Factors influencing SMEs access to finance: A case study of Westland Division,Kenya

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2011

Factors Influencing Small and Medium Enterprises' Access to Funding in Kenya: A Case Study of Westlands Division

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ABSTRACT

SMEs have been recognized as being great contributors to the Kenyan economy offering both employment and platform for innovative ideas. They form a larger percentage of the businesses that operate in Kenya as compared to their counterpart, the large companies. They are however faced by many constraints that hinder their performance and consequently their growth. One of the main constraints that have been highlighted over the years is the financial constraint. The need for finance is of paramount importance for the success of any firm, be it big or small. The purpose of this research was to investigate the factors that influence SMEs' access to funding.

The literature explored in this research highlight three main factors, namely firm's, financial and entrepreneurial characteristics. These form the independent variables in the theoretical framework that influence the dependent variable, that is, access to external funding. The analysis involves primary data obtained through questionnaire and interviews and secondary data from journals, books and internet.

This report contributes as a wake up call to the financial system to be more and more SMEs' sensitive and offer financial services that are all inclusive. The financing gap, in the credit market, that exists between large and small companies need to be abridged. This can be achieved by creating an enabling environment for SME, formulating regulatory framework that is SMEs' friendly, segmenting NSE for SMEs' listing. SMEs are also called up to keep good financial report and to form linkages or associations to ease the burden of accessing funds.

Keywords: SMEs, Financial inclusion, credit rating, MFIs, enabling environment

ACRONYMS

CBD	Central District Area
ERS	Economic Recovery Strategy
MFIs	Microfinance Institutions
MSMEs	Micro, Small and Medium- sized Enterprises
MSEs	Micro and Small-sized Enterprises
SMEs	Small and Medium-sized Enterprises
NSE	Nairobi Stock Exchange
SACCO	Savings and Credit Cooperative

DEFINITION OF TERMS

Credit Rating: Evaluation of the timely repayment ability of an individual or firm on debt security. Credit rating is built up on the basis of the (1) credit history, (2) present financial position, and the (3) likely future income (businessdictionary.com).

Credit Rationing: A measure employed by lending institutions to limit the availability of capital based on determinations they make about the credit-worthiness of borrowers as well as the lending environment in general. Raising interest rates above current market rates, regardless of the supply and demand equilibrium, is seen as a form of credit rationing (businessdictionary.com).

Default Risk (Default): Is the probability or likelihood that a borrower will not make the contractual interest and principal payments in time (Czarnitzki and Kraft, 2007).

Financial Inclusion: This is about creating financial systems that support all people – especially those previously excluded – by providing access to financial services delivered in a convenient, reliable and affordable manner. It's elimination of price and non-price barriers to financial services (businessdictionary.com).

MSMEs: Micro are rated as firms employing 1 to 10 employees; Small are classified as firms employing 11 to 50 employees; while Medium firms are classified as those employing 51 to 100 employees. MSMEs include both MSEs and SMEs (Onyango, 2010). The term 'SME' is used in this research to mean those firms with less than 100 employees.

Asymmetric Information: The view that the borrower has more information than the lender on his ability to repay the loan, the viability of the project, and the use of the money being borrowed (businessdictionary.com).

1.0 INTRODUCTION

Micro, small and medium sized enterprises are credited to offering about 75% of the general employment and contributing about 18% of GDP in the Kenyan economy. These enterprises cut across all sectors of economy including general trade (wholesale and retail), services, farm activities and manufacturing (Atieno, 2009). In a state-controlled economic system, though in this millennium is rarely practiced, production is the sole responsibility of the state. However, in free trade or capitalist economic system, production is in the hands of individuals or groups with little government control. A mixed economic system happens when some of the productions are operated by the state while others are left to free enterprises. Kenya practices a mixed economic system but with high capitalist tendencies. It is because of this prevailing economic system that we find a great variety of business organizations that are in the hands of individuals or groups. This variation ranges from size, ownership, products, services offered, advertising capabilities, growth opportunities, financial strengths, among others. This leads to various forms of businesses like sole proprietorship, partnership, private and public limited companies, co-operative societies for the private sector of the economy, and the public corporation for the public sector. This research investigates the factors influencing the small and medium enterprises' access to funding.

The capital needs of small and medium-size enterprises (SMEs) can be either satisfied by its own internal funds or by debt capital. The lack of access to credit remains a major constraint for the entrepreneurs in African countries. Unlike larger firms, SMEs rarely have access to public equity markets in most countries. Therefore do not have access to the public debt (Demirguc-Kunt et al 2002). Instead, they turn to banks and the credit market (trade credit, money lenders, informal lending from family/friends, and rural finance) for both short and long term credit.
Access to external resources is needed to ensure flexibility in resource allocation and reduce the impact of cash flow problems (Bigsten et al. 2000). Firms with access to funding are able to build up inventories to avoid stocking out during crises, while the availability of credit increases the growth potential of the surviving firms during periods of macroeconomic instability. Firms without access to bank funding are more vulnerable to external shocks (Nkurunziza, 2005). Credit also enables individuals to smooth out consumption in the face of varying incomes, provides income for investment and improves ability to cope with unexpected expenditure shocks. But lack of collateral and the high possibility of default can prevent individuals and small firms from obtaining credit.

Longer term relationships with a commercial bank or other financial institutions may indicate that a firm has a "formal" relationship in financial markets, which some have argued is important to help in gaining access to credit markets**.** A firm's credit history is an important determinant of whether a firm can obtain credit. Since owner and firm finances are often commingled and somewhat indistinguishable for some smaller businesses, the credit history of the owner may be just as important as the credit history of the firm (Berger and Udell, 2002, Baas and Schrooten, 2005).

SMEs have become important players in the Kenyan economy, but at the same time they continue to face constraints that limit their development and financial performance. Lack of access to financial services is one of the main constraints, and a number of factors have been identified to explain this problem. These include the segmented and incomplete nature of financial markets, which, increases transaction costs associated with financial services. On the supply side, most formal financial institutions consider SMEs un-creditworthy, thus denying them credit. Lack of access to financial resources has been seen as one of the reasons for the slow growth of firms. Difficulties in accessing credit has held back the micro and small enterprise sector in Kenya as most financial institutions view them as unstable and often place tighter lending requirements before advancing credit (Atieno, 2009).

Credit constraints operate in variety of ways in Kenya where undeveloped capital market forces SMEs to rely on self-financing or borrowing from friends or relatives. Lack of access to long-term credit for small enterprises forces them to rely on high cost short term finance. These difficulties stem from the more formal lending institutions which tend to rate all SMEs equally as un-credit worthy. However, the emergence of less formal institutions like MFIs and SACCOs do not ease this burden. These micro-credit institutions face limited expansion because of their limited funds. Their mainly short-term finance means they cannot easily turn the savings they collect into medium or long-term loans. They are also up against the cost of refinancing through the formal banking sector and have no access to refinancing either by the central bank (Wanjohi 2009).

The scenario witnessed in Kenya particularly during the climaxing period of the year 2008 testifies the need for credit among the common and low earning entrepreneurs. Numerous money lenders in the name of pyramid schemes came up, promising hope among investors, that they can make it to the financial freedom through soft borrowing. The rationale behind turning to these schemes among a good number of entrepreneurs was mainly to seek alternatives and soft credit with low interest rates while making profits. This is an indication that financial constraints remain a major challenge facing SMEs in Kenya (Wajohi 2009).

