentation is necessary to present fairly the enterprise's financial position.

**Income statement:** At a minimum, the face of the income statement should include line items that present the following amounts:

- (a) Revenue;
- (b) The results of operating activities
- (c) Finance costs
- (d) Tax expense;
- (e) Net profit or loss for the period.

Additional line items, headings and subtotals should be presented on the face of the income statement when such presentation is necessary to present fairly the enterprise's financial performance.

The common financial reports generated from the accounting systems of SMEs are the income statement and balance sheet. The income statement conveys the company's revenue, expense, and net income (or net loss) for a specific time period, which is very crucial for decision-makers. The balance sheet supplies information which helps users assess a company's ability to increase owners/managers wealth and remaining solvent.

The standard financial statements of SMEs do not include cash flow statement (Arnold et al 1984; DeThomas & Fredenberger 1985) and SMEs tend to limit preparation of financial reports to the statutory requirement (DeThomas & Fredenberger 1985). Therefore, the financial statements provided by the accounts typically do not include this information. Studies show that SMEs are more interested in cash and cash flow than reported earnings and assets (DeThomas & Fredenberger 1985; Nair & Rittenberg 1983). Making payroll and pay bill when they come due are the main concerns. Other reports such as age analyses of receivables, debt, and fixed assets, and budgets, which are not on the standard financial statements, are also useful for the financial decisions.

Financial indicators extracted from financial statements are also considered useful by a number of studies on small business (Beal 2000; English 2001).

Given the definition, measurement and detail concept on accounting practice, there is a need to consider variables that affect the accounting practice of a firm before developing the empirical model for the variable. As stated in different literatures, accounting practice is affected among others, by variables such as capital of the firm, educational level of the managers, and age of the firm.

**Age of the firm and accounting practice:** Once the firm moves along the different stage of the organisational life cycle, accounting related issues become important for the owner-manager to consider seriously. These include recording, cash flow information,

inventory and cost controls. A lack of such systems affects control of the business and finding sources of capital to finance daily operations become problematic (Dodge and Robbins, 1992).

A review of the literature on the financial management practices of small firms, revealed that owner-managers' personal and business goals dictate partly their approach to short-term financial management of their businesses (Deakins *et al.*, 2001; Jarvis *et al.*, 1996; Collins and Jarvis, 2002). There is also theoretical justification that the business life cycle model lends support to the evolutionary approach to financial management practices of small firms (Churchill and Lewis, 1983; Scott and Bruce, 1987; Dunn and Cheatham, 1993).

**Firm Capital and accounting practice:** Most of the SMEs have difficulty in maintaining accounting practice because of a limited capital they have for maintaining or employing professional person maintaining this task.

Except for yearly taxation returns and some form of profit and loss statements, other statements such as balance sheet, cash flow statement, fund statement, production report and variance report are infrequently used. These rather limited usage of financial and management accounting reports could be attributed to SMEs' inability to employ professional managers with functional specialization especially in the financial area due to their limited financial resources. Without adequate, effective and timely financial

reports and analysis, the SMEs are losing out on the benefits from those practices such as improved monitoring of financial health and progress, improved ability to anticipate fortunes or failures, better assessments of financial risks and greater ease in financial planning and control. Most importantly, in the context of SMEs requiring extra capital to grow, regular financial reports can provide indications on their ability to produce steady cash flows and to service debt. It has been established that the use of appropriate financial reporting and management accounting practices could be one of the determinants of company survival particularly SMEs (Gorton, 1999; McMahon & Holmes, 1991).

**Manager's education and accounting practice:** The low intake of accounting as one of the key contingent factors in an SME adopting new accounting procedures may be related to the academic background of the managers.

There is a positive correlation between structure of accounting department and level of education and training of manager's reported by (Collis and Jarvis 2002). They found that a large proportion of companies employ bookkeepers and credit controllers, which point to the importance attached on record keeping and controlling cash and the level of debts. Couple with the high level of education and training, that the "small companies have the financial expertise available internally to aid the generation and analysis of financial information" concluded by (Collis and Jarvis 2002, p.104).

### 3.3.2 Access to finance

There are two sources of finance available to SME which includes; internal and external sources. Internal sources as the dominant source of finance for most small-scale businesses. The internal sources are sources from the owner of the business or finance from the capital of the firm. The external sources of financing constitute bank finance and other forms of institutional credit.

**Measurement of access to finance:** Access to finance is measured by the number of times an SME had successfully obtained financial loan. Similarly the dependent variable access to finance was measured by the number of times an SME had successfully obtained financial assistance used by (Peter Quartey 2003). The theoretical frame work of the determinants of access to finance are presented as below.

**Accounting practice and access to finance:** One of the reasons for small firms to have less access to credit is the small firms face with information opacity such as unable to provide financial information (Binks & Ennew 1996). When the firm is small, most of the time it is owned and operated by the entrepreneur himself and there is no such legal requirement to regularly report financial information and many firms do not maintain formal financial accounts. That the lack of reliable information leads to comparably high interest rates even if a long term relationship between borrower and bank exists concluded by (Bass & Schrooten 2005).

SMEs lack of access to capital and high interest rates charges are partially the result of incomplete (or no) accounting records, and the inefficient use of accounting information. Poor record keeping and accounting information make it difficult for financial institutions to evaluate potential risks and returns, making them unwilling to lend to SMEs (World Bank 1978). As a result, SMEs pay high interest rates or fall back on the middlemen or moneylenders, whose loans are costly and often restrictive (Institute for Small and Medium Enterprises Development). The misuse and inaccuracy of accounting information causes SMEs to inaccurately assess their financial situation, and make poor financial decisions, as well as leads them to face with the high failure rate (Byron 1976).