Improving access to funding for small and medium-sized enterprises is crucial in fostering entrepreneurship, competition, innovation and growth in Kenya. Access to sufficient and adequate capital to grow and further develop their activities is a difficulty faced by many Kenyan SMEs. This situation is compounded by the difficulties in accessing finance as SME financing is considered by many financial providers as a high risk activity that generates high transaction costs and/or low returns on investment. Moreover, SMEs need to meet the challenge of adapting to the changing financial environment and the increasing complexity and extent of financial acquisition (Wajohi 2009).

1.1 Statement of the Problem

The issue under investigation in this research is the factors that influence SMEs' access to external funding. These firms have not had a smooth flow. They have come into many constrains that have seen some collapse, some selling off their assets, some being acquired by others whereas others have prospered to big companies. Lack of access to financial services is one of the main problems facing SMEs in Kenya. The difficulties that SMEs encounter when trying to access financing can be due to a great range of reasons like the firm's characteristics, financial characteristic and entrepreneurial skills and experience. Other reasons may be due to inadequate financial products and services, regulatory rigidities or gaps in the legal framework, lack of information on both the bank's and the SMEs' side. Banks may avoid providing financing to certain types of SMEs, in particular, start ups and very young firms that typically lack sufficient collateral, or firms whose activities offer the possibilities of high returns but at a substantial risk of loss (Beck et al, 2008).

SMEs tend by their very nature to show a far more volatile pattern of growth and earnings, with greater fluctuations, than larger companies. Their survival rate is lower than that of larger companies. Thus, SMEs are at a disadvantage when trying to obtain financing relative to larger and more established firms. It can also be difficult for potential creditors or investors to distinguish the financial situation of the company from that of its owners (Smallbone and Wyer, 2000).

A survey on micro and small business sponsored by the Danish government and released in Kenya, on April 2010, found out that players in this sector are dissatisfied with access to finance especially from major financial institutions in Kenya. About 65% of micro, small and medium investors in Kenya, according to the survey, say that they did not receive any financial assistance from financial institutions during difficult economic times. Only 12% said they received financial help with good terms of repayment. Bankers, on the other hand, hold that borrowers with good credit ratings stand to benefit from reduced interest rates on loans, besides a waiver on other lending conditions such as collateral requirements. Defaulters, however, risk being blacklisted and locked out of the credit market and those with negative credit ratings will pay premiums on loans. The survey shows that lenders tend to shy from the SME market on fears of defaults despite the presence of financially sound firms (Onyango, 2010). This suggests that there exists a 'financing gap' when it comes to SMEs' funding, and therefore it is the purpose of this research to evaluate the factors influencing SMEs' access to funding.

1.3 Research Objectives

1. To evaluate the influence of firm's characteristics on SMEs' access to finance.
2. To evaluate the influence of financial characteristics on SMEs' funding.
3. To evaluate the influence entrepreneurial characteristics have on the SMEs' access to funding.

1.4 Research Questions

1. Do the firm's characteristics have an influence on SMEs' access to funding?
2. Do the financial characteristics influence SMEs' access to funding?
3. What influence do entrepreneurial characteristics have on SMEs' access to funding?

1.5 Justification

This research is motivated by the increasing importance in Kenya's economy of SMEs, and the continuing constraints they face in their activities. The development of SMEs has been identified as one of the strategies for generating industrialization, employment generation and poverty reduction in Kenya. This objective has been outlined in Kenya's major policy documents such as the Sessional Paper Number 2 of 1996 on Industrial Transformation to the year 2020, and Sessional Paper Number 2 of 2005 on the Development of SMEs for Employment and Wealth Creation (Republic of Kenya 1996, 2005). It has also being highlighted in the Kenyan economic blueprint of vision 2030 as one of the pillars for addressing key economic issues like poverty eradication and unemployment. However, despite these recognitions at the policy level, the sector continues to face constraints that limit its economic contribution.

This research is both an important field of study for the Kenyan government, which in line with Vision 2030, is working towards a sustainable economy that achieves the Millennium Development Goals like solving the problem of unemployment. The government in its goal through Economic Recovery Strategy (ERS) is employing all players to make this dream come true. The research is also resourceful for prospective entrepreneurs wishing to start a small business. It is also a wake up call on the lending institutions to work up a strategy that would have a wider financial inclusion.

1.6 Scope

This research focuses on small and medium enterprises in Kenya. The SMEs in Westlands, an urban town in Nairobi County, were chosen as representatives in this research. Westlands town was chosen because of its nearness to Nairobi, the capital city of Kenya and also for its accessibility to the researcher. It is also a town whose infrastructures offer an enabling environment for SMEs' growth opportunities. Westlands is a commercial centre and also one of the eight administrative divisions in Nairobi. The resource availability, as in terms of time and finance, dictated the choice and the target population. The entire population of SMEs in Westlands CBD area is 2870, and all these are grouped into 12 different clusters for easier data collection. Cluster sampling is needed especially when the target population is too large and at the same time resources are scarce (Mugenda & Mugenda, 2003). 6 of the 12 clusters are then chosen to represent all the clusters, and therefore the target population. The results of this research should therefore be interpreted accordingly to suit this scope.

1.7 Limitation

The main challenge the researcher encountered in this research was lack of proper documentation of the operating SMEs in Westlands. Due to lack of conventional definition that distinguishes micro from small, and from medium enterprises; there was a difficult because those firms that were regarded as SMEs by the city council of Nairobi actually included micro, small and medium enterprises. That is why this research also adopted the term 'SMEs' to include micro, small and medium enterprises. Forming clusters that would exclude overlap of the type of business was also a great challenge in this research. Another limitation was time and financial constrains that saw the research reducing the number of respondents to suit the available resources.

2.0 LITERATURE REVIEW

2.1 Introduction

The current interest in access to finance and financial institutions and markets can be partially traced back to a World Bank attempt to establish more rigorous data on financial systems, their structure and development (Beck et al., 2000). A number of papers and reports in recent years have further evolved the analysis and application of such work including Beck and Demirguc-Kunt (2008); Beck and de la Torre (2007); Beck, Demirguc-Kunt and Maksimovic (2004). These authors have analyzed financial access of the poor and of firms in developing countries, as well as the impact of financial access on economic development and growth.

Another set of authors has studied financial inclusion including Helms (2006) who focused on microfinance and the inclusiveness of financial systems in developing countries; Basu (2006) on financial inclusion in India; Kumar and Beck (2005) on the inclusion of the bank system in Brazil; and Tejerina et al. (2006) who looked more generally at financial inclusion in Latin America and the Caribbean. This set of literature notes a clear link between access to finance and developed financial systems, on one hand, and economic development and growth, on the other.

Financing constraints reduce firm growth by 10% for small firms but only 6% for large firms, confirming that small firms are more adversely affected by a lack of financial access (Beck et al., 2006). A survey on worldwide financial patterns that used a data from 48 countries on formal and informal banking, leasing and supplier (trade) finance notes that small firms located in countries with weaker financial systems use less external finance and especially bank credit compared to other countries (Beck et al., 2004).

2.2.1 Theoretical Framework

The theoretical framework of the study is a structure that can hold or support a theory of a research work. It presents a theory which explains why the problem under study exists. Theory is a formulation regarding the cause and effect relationships between two or more variables, which may or may not have been tested. Thus, the theoretical framework is but a theory that serves as a basis for conducting research. It helps the researcher see clearly the variables of the study; provides him with a general framework for data analysis; and is essential in preparing a research proposal using descriptive and experimental methods (Saunders et al, 2009).

This section looks at the theories or hypotheses derived from literature to test whether there are any significant relationships between the independent variables and the dependent variable. These theories focus on the determinant variables that have been identified in the previous literature which have been associated with SMEs' access to finance. In this research, the explanatory variables which follow the theories have been classified as: firm characteristics (proponent authors are Berger and Udell, Schiffer and Weder, Beck), financial characteristics (proponent authors are Bass & Schrooten, Berry, Bigsten) and entrepreneurial characteristics (proponent authors are Talavera, Xiong and Xiong, Kumar & Francisco).

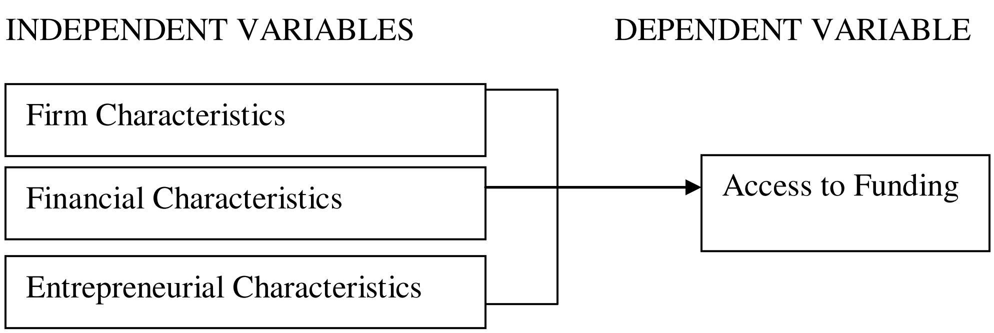

Figure 2.1: Theoretical Framework

2.2.2 Firm Characteristics

Firm characteristics affect SMEs' ability to access external finance. The size and age of the firm were identified as important variables under this category. Firm size is one of the most important variables in literature related to access to credit. This was true for both developed as well as developing countries. As this research is focused on small and medium sized firms, it does not seem logical to consider size as a determinant of access to finance. However, even among the small and medium-sized enterprises' category, there is still a large variation in the size of the firms.

Numerous studies have discussed that small and medium-sized enterprises are financially more constrained than large firms (Carpenter and Petersen, 2002). Firstly, the small firms are faced with information opacity such as inability to provide financial information. 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 audited financial accounts. Second, smaller firms have fewer assets to offer as collateral. In order to reduce the anticipated risk and moral hazard associated with lending, the banks use collateral as one of the instrument. Berger and Udell (1998) found smaller and younger firms are more likely to face higher cost of financing and at the same time they are required to offer collateral.

Thirdly, there is high risk involved because small firms have high failure rate compared to large firms. For example, Schiffer and Weder (2001) sampled firms across a number of countries and found that there was a negative relationship between the size of a business and the risk it might pose for a lender. In fact, firm size is a key variable in the analysis of financial restrictions (Beck et al., 2005). Thus, in general, large and small firms do not have equal opportunities in accessing external sources of finance. So while the presence of both large and small firms is important for market competition and, hence, for economic growth, in order to ensure industrial dynamics, firms must have access to financial markets. The firms that are typically most severely affected by the financial markets imperfections are small firms, as their internal information can be rather opaque or, at least, not as public as it is in the case of their larger counterparts. Small firms seeking small loans face higher transaction costs and higher risk premiums since they are more opaque and have less collateral to offer (Beck et al. 2006). Similar results have been found by Beck et al. (2005, and Schiffer and Weder (2001). Schiffer and Weder (2001) confirm that small firms have to confront higher barriers to their financing and growth.

Oliveira and Fortunato (2006) find that small firms face greater financial constraints and that these have a negative impact on their growth. Medium-sized firms face greater financial constraints than large firms. Small firms cannot exploit economies of scale in the same way as large firms can. These authors claim that since young companies have not accumulated sufficient cash flow and are unable to rely on bank financing, they have to depend on the original equity investment of their owners.

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. The stage of growth at which the SME is at can have a great impact on its accessibility to finance.

The studies conducted in the past have found that the financing constraints are particularly severe in startup 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 older firms are provided with credit three times more often than their smaller counterparts. A similar survey was conducted by Levy (1993) 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.

Moreover, older firms could benefit from their established bank contacts as banks use relationship lending to reduce problems of asymmetric information. Newly founded firms may not have built such relationships yet (Berger and Udell 2002). In addition, bank financing may be limited for R&D projects of young firms because of the higher default risk of young companies (Fritsch et al. 2006). Czarnitzki and Kraft (2007) suggest that a rating in the third worst category (out of six) already results in three times higher interest rates than in the best category. Assuming that especially young firms are without track record and with uncertain prospects are rated rather low, bank loans would become too expensive for those firms. Since young companies cannot rely on internal funds resulting from cash inflow from former product sales either, financing constraints may be more binding for such firms. Further literature provides evidence for the fact that young or small firms face financial constraints (Berger and Udell 2002, Carpenter and Petersen 2002, Czarnitzki 2006). For older or larger companies evidence for constraints is harder to find.

2.2.3 Financial Characteristics

Financial characteristics have been categorized into three variables namely, having audited financial statements, asset tangibility, and firm performance. Bass & Schrooten (2005) concluded that the lack of reliable information leads to comparably high interest rates even if a long term relationship between borrower and bank exists. In a situation like this, having audited financial statements play a major role. Audited financial statements are very useful in accessing credit from financial institutions because they present a picture of the financial performance of a firm. Often, banks require audited financial statements before granting credit. For example, Berry et al (1993) found that lenders in the UK pay much attention to accounting information in order to deal with the loan applications of small firms. Given the reduced information risk arising from audited financial statements, potential lending institutions may offer low interest rates as well. In other words, audited financial statements improve borrower's credibility and therefore reduce risk for lenders.

However, most of the SMEs in Kenya have difficulty in getting credit from the formal financial institutions because they lack proper financial records. Most of the businesses often keep multiple sets of books and do not have audited financial statements based on reliable accounting standards. On the other hand, these firms end up getting loans at higher interest rates because banks considered them as high risk borrowers. Asymmetric information problems may be more pronounced for small firms (Wanjohi 2009). Monitoring SMEs is more difficult and expensive as information on them is less easily available, they have less credit history, are subject to less rigorous reporting requirements and the quality of their financial statements may vary (Pettit and Singer 1985). All these elements result in SMEs often facing difficulties in signaling their creditworthiness.

Previous researchers suggest that bank financing will depend upon whether the lending can be secured by collateral (Storey, 1994; Berger and Udell, 1998). When other factors are held constant, firms with more intangible assets need to borrow less, compared with firms with more tangible assets, because of collateral factor. SMEs have fewer collateralizable 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 have 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.

In perfect markets all valuable projects should be funded (Merton 1987); therefore, the income gearing approach (used for large firms) to bank lending is preferable to the traditional capital gearing (used for small firms) method since it relies on the firm's future performance rather than on the provision of collateral. However, this requires the bank to understand how the firm and its markets operate; for banks, the assessment of future cash flows is often unfeasible. Smaller firms suffer most from these problems (Giudici and Paleari 2000). Additionally, the income gearing approach requires the firm to provide the bank with up-to-date information which has been argued to be a problem. In summary, for SMEs that apply for a loan, banks usually rely on the capital gearing method.

Although it is difficult to construct the measures for firm performance in the SME sector, some studies have attempted to do this and found that greater sales and profits are associated with greater access to credit (Bigsten et al., 2000).The European Commission (2003) also stated poor business performance as one of the reasons for not receiving Credit. In addition, firms with increasing sales and increasing sales turnover ratios would be expected to have less credit constraints.