In view of their smallness, they need continued support in the functional areas of their businesses. The often neglected area is the accounting and finance function of the small business and yet this has not attracted much interest from the support agencies. This being so despite findings from empirical studies showed the lower intake of working capital management by small firms (Howorth and Westhead, 2003) and the absence of accounting systems to provide owner-managers with information about their business (Dodge and Robbins, 1992).

**Collateral and access to finance:** One constraint of the SME's inability to access funds are the general inability on the part of SME's to provide acceptable collateral/securities to back up their loan request.

Previous researchers suggest that bank financing will depend upon whether the lending can be secured by collateral (Berger and Udell, 1998). Other factors held constant, firms with more intangible assets need to borrow less, compared with firms with more tangible assets, because of collateral factor stated by (Johnsen and McMahon 2005). In the previous research, collateral has been proxied by land, machinery or personal assets (Kumar and Francisco, 2005). Plant and machinery divided by total assets as a proxy for the securability of assets used by (Bennett and Donnelly 1993). Three proxies for the collateral asset attribute, namely, the ratio of land and buildings to total assets, the ratio of plant and equipment to total assets and the ratio of inventories to total assets used by (Bhaduri 2002).

SMEs have fewer collateralisable assets than large firms. This may partly relate to the stage of growth the firm belongs to. In the earlier stages of the firm, it may have lower retained profits which may hinder them to purchase fixed assets compared to the larger firms which has a longer history. Another reason for small firms to have a smaller proportion of fixed assets is the capital constraints faced by them. Because of the need to raise large amounts of capital, it finds difficult for them to acquire a large number of fixed assets.

**Age of the firm and access to finance:** Firms' sources of finance change over time. For instance, a firm may start as a family owned business, by using its internal financing sources such as personal savings and family finance. Subsequently, it will then grow to

obtain funds from its suppliers. When it has well established a good business track record, developed accounting systems and established a legal identity, it may be able to obtain loans from banks.

Therefore, it is worth investigating the firm age. A number of studies have found that there is a correlation between firm age and access to credit. Being in the business for many years suggests that the firms are at least competitive on average. It can be argued that being an older firm means there is lower informational opacity. The reason is information required by the lenders to evaluate and process applications is readily available because these businesses have an established reputation or track record.

On the other hand, the new firms are not likely to meet the collateral requirements of the banks since they have not accumulated sufficient assets. Combined with the absence of information on their financial records, this makes difficult to lenders to assess lending proposals submitted by new firms.

The studies conducted in the past have found that the financing constraints are particularly severe in start up enterprises and relatively young firms (three years old or less). For example, Aryeetey et al (1994) conducted a survey of 133 firms, of which 76 had less than 10 workers, in various industries in Ghana in the early 1990s. They found that only 10 percent of start up firms in Ghana could obtain bank loans but medium size enterprises and older firms are provided with credit three times more often than their smaller counterparts. The similar survey was conducted in Sri Lanka and Tanzania and

reported that 80 percent of firms with 16 or more workers and with 6 or more years in operation are able to access bank loans, compared to the success rate of around 55 percent in the case of smaller firms with 6-15 employees of similar age, and less than 10 percent for firms with 5 or fewer workers, regardless of age (Levy 1993).

### 3.4 Empirical model

**Measurement of accounting practices:** Based on the evidence presented previously the accounting practice of SMEs is measured based on their normal recording system, preparation of balance sheet and income statement. Based on this firms with no recording system and other accounting tasks is seen as firms do not maintain any accounts, firms with only keeping records do not maintain financial reports is considered as maintaining minimum accounts, and firms with standardized recording system based on IASB, prepare balance sheet and income statement is considered as firms maintaining formal accounting practice.

Firms do not maintain any record is valued=0, firms maintain minimum accounting is valued= 1 and firms maintain formal accounting practice is valued=2

**Measurement of access to finance:** In order to provide evidence on who gets credit among SMEs, the firms are divided in two based upon their response to question whether they have a bank loan. If the firm answered „Yes”, they are classified as non constrained firms”. If they answered “No” there may be two possibilities. One possibility may be that they do not need credit or did not apply credit due to religious or cultural reasons (voluntary exclusion). Others may not have a loan due to the reason that they applied for a bank loan and rejected by the bank or did not apply for a loan thinking it will get rejected by the bank. All of these types of firms are classified as non borrowers and categorised as constrained firms” in this research. Therefore access to finance is measured by the number of times (frequency) firms get access to credit from banks each year.

**Age of the firm:** The number of years in business has been identified as an important variable in the previous studies which determines the accounting practice and creditworthiness of the business. The information required by the lenders at the time of granting credit may be limited for younger firms due to lack of established track record. Hence, the transaction costs associated with lending to younger firms are likely to be relatively high. Further, the younger firms may not be able to offer collaterals acceptable to the banks as those firms have not accumulated sufficient fixed assets.

Age of the business is measured by the number of years the business in operation. For this analysis purpose the average of each age interval is taken and the ceiling age used was 20 years.

**Collateral:** The collateral of the firm is measured using fixed asset to total asset ratio. It is measured as follows:

$$\text{Tangible asset/collateral} = \text{tangible net fixed assets} / \text{total assets}$$

**Education level of the manager:** Education of the principal owner manager is redefined by categories from 0 to 4, corresponding to whether manager is illiterate, less than grade 9, grade 9 to twelve complete, TVET/Diploma and BA/BSC degree and above. The education variables is managers level of education (illiterate =0, less than grade nine =1, grade nine to twelve complete = 2, TVET/Diploma= 3, BA/BSC Degree and above=4).