2.2.4 Entrepreneurial characteristics

Entrepreneurial characteristics have profound consequences for running a business. In the case of SMEs the owner's characteristics are hard to separate from those of the business. Previous research has been conducted to explore the managerial characteristics and enterprise growth. It is generally assumed that individuals who have certain business or management ability will influence their success in business. Schmitz (1982) also highlighted that the small scale producers in developing countries fail to expand primarily because they lack managerial ability.

For this reason, entrepreneur related factors take a priority position in all credit assessments by the borrowers. The entrepreneur related factors are educational background, experience and networks. Past research found a positive relationship between higher educational qualifications and business growth (Kozan, Oksoy, & Ozsoy, 2006). Education affects entrepreneurs' motivation (Smallbone & Wyer, 2000). Furthermore, education helps to enhance the exploratory skills, improves communication abilities and foresight. These enhanced skills are positively related to presenting a plausible case for a loan to a banker at the time of preparing a loan proposal and hence convincing the banker during the client interview.

Previous research, in particular has explored how the managerial education affects the access to credit. For example, Kumar & Francisco (2005), found a strong education effect in explaining access to financial services in Brazil. They also found that graduates had the least difficulties raising finance from banks. The researchers have given three interpretations for this finding. Firstly, more educated entrepreneurs have the ability to present positive financial information and strong business plans and they have the ability to maintain a better relationship with financial institutions compared to less educated entrepreneurs. Secondly, the educated managers/owners have the skills to manage the other functions of the business such as finance, marketing, human resources and these skills results to high performance of the business which helps those firms to access finance without any difficulty. The third reason stems from the supply side, where the bankers value higher education level of the owner/manager in the loan approval process as an important criterion.

Previous researchers have found positive relationships between previous management experience and business growth, and therefore better placed in accessing finance. Furthermore, Storey (1994) explains that this is due to the desire of owner/managers to exceed the wage level they sacrificed in becoming self-employed. He emphasizes the positive effect of past experience on small business growth by proposing that owner-managers with previous experience are more likely to avoid costly mistakes than those with no prior experience.

Researchers have also emphasized that networks can be used as the solutions to overcome the problems of access to limited resources and markets (Atieno, 2009). It is also argued that networks help to provide advice, information and capital to small firms. Applying this idea in the context of banking, it can also be argued that, being associated with a professional, trade or social associations such as clubs, societies or associations may also lead to having access to bank loans.

Talavera, Xiong and Xiong (2010) investigated the impact of social capital on financial obstacles faced by entrepreneurs using a pooled data of about 270 small companies. The researchers concluded that membership in business associations increase the probability of having a loan by 14.8 percent. They have acknowledged that networking sometimes called external relations, of firms among industry, trade associations and other forms of association create learning by facilitating the sharing of knowledge, providing a means for organizations to learn from the experience of others in the industry. It is therefore clear that small business owner/managers use networking to obtain key information, learning opportunities and problems and to gain access to, or enhance understanding of sources of finance. Thus, it is logical to assume that businesses with networks are more likely to have easy access to bank credit compared to those who do not have such networks.

2.2.5 Access to Finance

While reviewing a number of surveys and research, we note four reasons in the literature for the importance of access to financial services for small firms. Firstly, financial market imperfections are likely to hit smaller firms harder (Beck et al., 2006). Secondly, new firm entry has a clear impact on economic growth and access to finance provides more opportunities for new firm formation. Thirdly, access to finance can act as an incentive to spur knowledge creation. Fourthly, access to finance, according to Peachey and Roe (2006) should be considered as a basic need alongside the provision of health, education and water.

In general, analyses of the effects of financial constraints on firm performance have focused on distinct aspects: firm investment where more financially constrained firms do not show further investments (Alti, 2003; Almeida and Campello, 2007;), firm growth in which financially constrained firms remain stagnant without any substantial advancement (Carpenter and Petersen, 2002; Beck et al., 2005; Fagiolo and Luzzi, 2006; Hutchinson and Xavier, 2006; Coad, 2008), firm innovation (Hyytinen and Toivanen, 2005; Savignac, 2008; Mohnen et al., 2008) and firm size distribution where no expansion is taking place due to the financial constrains (Cabral and Mata, 2003).

2.3 Critique of the Existing Literature Relevant to the Study

There has been strong criticism in the literature from some authors like Hutchinson and Xavier, 2006; Coad, 2008; Cabral and Mata, 2003 whether the relationship between cash flow and investment is a sufficient indication of overall financial constraints as held by others like Czarnitzki and Kraft 2007; Berger and Udell 2002; Carpenter and Petersen 2002. Moreover, the results concerning the existence of financial constraints are often ambiguous in these studies. Other different explanations would be stating that the smaller firms may themselves limit their financial structure with the aim of avoiding the need to share control of the business with others (Smallbone, D. & Wyer, P 2000; Schiffer, M & Weder, B 2001). This was proposed as the main reason why many entrepreneurs quit they formal employment to venture into their own businesses (Kumar, A., & Francisco, M 2005).

2.4 Summary

It is clear from the above arguments that the small firms' access to financing may either come from supply side market failure or demand side market failure. From the supply side, the lending institutions may shy off from SME funding due to fear of default, generally bracketing SME sector as high risk Endeavour or from information asymmetry that happens to be experienced at a higher level in SME sector. On the other hand, the demand side may be due to the entrepreneur lack of proper information, lack of business networking or business skills. Firm's, financial and entrepreneurial characteristics have been highlighted in this research as the main factors that influence SMEs' access to funding.

2.5 Research Gaps

In this literature review, the researcher identified three research gaps that need to be highlighted here. First, there lacks a conventional definition of SMEs, and therefore, the lending institutions apply their own criteria and measures while dealing with SMEs. It has been found that this problem of consistent definition is experienced world over. Second, it has been found that it is difficult to measure the performance of SMEs. Consequently, lending institutions do not pay attention to the all important aspect of future cash flows that could otherwise be used as an indicator of credit worthiness. Further there is a lack of credit rating agencies that are well suited for the all crucial SMEs' sector.

METHODOLOGY

3.1 Introduction

In this chapter, the details of all information regarding the methods used to carry out the research, the type of research design used, the sample size, sampling techniques, the procedure used to obtain the samples and the research instruments used and the methods of data collection are discussed. This chapter also discusses how the data was collected and organized. It also indicates how the analyzed data was presented.

3.2 Research Design

The research uses descriptive design which enables a clear presentation of the variables under investigation. Descriptive statistics are used to describe the basic features of the data in a study. They provide simple summaries about the sample and the measures. With descriptive statistics one is simply describing what is or what the data shows. Descriptive statistics are used to present both quantitative and qualitative descriptions in a manageable form. Together with simple graphics analysis, they form the basis of virtually every quantitative analysis of data (Socialscienceresearch.net). Because this research is both quantitative and qualitative, it uses descriptive design. To this extent therefore, the independent variables of the study comprise of firm characteristics, financial characteristics and entrepreneurial characteristics. These were evaluated in relation to how they affect the dependent variable of access to funding. The data was collected, edited, summarized and reduced to basic representative values that helped present the findings in tables and graphs. The researcher used both primary and secondary data. Primary data was obtained through questionnaire and interviews while secondary data was obtained from journals, books and internet.

3.3 Population

Population refers to the entire group of individuals, events or objects having common observable characteristics. It is the aggregate of all that conforms to a given specification (Mugenda and Mugenda, 2003). For the purpose of this research, the population of SMEs in Westlands an urban town in Nairobi was chosen. The entire or target population comprises of 2,870 SMEs as according to the City Council of Nairobi human resource department, 2009.

3.4 Sample and Sampling Technique

Sampling is the process of selecting a number of individuals for a study in such a way that the individuals selected represent the large group from which they are selected. The purpose of sampling is to secure a representative group which will enable the researcher to gain information about the population (Mugenda and Mugenda, 2003). The sampling technique employed was generally probabilistic or representative sampling which is most common for survey-based research strategies where there is need to make inferences from the sample about a population in order to answer the research questions or to meet the research objectives (Saunders et al., 2009).

In this research, cluster sampling was used. According to Mugenda and Mugenda (2003), cluster sampling is used when it is not possible to obtain a sampling frame because the population is either very large or scattered over a large geographical area. Since the target population in this research is large, and due to time and resource constraints, was logically inaccessible, cluster sampling was suitably employed. In cluster sampling, the total population is divided into a number of discrete groups (clusters) prior to sampling. The groups, in this research were based on the type of business. The sampling frame is the complete list of clusters rather than a complete list of individual cases within the target population. From these, a few clusters are then selected using simple random sampling. A sample size is obtained by calculating a suitable percentage where necessary, in this case 10% (Saunders et al., 2009). This can be shown as below in Table I.

Table I: The Sampling Frame

Cluster No.	Cluster Type	Business Population	%age Representation	Sample Size
01	Agricultural	139	10	14
02	Entertainment	311	10	31
03	Industrial	98	10	10
04	Technology	221	10	22
05	Medical	277	10	28
06	Travel	177	10	18
07	Media	96	10	10
08	Education	104	10	10
09	Electrical	44	10	4
10	Shopping	371	10	37
11	Building	240	10	24
12	Others	792	10	79
Total		**2870**	**10**	**287**

From these 12 clusters, six were selected at random and the individual cases as shown by the sample size used as representative of all clusters and hence the entire target population. Clusters 03, 04, 06, 09, 10 and 11 were selected and hence the total number of sample size came to 115 (see Table II).

3.5 Instruments

Research instruments are the techniques used in collecting primary data. The main instruments for data collection in this research were through questionnaires and interviews. Structured questions were used in this research with some questions using Likert scale to measure the interval level of opinion of the respondents. The respondents included the staff and the managers of the sampled companies. Secondary data was also used from journals, books and internet.

3.6 Data Collection Procedure

Data collection is the process of gathering and measuring information on variables of interest, in an established systematic fashion that enables one to answer stated research questions, test hypotheses, and evaluate outcomes. The data collection component of research is common to all fields of study including physical and social sciences, humanities, business, etc. While methods vary by discipline, the emphasis on ensuring accurate and honest collection remains the same (Socialscienceresearch.net).

This research involved data collection from primary and secondary sources. The primary data was collected through questionnaires and interviews while the secondary data was mainly from publications, journals and internet. The questionnaires used were distributed to the respondent for self-administering and report to be collected later. In some cases the questions were read out to the respondents and responses recorded on the questionnaire accordingly. Where interview was used, notes were taken to record the responses.

3.7 Data Processing and Analysis

Data was analyzed by both qualitative and quantitative approaches. The data obtained from questionnaire was entered into a computer and analyzed using Statistical Package for Social Sciences software (SPSS). It is a package of programs for manipulating, analyzing, calculating and presenting data. The package is widely used in the social and behavioral sciences. This software was chosen in this research because it is able to handle large quantities of data and is thus efficient for the data processing and analysis. The data was summarized and presented using tables, bars, charts, graphs and percentage.

RESEARCH FINDINGS AND DISCUSSION

4.1 Introduction

This chapter provides analyses and interpretations of the raw data gathered in the course of the research project. These analyses and interpretations are related to the specific objectives that guided the researcher throughout the course of the research and the questions as developed in the questionnaire. These objectives included: (1) to evaluate the influence of firm characteristics on SMEs' access to finance which included two variables, namely, size and age of the business; (2) to evaluate the influence of financial characteristics on SMEs' funding, which had three variables, namely, book keeping system, asset tangibility, and performance; and (3) to evaluate the influence entrepreneurial characteristics have on the SMEs' access to funding, which investigated three independent variables, namely, education, previous experience and forming linkages.

To help analyze and interpret data gathered from the research instruments employed, the data was entered into a computer. Charts and tables showing results, frequencies and percentages were generated, using SPSS computer software, from the data gathered through questionnaire and interviews conducted to the various respondents in the SMEs' sector in Westlands town.

Table II: The Sample Size

Cluster Type	Population	Sample Size
Industrial	98	10
Technology	221	22
Electrical	44	4
Shopping	371	37
Building	240	24
Travel	177	18
Total	1151	115

These respondents included both the employers and the employees. A total of 115 respondents participated in the research from the six randomly selected representative samples (see the sampling frame).

4.2 Firm Characteristics

The responses concerning the firm characteristics were derived from question items 1.1, 1.2, 1.3 and 1.4 as developed in the questionnaire (see Appendix I). The questions were meant to capture the relation between the size and age of SME and its access to funding. The two independent variables, size and age, had earlier been identified in literature review as key determinants of a firm characteristics that influence funding. Of the 115 respondents 53% were micro, 33% small while 14% were medium enterprises. Very young were those SMEs below 3 years, young were those below 10 years, medium were firms below 20 years while old were those above 20 years of operation.

Table III: Data on Size and Age of the SME

Size	*Very Young*	*Young*	*Medium*	*Old*	**Total**
Micro	25	6	30	0	61
Small	0	24	14	0	38
Medium	0	10	6	0	16
Total	25	40	50	0	115

These showed up different responses to the various question items in the questionnaire. One of the key indications about the variation in size is that the smaller a firm is the higher the opacity of information. The size was found to be directly correlated with the provision of information. For example, of the 61 micro enterprises, only 31% have audited accounts while most only keep simple record (based on single entry accounting system) of the cash received. Only a few even maintain a separate bank account for their businesses. As the firm becomes bigger, that is, from micro to small and to medium, the keeping of records become more and more detailed. All of the small and medium enterprises contacted keep records. Only 10% of these do not audit their accounts. For these enterprises, separate persons are engaged in book keeping rather than having the owner/manager doing it all.

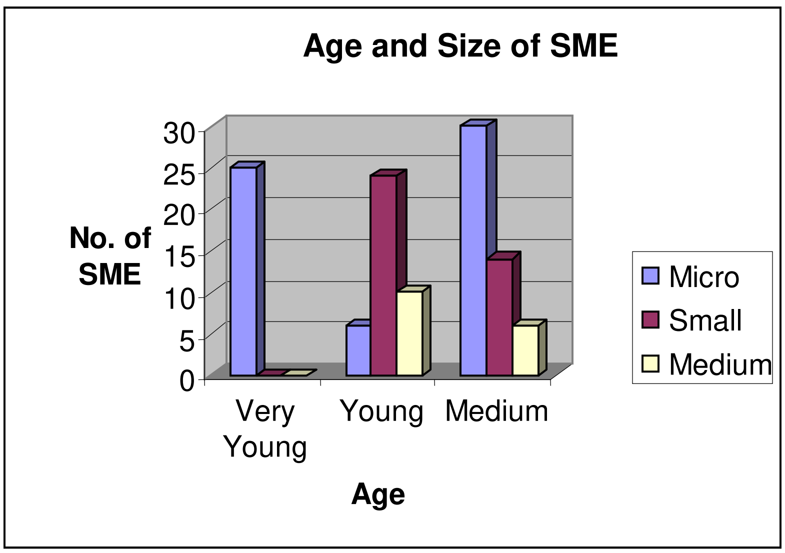

Figure 4.1: Distribution of SMEs on Age and Size

Concerning the influence of age of the firm on the access to funding, 37% were neutral, while 45% agreed with only 8% disagreeing with this statement. This pointed out that there were more respondents who generally agreed than those who disagreed that being in business for a longer time may influence access to funding (see Table IV and Figure 4.2). Moreover, the firms that were considered very young (21%) considered themselves disadvantaged while trying to access funds from the bank. This was true for especially start up businesses. Different stages of growth at which the firm was were directly related to the age of the SMEs. Among the respondents who were neutral to this statement, it was found that they either lacked proper information on the relation between age and fund accessibility or did not consider borrowing.