**Accounting practice of the firm:** For the test of access to credit accounting practice is an independent variable which takes a value (0= do not maintain any records, 1=maintain minimum records and 2= maintain a formal accounts).

**Capital:** Capital is an independent variable which is measured using capital to total asset ratio. It is measured as:

$$\text{Capital} = \text{Capital} / \text{total asset}$$

Depending on the theoretical model and the measurements of the variables explained above, the empirical model that this study employs is given by:

$$\text{ACP} = \beta_0 + \beta_1 \text{CAP} + \beta_2 \text{EDU} + \beta_3 \text{AGE} + \epsilon \dots \dots \dots (1)$$

Where;

ACP: accounting practice

$\beta$ : coefficient

CAP: Capital

EDU: Education

AGE: Age of the firm

$\varepsilon$  :error term

In the same manner, the empirical model of access to finance is given by:

$$AF = \alpha_0 + \alpha_1 COL + \alpha_2 ACP + \alpha_3 AGE + v \dots\dots\dots (2)$$

Where;

AF: Access to finance

$\alpha$ = coefficient

COL: Collateral

ACP: Accounting practice

AGE: Age of the firm

$v$ = error term

### *3.5 Methodology*

In this section the methods and techniques of estimating analysing the above models and other variables are discussed. To start with, the models of accounting practice and access to finance developed under the empirical model section are estimated using simple ordinary least square (OLS) method. The sources of fund and other variables, on the other hand, are analyzed using descriptive analyses such as tables, percentages and bar.

As explained in different econometric models, there is a need to test the presence of multicollinearity as its presence leads to biased estimates. This study employs simple correlation coefficients between the explanatory variables to test the presence or absence of multicollinearity. Following some authors (e.g., Studenmund, 2001) it is argued that the test does not detect the existence of severe multicollinearity of explanatory variables if the values of the correlation coefficients between the explanatory variables are lower than 0.8. This study also uses the same argument.

In addition to testing the presence of multicollinearity, this study also considers the goodness of fit of the model. As it is discussed in different econometric models, the goodness of fit of a model for a simple OLS model is tested by R square. The R square of a model explains how good the model is in explaining the dependent variable. In other words, it explains the explaining power of the explanatory variables on the dependent variable. In this regard, if the independent variables included in the model explain the dependent variable well, the better is the model and the more R square approaches to one.

On the other hand, if the independent variables included in the model do not explain the dependent variable well, the goodness of the model is not fit and the value of R square approaches to zero (Gujurati, 20004).

## CHAPTER FOUR

### RESULTS AND DISCUSSIONS OF DESCRIPTIVE ANALYSIS

#### 4.1 Descriptive statistics

The pattern of distribution and retrievals of questionnaire, in accordance with the different business classes, i.e. small and medium enterprises, provides very useful insights into the spatial concentrations of such businesses in Addis Ababa.

Accordingly, an attempt is made here, to summarize these response patterns as revealed by the results of the survey. It should however be appreciated, right from the on-set, that what governed the proportional distributed between the small and medium scale enterprises was the degree of spread across the city .

A total of 112 questionnaires were distributed across the various SME in Addis Ababa, out of which the whole 112 were completed and retrieved, representing 100% retrieval (response) rate. Out of the 112 questionnaires administered 75 and 37 were distributed to Small and Medium scale enterprises respectively. The number of questionnaires retrieved from small and medium scale enterprises are 75 and 37 respectively. This represents a retrieval rate of 100% for both small and medium scale enterprises.

#### 4.1.1 Distribution of the SME's by the legal status and size

The legal status of the firms was analysed in terms of whether they are sole proprietorships, partnerships, private limited company. The size of the business is also analysed as small and medium sized enterprises. The study result is depicted below on the legal status and size of SME Addis Ababa.

**Table 4-1** Distribution of the SME's by the legal status and size

Legal status	Business by size	Number	Percentage
Sole proprietor	Small	29	39
	Medium	7	19
Partnership	Small	10	13
	Medium	6	16
Private Limited company	Small	36	48
	Medium	24	65

Source: Own survey

The result revealed that sole proprietorship represent 32 percent of the sample SME, out of which 39 percent is small scale business and medium scale enterprise claim 19. Private limited company takes the lion share of sample SME that is 54 percent of sample firm is under this legal status, from this it has 48 percent of sample small scale enterprise and 65 percent of sample medium enterprise.

Partnerships, according to survey reports, are less prominent in the city. This category of legal status represents only 14 percent of all the sample firms. This firm has 13 percent of sample small scale enterprise and 16 percent of sample medium scale enterprise.

#### 4.1.2 Age of the SME

It is of interest to test if the business life cycle model has an impact on the sample firms accounting systems. A similar finding was reported by Dodge and Robbins (1992) and Kesseven Padachi (2008). The survey result is depicted in the following table.

**Table 4-2** Age of the SME

Year of operation	Business by type	Number	Percentage
1 to 7 years	Service	4	12
	Retail	7	12.5
	Wholesale	2	9
Above 7 years to 11 years	Service	6	18
	Retail	14	25
	Wholesale	4	17
Above 11 years to 15 years	Service	13	39
	Retail	13	23
	Wholesale	5	22
More than 15 years	Service	10	30
	Retail	22	39
	Wholesale	12	52

Source: Own survey of SME;

As shown in the above table the survey result has indicated that the years of establishment of the enterprises in the city ranged from one to more than fifteen years. There is an indication that most of the firms were established before fifteen years ago as shown by the survey results. In the Wholesale business 52 percent of the enterprises were established in the last fifteen years, retail recorded 39 percent and service accounted for 30 percent. Business lines that fall under the above 11 to 15 year range accounted for 39 percent of service business, 23 percent of retail business and 22 percent of wholesale business. Similarly business lines that fall under the above 7 to 11 year range accounted for 18 percent service business, 25 percent retail business and 17 percent wholesale business.

However, the distribution of enterprises that were established between 1 to 7 years ago has relatively fewer. Apart from service business which claimed 12 percent, retail business claimed 12.5 percent and wholesale business accounted for 9 percent.

An analysis of the distribution based on year of establishment by major lines of business under the different business classes shows that the oldest firms in the city are mostly found under the wholesale and retail business and these were established more than ten years ago. Very few enterprises indicated that they were established between 1 to 7 years ago.

The cross tabulation reveals that most of firms in the age of above 11 to 15 years (45%) and more than 15 years (52%) keep formal accounts and pay more attention to accounting routines. It may thus conclude that the accounting tasks are seen more as a necessity and not as a normal function among the small to medium sized in Addis Ababa SME. Firms below 1 to 7 years of age are in its establishment stage and may thus have very basic systems of recording.

#### 4.1.3 Management of the SME

SMEs can be managed by different individuals such as; by owners, by employee/salary manager or some other individuals. The following table 4-3 displays the manager of sample SME.

**Table 4-3** Management of the SME

Manager of the SME	Number	Percentage
Owner	68	61
Employee manager/salary manager	33	29
Someone else	11	10

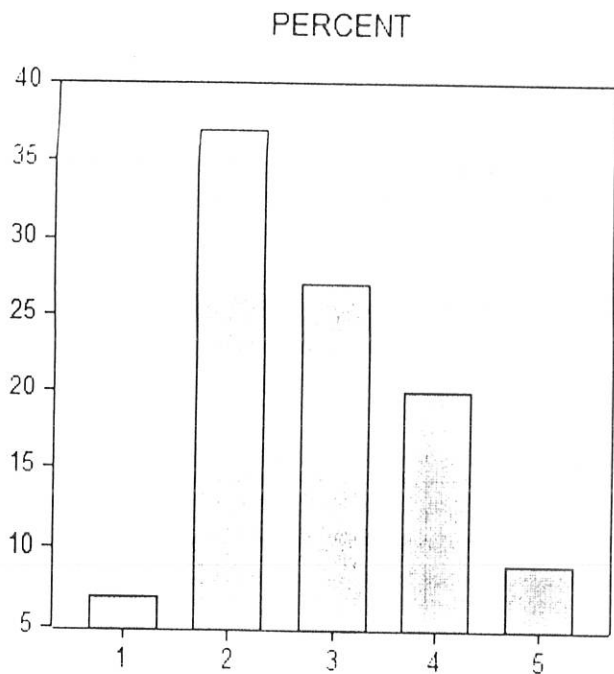
Source: Own survey of SME

Table 4-3 displays the sampled firms' management structure under three categories; namely owner, employee manager (salary manager) and others (someone else).

The largest proportion of sampled SME's 61 percent was owner-managed, 29 percent were salary-managed firms and firms managed by others individual(s) is/are accounted for 10 percent of the total sample. It included from the above facts the managers' educational level and accounting skills are the determinant for the firms accounting practice.

#### **4.1.4 Level of Education of the SME managers**

The low intake of accounting as one of the key contingent factors in an SME adopting new accounting procedures may be related to the background and attitude of the manager. They may be well versed with the product/service that their businesses deal with. However, they may not be trained or proficient in business management skills, especially at the early stage of the business life cycle. The following figure 4-1 shows the academic background of the SME manager.



**Figure 4.1:** Level of Education of the SME managers

Source: Own computation

Note: the numbers on the horizontal axis: 1, 2, 3, 4, and 5 are illiterate, less than grade 9, grade 9 to 12 complete, TVT or diploma and BA/ BSc and above, respectively. The vertical axis represents percentage of educational level.

The study result reveals that there is only 7 percent manager within the sample SME with no formal education, 37 percent had obtained less than grade nine educations, 27 percent had obtained at grade nine to twelve complete education, 20 percent had obtained TVET/diploma level of education and 9 percent were university graduates with BA/BSC degree and above. More over 18 percent have professional qualifications in Accounting, Marketing, Management and economics. The relatively high literacy rate within

management of SMEs in the city may have helped these firms to maintain an accounting record and in getting access to finance. The study result revealed that most of firms with manager's academic background of accounting, marketing, management and economics maintain formal accounting practice and have access to finance than other firms.

#### 4.1.5 The role of the manager in SME firms

The role of the manager is the main determinant for the firms success. The main role of the manager is categorized as; overall responsibility, administrative and finance and some other responsibility. The survey report is depicted in the table 4-5 below.

**Table 4-4** the role of the manager in SME firms.

Main roles	Number	Percentage
Overall responsibility	74	66
Administrative and finance	38	34
Some other responsibility	-	-

Source: Own survey of SME

The survey has indicated that the largest proportion of the SME managers' main role is the overall responsibility of the firms. The study result shows that 66 percent of sampled SME managers' role is overall responsibility. Where managers responsible only in administrative and finance is accounted for 34 percent of the sampled SME. Thus, in the majority of the cases, the manager oversees all the operational aspects of the enterprise

and may thus have no time to perform even some of the basic accounting routines. In addition to this a significant number of manger is also engaged in administrative and finance, which indicates that manager education is the determinant variable for the firm accounting practice.

#### 4.1.6 Accounting practice of SME

Accounting may be the key to small business success. Wichmann (1983) reported the results of an analysis of Small Business Institute (SBI) cases, which were grouped into seventeen problem areas. Accounting was found to be the most frequent problem, and the number one in this category was recordkeeping (60%). The study result is depicted below in the table4-5.