Table IV: Data on Responses to Questions Containing a Statement

Question Statement	*SD*	*D*	*N*	*A*	**SA**
1. The age of the firm affects its ability to access funds	5	11	37	37	25
2. Lack of reputation and contact in the banking market make it hard to borrow money from the banks	8	3	37	35	32
3. Small businesses are usually charged higher interest rate by banks than large firms	0	8	41	32	34
4. Having business skills will influence business performance and hence access to funding	4	3	11	32	65

SD: Strongly Disagree, D: Disagree, N: Neutral, A: Agree, SA: Strongly Agree

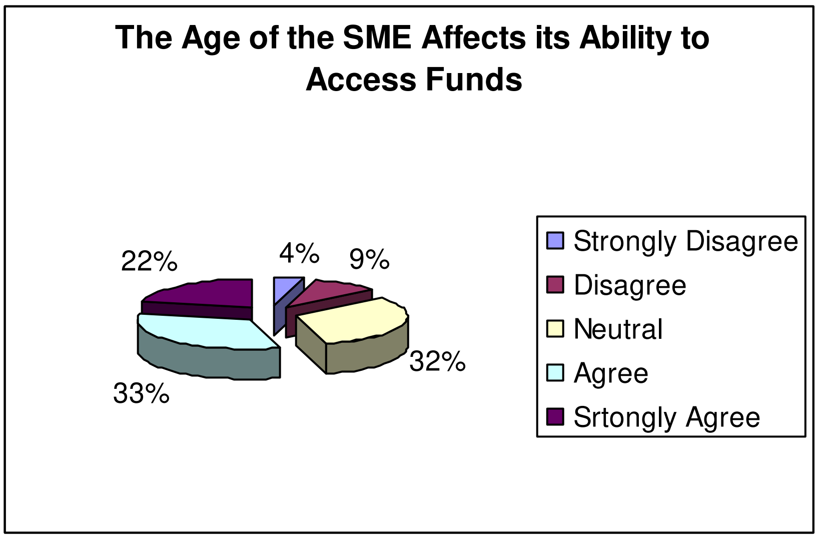

Figure 4.2: On whether the age of the firm affects its ability to access funds

On the lack of reputation and contact in the banking market and its adverse effect on borrowing, 32% were neutral while 58% agreed to the question statement (see Table IV and Figure 4.3). Many of the respondents stated that it is important to establish reputation in the banking market. But this is only possible if one considers borrowing and if he/she does so, is able to clear debt in time. Borrowing once and later again could improve such contacts with one's preferred lender. This way, it can build a history with the client, which can be used to assess credit worthiness of the applicant later on. However, among the micro enterprises, there was an explicit fear of the burden of a bank loan and hence keep off from establishing such important contacts. The 32% who indicated that they were neutral were found that they do not consider borrowing. This makes it hard to rely on relationship lending for these SMEs.

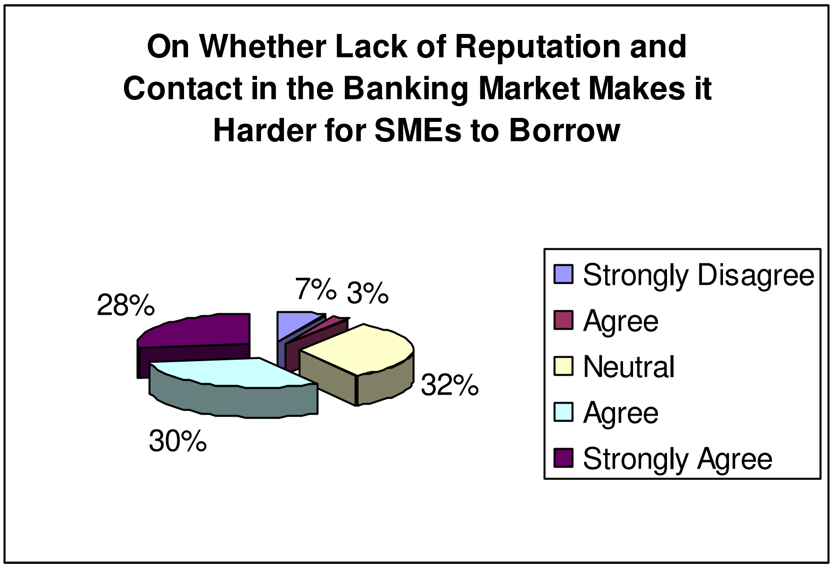

Figure 4.3: On whether lack of reputation and contact in the banking market makes it hard to borrow

4.3 Financial Characteristics

Under this subheading, the research aimed at establishing the influence that financial characteristics of the SMEs have on accessing funding. This objective classified three main independent variables that guided the research. These are; keeping of financial records, asset tangibility, and firm performance and the responses to questions 2.1 to 2.12 as reflected in the questionnaire gave the basis for this analysis. Of the 115 respondents, 82% keep records while 18% indicated that they do not keep any record. However, among the 82%, a variety of book keeping system, especially in the micro enterprises, exists. Majority of the micro have only simple records that would not provide the much needed information by the credit lending institutions. These records were mainly kept by the owner/manager. Among the small and medium enterprises contacted however, 90% audit their accounts which enabled them to provide adequate information in case of borrowing.

Table V: Responses on Yes/No Questions

Question	*Yes*	*No*
1. Does your business have a book keeping system?	94	21
2. Does your business borrow money to finance its activities?	47	68
3. Do you maintain a separate bank account for your business?	91	24
4. Does your business have an outstanding loan?	29	86
5. Do you think you still need more funding for you business?	58	57
6. Do you have previous experience background?	74	41
7. Are you a member of any association/group that you may consider for a loan or important to your business?	35	80

Availability of assets to be used as collateral was identified in the literature as one of the important factors that influence ability to access funding. This is mainly because banks and

lending institutions require collateral or asset tangibility especially while dealing with the SME sector whose information availability is scarce and hence higher information asymmetry. Lack of borrowing was associated to lack of asset for these firms. On the other hand, lack of guarantors in case of borrowing from credit unions was another hindrance to fund accessibility. Those with the asset tangibility were found that the assets referred to were actually owners'/managers' but not businesses' assets. Some had more than one asset. However even with these assets, some had fear of the burden that is associated with a bank loan and therefore would rather continue in their current financial constraints rather than risk the few assts they had.
The other independent variable under financial characteristics is the performance of the SME. All the respondents considered their business successful. However, there were variant ways of how they measured success as shown in Table VI below. This varied from type to type, and from size to size. The typical measure of success and performance was identified as sales volume with 75% responses. Some indicated more than one measuring rod of success.