**Table 4-5** Accounting practice of SME

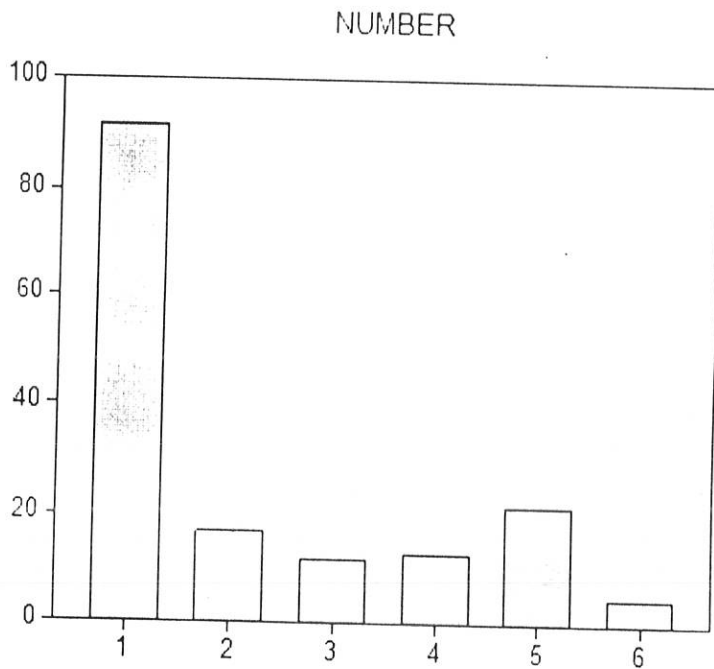
Accounting system	Number	Percent
Do not maintain any accounting	–	–
Maintain minimum accounting	65	58
Maintain formal accounting practice	47	42

Source: Survey of SME 2011

The survey result indicates that most of the sampled SME is not maintaining a formal accounting. That is firms that maintain only minimum records is accounted for 58 percent of the sampled SME's and firms maintain formal accounting is accounted for 42 percent of the sample. Thus in the majority of the case the failure of firms in getting access to finance may be because of not maintaining a formal accounting.

#### *4.1.7 Source of financing SME at start-up and expansion of the business*

There are a lot of sources available for the financing of SMEs sector. This includes among others own savings, friends/relative, iqub, microfinance, Banks, and informal money lenders. These sources of financing SMEs are available in Ethiopia but having access to some of the sources is a major constraint and has hampered the growth of the SME sector. The survey report on the sources of finance to SMEs is presented in figure 4-2 below.



**Figure 4.2:** Source of financing SME at start-up and expansion of the business

Source: own computation

Note: the numbers on the horizontal axis: 1, 2, 3, 4, 5 and 6 are own saving, friend/relatives, iqub, microfinance, bank and informal money lenders, respectively. The vertical axis represents percentage of educational level.

The above table displays an SME source of financing for the start up and expansion of the business. The study result shows that a large proportion (82%) of respondents started and expand business with their own money, this followed by money obtained from relatives and(or) friends (15%), iqub schemes (social capital) claim 11%, microfinance institutions (11.6 %), banks (19.6%), and informal money lenders (4.5%). This indicates

most of the SMEs do not have access to the credit giving by financial institutions. Although money raised from finance institution is not a major source of start-up capital and expansion of business, its contribution is quite significant.

#### 4.1.8 Constraints in accessing to credit

There are a lot of constraints for getting an access to credit among SMEs sector. This includes among others accounting practice, Collateral, size of the business, initial capital, total debt and others. The survey report is presented below on the constraint to get access credit among SMEs sector in Addis Ababa.

**Table 4-6** Constraints in accessing to credit (Total firms 90)

Constraints	Number	Percent
Accounting practice	32	35.5
Collateral	42	46.7
Age	19	21
Others	27	30

Source: Own survey of SME

The survey result indicates that SME's in Addis Ababa are more credit constrained because of the different factors. The study observed a positive relationship of access to finance with the factors such as; accounting practice, collateral, age of the firm and other factors. This is 35.5 percent of sample SME's lack access to finance because of

poor(minimum) accounting practice, collateral claim 46.7 percent, age of the firm 21 percent, and other factors claim 30 percent of the sample. This indicates that accounting practice of the SME is significantly affects access to credit of the firm.

#### 4.1.9 Frequency of accessing to credit

The frequency of accessing to credit of a firm each year certainly indicates the access to credit of the firm. The table 4-9 below shows the frequency of SME accessing to bank credit in the year 2010.

**Table4-7** Frequency of accessing to credit

Frequency	Number	Percent
No access in a year	9	41
Only one time	11	50
Two times	2	9

Source: survey of SME 2011

As revealed in the above table the frequency of accessing to credit range from less than one time in a year to two times a year. From sample SME having access to credit 42 percent have no access to credit in a year, 50 percent have one time access to credit in a year and 9 percent have two time access to credit in a year. Therefore the above result may indicates that most of firms have only one time access to finance in a year and only a few firms have two times access to finance in a year.

A significant number of firm have no access to finance in year this is because of the fact that they were borrowed long term loan in the previous year.

#### 4.1.10 Accounting tasks of SME

Accounting may be the key to small business success. Wichmann (1983) reported the results of an analysis of Small Business Institute (SBI) cases, which were grouped into seventeen problem areas. Accounting was found to be the most frequent problem, and the number one.

**Table 4-8** Accounting tasks of SME

Practices/accounting tasks	Number	Percent
Keeping records	112	100
Payroll	112	100
Taxation/ VAT	93	83
Bank statement	22	20
Income statement	36	32
balance sheet	27	24
Periodic management accounts	60	53
Inventory and cost controls	53	47
Break even analysis	–	–
Cash budget	7	6.25
Sales budget	8	7
Expenses budget	8	7
Budget variance analysis	–	–
Ratio analysis	–	–
Working capital management	18	14

Source: Own survey of SME

The survey result indicates that most of the sampled SME maintain only a limited (minimum) accounting practice. Accounting practice maintained by most of the firm is as follows; 100 percent of the sample firm prepare payroll and maintain a minimum records. From the sample SME 83 percent is the VAT register and maintain a VAT records. 20 percent, 32percent, 24percent, 53percent, 14 percent and 47 percent of sample firm maintain bank statement, income statement, balance sheet, periodic management account, working capital management and inventory and cost control respectively. Only a few number of the maintain cash budget, sales budget and expense budget. There is no firm which prepares break even analysis, budget variance analysis and ratio analysis account. Therefore this study evidence the poor accounting practice of most of the SME in the city.

#### **4.1.11 General Profile of Surveyed Banks**

As mentioned earlier in the paper, the study interviewed 6 banks to ascertain the nature of their operations particularly the credit service they offer to SME in Ethiopia. The institutions visited include the commercial bank of Ethiopia, business and construction Bank of Ethiopia, Dashen Bank, Awash international Bank, Oromia international bank and cooperative bank of Oromia. Government owned Banks accounted for 33.33 percent of the sample and the rest is private owned banks.

Banks providing financial services to SMEs were asked to rank their credit portfolio from 1 to 3 (1-very importantly, 2-importantly, 3-less importantly). The table4-11 below summarizes the response of sampled banks.

**Table 4-9** General Profile of Surveyed Banks

Bank requirement	Rank					
	Very importantly(1)		Importantly (2)		Less importantly(3)	
	Number	Percent	Number	Percent	Number	Percent
Financial information	4	67	2	33	–	–
Collateral	3	50	3	50	–	–
capital	4	67	2	33	–	–
Age of the firm	1	16.7	4	67	1	16.7

Source :own survey of banks

Six selected Banks providing financial services responded to this question and their responses are as follows: 100 percent of respondents gave a rank of 1 and 2 for the requirement of financial information. This indicates that SME serving banks attach very importance and importance to the requirement of financial information provision in their credit portfolio. Banks require maintaining formal accounting, but sometimes if the other requirement like collateral is exist the financial accounting requirement is maintaining only minimum records for example commercial bank of Ethiopia. From the financial information, information commonly required by banks are; income statement, balance sheet and a relatively few banks require statement of cash flow. In the case of collateral,

100 percent of the institutions gave a rank of 1 to 2. This is a possible indication that collateral based financing ranks high among the credit portfolio of these banks.

Age of the firm is also seen as a requirement by the most of the banks. The study result reveals that 83.7 percent of sample banks require age of the firm very importantly and importantly. Only 16.7 percent of sample banks see age of the firm less importantly.

Because of the above reason and others banks are reluctant in lending loan SMEs. Similar finding were made that the formal financial institutions are reluctant to avail credit facilities the sector. Formal financial institutions such as commercial banks are reluctant to lend small amounts of money to small businesses because the cost of administering the loan exceeds the benefits accrued to them (Eshetu Bekele and Mammo Muchie 2009).

## CHAPTER FIVE

### REGRESSION RESULTS AND DISCUSSIONS

#### 5.1 Multicollinearity test

To check whether there is multicollinearity in the model the simple correlation coefficients between the explanatory variables have been examined. Following some authors (e.g., Studenmund, 2001) it is argued that the test does not detect the existence of severe multicollinearity of explanatory variables if the values of the correlation coefficients between the explanatory variables are lower than 0.8. Following the same argument, as one can see from table 1 and 2 on the appendix 2, values of all the correlation coefficients between explanatory variables are lower than 0.80, there is no severe multicollinearity between the explanatory variables under consideration.

This section employs econometric analysis to ascertain the determinants of SME accounting practice and access to finance. The analyses were specifically examining determinants of accounting practice and access to credit. Although statistical computation has been used above, the compelling reason for using a regression technique is that it estimates the impact of each explanatory variable after allowing for variations in the dependent variables. The regression is the result of the five year (2006-2010) relationship between the dependent and independent variables.

### 5.1 Accounting practice of SME Regression results

The output of regression on the accounting practice of SME is shown in the following table 5-1.

**Table 5-1:** Results of ordinary least square regression for firm accounting practice

Accounting practice	Coef.	Std. Err.	P>t
Age	.0893091	.0009677	0.007
Capital	17.32594	.2968292	0.011
education	2.413027	.03533	0.009
_cons	19.84139	.3181748	0.010

The OLS regression result shows that the P-value of an independent variable age is (0.007). This suggests that the age of a firm is statistically significant determinant of accounting practice at 1 percent significant level. The fact that the coefficient of the variable is positive implies that the variable has a positive effect on accounting practice

In the case of variable capital the OLS regression results revealed that capital has a significantly positive influence on firm accounting practice. The P-value of an independent variable capital is (0.011), which indicates that the capital has positively influence firm accounting practice at a 5 percent significant level. Truly coefficient of the variable is positive implies that the variable has a positive effect on accounting practice

Similarly the OLS regression results revealed that the variable education has a significantly positive influence on firm accounting practice. Capital exerts a positive significant influence on firm accounting practice at a P-value of (0.009). Therefore manager education is significant at a 1 percent significance level. The fact that the coefficient of the variable is positive implies that the variable has a positive effect on accounting practice.