Table VI: Measures of Performance and Success

Key Performance Indicator	*No. of SMEs*
Sales	86
Cash Inflows	31
Future Prospects	44
Being Debt free	26
Profit Margin	16

Since SMEs rarely calculate and indicate the financial or accounting ratios that are used by bigger firms as indicators of performance, it would therefore mean that there exist various performance indicators. These however may not be adequate to be presented to the lending institutions because they are considered to be very subjective. This is coupled with the inadequacy of a proper book keeping system to support such claims of success and performance. With these trends, SMEs are left at a disadvantage when it comes to borrowing.

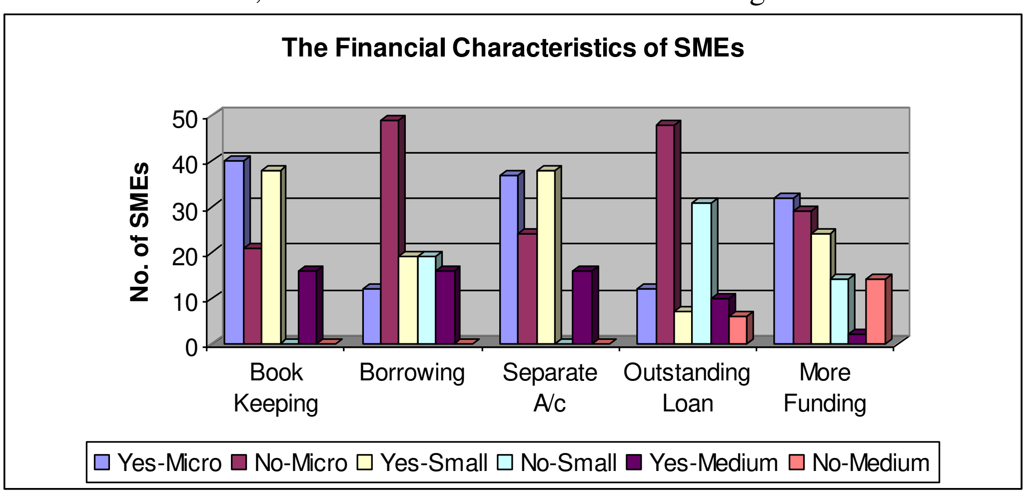

Figure 4.4: On the Financial Characteristics of the SMEs

Another interesting result of this research was that only 41% of the respondents borrow or can consider borrowing while 59% do not. For those who borrow, 47% prefer to borrow from relatives or friends, 40% consider bank loans while 13% preferred short term bank overdraft (see Table V and Figure 4.4. Bank overdraft was mainly preferred by the medium enterprises. Those who do not borrow from the bank gave the burden of repayment and the preconditions attached to a bank loan as the main reasons of not borrowing. None of the respondents preferred to borrow from credit unions. Government grants were considered unfavorable requiring group borrowing. Others do not consider borrowing on religious ground.

To further the reason why SMEs have difficulty in accessing funds, 21% of the respondents were found that they do not keep a separate bank account for their businesses (see Table V and Figure 4.4). This means that they do not separate the business activities from the owner/manager's expenditures. This has adverse implications to the business operations and the ability to repay if one were to borrow. The lack of separation of the business from the owner/manager is considered in the literature to have a negative relation to funding.

On whether SMEs are usually charged higher interest rate on loans than large firms, 35% were neutral, whereas 58% agreed (see Table IV and Figure 4.5). Those who were neutral had not considered borrowing and/or had no information about the lending market. This pointed to the fact that the entrepreneurs themselves may lack adequate information about the operations of the lending institutions and the various financial services available for the SME sector.

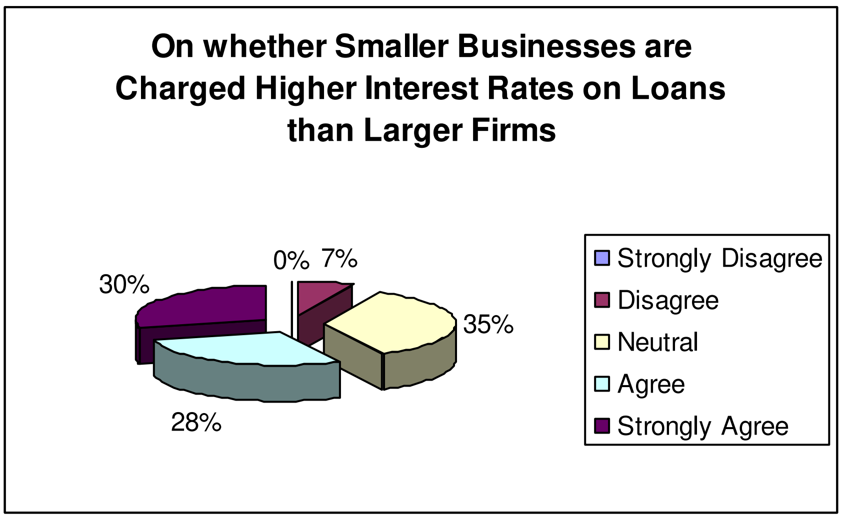

Figure 4.5: On whether SMEs are charged higher interest rate on loans than larger firms

4.4 Entrepreneurial Characteristics

The other objective of this research was to establish whether the entrepreneurial characteristics have an influence to fund accessibility. Under this objective three variables were considered; namely, education background, previous experience and the entrepreneur's ability to form linkages to enhance group borrowing. These were captured under question items 3.1, 3.2, 3.3, 3.4, 3.5 and 3.6 as formulated in the questionnaire. All the entrepreneurs interviewed have an education background which they considered important for their business. However, this was only considered as important for establishing a good customers' relation but not in establishing or enabling writing a business proposal for borrowing as indicated by Kumar & Francisco (2005) in the literature. Some in fact indicated that it does not matter how good a business proposal one presents to the lender, but rather the security that one offers against the loan.

30% of the respondents have an association that they can consider for a loan. With the need for group borrowing, these associations could prove important for the members. However, 70% did not have any association (see Table V and Figure 4.6). This was as a result of fear of default of members who may borrow under the group's name only to disappear later. This result indicates that the entrepreneurs based in Westlands do not consider group borrowing as favorable. Since government grants are pegged on group borrowing, this has locked out these people.

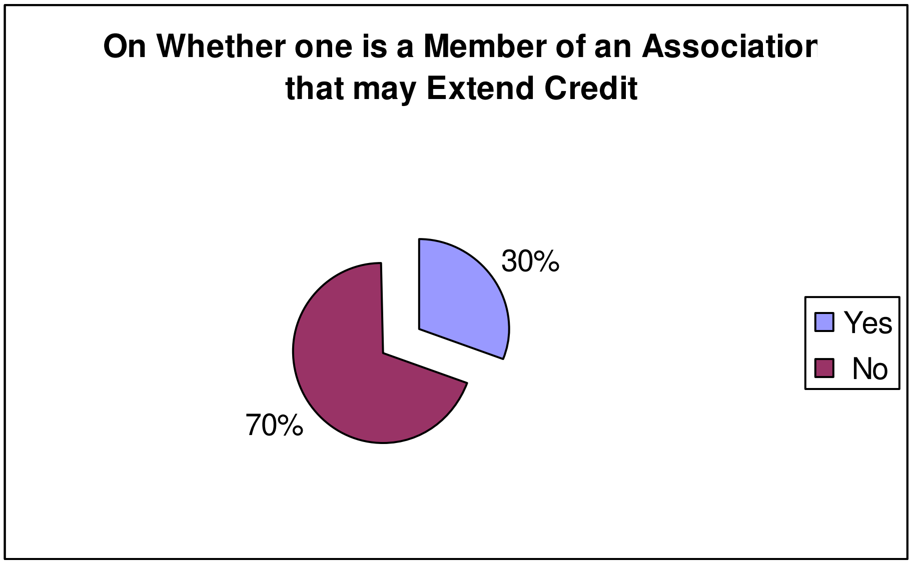

Figure 4.6: On whether the entrepreneur is a member of any group that may extend credit

On whether business skills acquired previously would influence access to funding, 84% agreed whereas 10% were neutral (see Table IV and Figure 4.7). This indicated the need for entrepreneur's ability to run the business, to solicit for funds and manage the same. If an entrepreneur was able to do so he/she may be able to associate with a group, acquire more business acumen, and influence the SME to move towards a better performance.