Finally the goodness fit of the model is tested using R square. The R square of a model explains how good the model is in explaining the dependent variable. As shown in appendices table-2 the model is good fit at R square of 0.9999. This implies that the independent variables included in the model explain the dependent variable well and the better is the model.

## 5.2 Access to finance regression result

The output of a regression on access to finance of SME is shown in the table5-2 below.

**Table 5-2:** Results of ordinary least square regression for access to finance

Access to finance	Coef.	Std. Err.	P>t
Collateral	2.361374	.1651681	0.044
Accounting practice	.3038975	.0198569	0.042
Age	0.627283	.0054186	0.055
_cons	.8807507	.0590386	0.043

The OLS regression results indicates that accounting practice positively influence the access to credit of the firm. That is accounting practice positively influence a firm access to credit at a P-value of (0.042). Therefore accounting practice is significant at a significant level of 5 percent. Coefficient of the variable is positive implies that the variable has a positive effect on access to finance.

The result also reveals that collateral exerts a positive and significant influence on access to credit of the firm. The result indicates that collateral positively influence a firm access to credit at a P-value of (0.044). Therefore collateral is significant at a 5 percent significance level. The fact that the coefficient of the variable is positive implies that the variable has a positive effect on access to finance.

Similarly the OLS regression result shows that the P-value of an independent variable age is (0.055). This suggests that the age of a firm is statistically significant determinant of accounting practice at 10 percent significant level. The fact that the coefficient of the variable is positive implies that the variable has a positive effect on access to finance.

Finally the goodness fit of the model is tested using R square. The R square of a model explains how good the model is in explaining the dependent variable. As shown in appendices table-4 the model is good fit at R square of 0.9991. This implies that the independent variables included in the model explain the dependent variable well and the better is the model.

## CHAPTER SIX

### CONCLUSIONS AND RECOMMENDATIONS

#### 6.1 Conclusion

SMEs are an important ingredient for stable and equitable growth in any national economy. Ethiopia takes the development and expansion of SME's as the main way to solve many of the social problems. At present in Addis Ababa various reforms and development activities are being carried out. One of these is the promotion and development of SME's in the city.

Considering the enormous potentials of the SMEs sector, and despite the acknowledgement of its immense contribution to sustainable economic development, its performance still falls below expectation in many developing countries. SMEs frequently lack access to institutional credit, causing them to encounter high financing costs and high failure rates. Similarly in Addis Ababa SMEs continue to exist with many problems among others are; inability to maintain accounting practice and lack of access to credit. SMEs lack of access to credit and high interest rates charges are partially the result of incomplete (or no) accounting records, and the inefficient use of accounting information. Poor record keeping and accounting information make it difficult for financial institutions to evaluate potential risks and returns, making them unwilling to lend to SMEs. Age of the firm and collateral are also the other determinant factor of the access to finance.

Incomplete (or no) accounting practice of SMEs is the result of limited capital they have, age of the firm and manager level of education. These are the determinant of the accounting practice of the SME. All the above problems hinder SME not to continue to expand and function as expected in the country.

## **6.2 Recommendations**

Based on the findings of the study, the following recommendations can be drawn.

- There is the need for clear national development objectives to meet the needs of the SMEs sector. Sound policies and regulations should be developed since this sector is the missed sector in the country particularly medium sized business.
- Since there is international acceptance that SME require simplified financial reporting standards fitting their reduced size and narrow stakeholder base, the government needs to adopt Simplified financial reporting standards set for SME.
- Government should accelerate the development of market for financial services suited to the special characteristics of SMEs by promoting product innovation and building institutional capacity. Improving SMEs access to credits requires an increase in the number of financial institutions that find lending to SMEs to be profitable and therefore sustainable.

- Easy accessibility to credit through specialized or development oriented banking or financing institutions. Funds being made available through these sources should be given at preferential interest rates.

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## APPENDICES

### Appendix 1: Questionnaires

ADDIS ABABA UNIVERSITY

SCHOOL OF BUSINESS AND PUBLIC ADMINISTRATION

DEPARTMENT OF ACCOUNTING AND FINANCE

This questionnaire on the subject "Accounting practice of small and medium sized enterprises and its effect on access to finance in Addis Ababa " has been designed purposely to source information on accounting practice of the firms and credit delivery to start-up and/or expand SMEs businesses in Addis Ababa through the external sources of finance. The information supplied will be treated in utmost confidentiality and use mainly for the purpose in which the study is intended (Only for academic purpose).

Your honest and objective answers to the following questions will be highly appreciated and acknowledge. This is the question to be filled by the owner or the manager of the business. Please answer the following question accordingly; by choosing best alternative for multiple choices and for the box provided put a tick mark (✓) in the appropriate box provided for the answers. You may have more than one choice depending on some questions.

Name of your business \_\_\_\_\_ (optional)

1. What is the type of your business?
  - a) Service      b) wholesaler      c) Retailer
2. How old is your business?
  - a) 1 to 7 years      b) Above 7 years to 11 years
  - c) Above 11 years to 15 years      d) More than 15 years
3. What is the number of your employees?
  - a) five to twenty      b) twenty one to ninety nine
4. Who is the manager of your business?
  - a) The owner      b) employed manager/salary manager      d) someone else
5. What is your academic background?
  - a) Illiterate      b) less than grade 9      c) grade 9 to twelve complete
  - d) TVET/Diploma      e) BA/BSC and above
6. If your answer for Q.5 is TVET/Diploma and above what is your professional background?  
 Accounting     Management     Economics     Others
7. When did you complete your educational level?
  - a) In 2010      b) In 2009      c) In 2008      d) In 2007      e) In 2006      f) before 2006
8. What is your main role as the business manager?
  - a) Over all responsibility      b) administrative and finance

- c) Some other responsibility
9. What do you say about your accounting system?
- a) Do not maintain any records    b) keep minimum records    c) keep formal accounts
10. On average for what times you have been getting access to bank credit in the year 2010?
- a) One time    b) two times    c) three times    d) more than three times
11. If you maintain an accounting records who maintains it?
- a) Manager of the business    b) accountant of the business    c) external accountants
12. Could you have an access to credit for financing your business?
- Yes     No
13. If your answer for Q.11 is yes for what times do you get access to credit?
- Only One time     two times     Three times     More than three times
14. IF your answer for Q.11 is No what is your reason?
- Lack of access     No need of credit
15. Which of the following factors may hinder you in accessing credit?
- Collateral     Accounting practice
- Age of the firm
16. Is there is (are) any other thing that may hinder you not to get access to finance?
- Yes     No

17. What was the source of finance for the start up of your business?

- Own saving    Friends/relatives    Banks    Micro finance  
 Iqub    Informal money lenders

**Please put the check mark in the box provided for the question 15-19.**

18. Which of the following accounting do you practice in the business?

- Keeping records    payroll    taxation/ VAT    Bank statement

19. Which of the following financial accounting reports are you preparing?

- Income statement    balance sheet

20. Which of the following cost and management accounting do you practice?

- Periodic management accounts    Inventory and cost controls  
 Break even analysis

21. From the budgetary accounting which of the following do you prepare?

- Cash budget    Sales budget  
 Budget variance analysis    Expenses budget

22. Which of the following financial management would you practice?

- Ratio analysis    Working capital management

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Your honest and objective answers to the following questions will be highly appreciated and acknowledge. This is the question to be filled by the concerned body in the banks. Please answer the following question accordingly; by choosing best alternative for multiple choices and for the box provided put a tick mark ( $\surd$ ) in the appropriate box provided for the answers. You may have more than one choice depending on some questions.

For this study Small and medium sized enterprise (SME) is business which has employee 5 to 99.

Name of the bank (optional) \_\_\_\_\_

1. Do you have customers from small and medium sized enterprise?

Yes                       No

2. Do you agree that Accounting practices of SME lead to influence access to finance?

Yes                       No

3. Would you require provision of financial information for providing the loan to small and medium sized enterprise?

Yes                       No

If yes how do you rank it?

1) Very importantly              2) importantly              3) less importantly

4. What type of accounting system would you require from small and medium sized enterprises in order to provide the loan?

a) Keeping minimum records    b) keeping formal accounts

5. From the financial statements which one(s) do you require from the applicants for the loan?

Balance sheet     income statement

Statement of retained earning                       statement of cash flow

6. Would you require collateral for providing the loan to small and medium sized enterprise?

Yes       No

If yes how do you rank it?

1) Very importantly      2) importantly      3) less importantly

7. Do you see the age of the SME to provide them loan?

Yes       No

If yes how do you rank it?

1) Very importantly      2) importantly      3) less importantly

8. Would you see the management skill as a requirement for the provision of the loan to small and medium sized enterprise?

Yes       No

If yes how you rank it?

1) Very importantly      2) Importantly      3) Less importantly

9. Would you allow the firm with collateral but no accounting record or financial information loan ?

Yes       No

10. Would you have other criteria for the provision of loan to SME?

No       Yes

Appendix two: tests and results

Accounting practice

Table-1 Multicollinearity test

	edu	age	cap
edu	1.0000		
age	0.5906	1.0000	
cap	-0.5654	-0.4952	1.0000

**Table-2:** Regression Output of accounting practice

reg acp edu age cap					
Source	SS	df	MS	Number of obs= 5	
Model	.013318503	3	.004439501	F( 3, 1)	= 2945.78
Residual	1.5071e-06	1	1.5071e-06	Prob > F	= 0.0135
Total	.01332001	4	.003330003	R-squared	= 0.9999
				Adj R-squared	= 0.9995
				Root MSE	= .00123
	Coef.	Std. Err.	P>t	[95% Conf. Interval]	
acp					
edu	2.413027	.03533	0.009	-2.861937	-1.964117
age	.0893091	.0009677	0.007	.0770136	.1016046
cap	17.32594	.2968292	0.011	-21.09752	-13.55437
_cons	19.84139	.3181748	0.010	15.7986	23.88419

**Access to finance**

**Table- 3** Multicollinearity table

	col	acp	age
Col	1.0000		
acp	0.4866	1.0000	
age	0.5932	0.4110	1.0000

**Table-4** Regression Output of access to finance

. reg frequency col acp age				
Source	SS	df	MS	
Model	.002198001	3	.000732667	Number of obs = 5
Residual	1.9981e-06	1	1.9981e-06	F( 3, 1) = 366.68
Total	.0022	4	.00055	Prob > F = 0.0384
				R-squared = 0.9991
				Adj R-squared = 0.9964
				Root MSE = .00141


Access to finance	Coef.	Std. Err.	P>t	[95% Conf. Interval]
col	2.361374	.1651681	0.044	.2627146 4.460034
acp	.3038975	.0198569	0.042	-.5562036 -.0515913
age	.0627283	.0054186	0.055	-.1315783 .0061218
_cons	.8807507	.0590386	0.043	.1305936 1.630908

**Declaration**

I, the undersigned, declare that this thesis is my original work and has not been presented for a degree in any other university, and that all sources of materials used for the thesis have been duly acknowledged.

**Declared by:**

Name TAPA MOSISA

Signature 

Date 22/06/2011

**Confirmed by:**

Name \_\_\_\_\_

Signature \_\_\_\_\_

Date \_\_\_\_\_

Date and place of submission \_\_\_\_\_