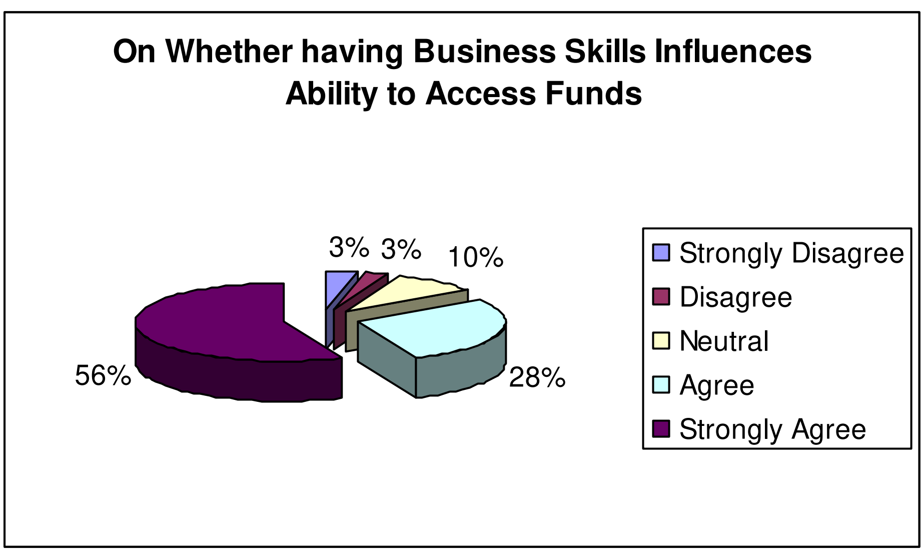

Figure 4.7: On whether having business skills influences access to funding

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

This chapter deals with summary, conclusions and recommendations. The summary highlights the entire assessment of the factors influencing small and medium enterprises' access to funding in Kenya. The conclusions are drawn from the answers the research questions sought to understand while the recommendations are based on the conclusions drawn while at the same time giving research areas that can further be done to enhance financial inclusion to benefit the SME sector. It is therefore organized into the following main parts, namely, summary, conclusions, recommendations and suggested further research.

5.2 Summary

SMEs have been recognized as being great contributors to the Kenyan economy offering both employment and platform for innovative ideas. They form a larger percentage of the businesses that operate in Kenya as compared to their counterpart, the large companies. They are however faced by many constraints that hinder their performance and consequently their growth. One of the main constraints that have been highlighted over the years is the financial constraint. The need for finance is of paramount importance for the success of any firm, be it big or small. The objective of this research was to investigate the factors that influence SMEs' access to funding especially in reference to Westlands. Those that responded to the questions of the study were 115 of the 123 that were contacted. The responses were collected by use of structure questionnaire and where possible note taking during the interview with the respondents.

The literature that was explored in this research highlighted three main factors that contribute to accessibility to funding for SMEs. These factors guided this research throughout the course. These are firm, financial and entrepreneurial characteristics. The SMEs contacted were of the view that financial constraints do exist in the SME sector. This was attributed to a financing gap that exists between larger and the smaller companies' accessibility to funding. Lack of access to equity financing coupled with the lenders shying off from SMEs' funding only tends to augment this difficulty. Under the firm characteristics, size and age of the firm were investigated to determine whether they influence SME's access to funding. It was found that the smaller the business, the greater the difficulty of accessing funds. The size was found to be directly correlated to the provision of information. It was evident from the findings that 58% generally agreed that establishing relationship with the lending institutions would ease the burden of borrowing. Borrowing once and later again could improve such contacts with one's preferred lender. This way, it can build a history with the client, which can be used to assess credit worthiness of the applicant later on. Hence, being in business for a longer time could help establishing this relationship and consequently influence accessibility to funding.

The financial characteristics also contribute to the SMEs' access to funding. According to literature review, the lending institutions were found to look at the financial performance of the applicant before extending credit. The variables sought after in this section were book keeping, asset tangibility and firm performance. The findings showed that of the 115 respondents 82% keep records while 18% do not. But due to lack of a well detailed financial reporting, such records would not be viable evidence for lenders to extend credit. All the respondents regarded their businesses successful. However, different measures of performance are employed in the SME sector. Some of these measures were found to be very subjective and lack of proper accounting records could not provide sufficient evidence to support such claims in case of applying for a loan.

On the entrepreneurial characteristics, education background, previous experiences and forming linkages were investigated as independent variables influencing access to funding for SMEs. All the respondents had an education background though to varying degrees and they considered this important in running their business. However this was seen as important in helping the entrepreneur in relating with the customers rather in helping him/her in accessing finance. 84% generally agreed that business skills acquired previously would influence access to funding.

5.3 Conclusions

The research draws its conclusions from the research questions that guided the researcher in this project. These questions had previously been formulated in chapter one of this research. These are:

Research Question 1: Do the firm characteristics have an influence on SMEs' access to funding?

The size and age of the firm were found to have an influence on funding. The start up business and very young firms (below 3 years) were found to have a major setback in accessing credit especially because of lack of collateral and information opacity. Smaller firms also experienced the same difficulty and were found to provide inadequate information to enable them access credit.

Research Question 2: Do the financial characteristics influence SMEs' access to funding?

This research concludes that SMEs have a difficulty in accessing funds due to their financial characteristics. These include lack of proper book keeping system, lack of asset tangibility and lack of standard measures of performance. It is worthy noting that among the contacted SMEs, the performance measurements that are employed are subjective and some SMEs lack supportive documents of these. The fear of risk associated with borrowing also locks out even those who have asset tangibility.

Research Question 3: What influence do entrepreneurial characteristics have on SMEs' access to funding?

In the SME sector, it is difficult to separate the owner/manager from the business itself. Hence, the entrepreneur plays a major role in the performance of the business. The entrepreneur characteristics that were investigated were education background, previous experience and ability to form linkages. The business skills that the entrepreneur has influence his/her ability to access credit and to manage the same for the success of the business. It is because of previously acquired business skills that majority were able to keep substantial accounting records. Majority (70%) of the respondents were not members of any association that could extend credit. This was an indication that they do not rely on group borrowing that is a requisite of accessing government's grants.

5.4 Recommendations

The Government can play an important role in supporting the SME sector, in particular, in cases of market failures and incomplete markets that inhibit the provision of adequate financing or financing on terms suitable for the stage of SME development. This would help in creating an enabling environment for the SME sector, entrepreneurship and innovation; an enabling environment that provides, among other things, political stability and security. This boosts the investors' confidence. Government measures to promote SMEs should be carefully focused, aiming at making markets work efficiently and at providing incentives for the private sector to assume an active role in SME finance. It should also reduce the transaction costs that the SMEs incur in order to access government grants.

Public policy should improve awareness among entrepreneurs of the range of financing options available from official programmes, MFIs, private investors, and banks. Lack of proper knowledge of the available financial services has locked many entrepreneurs from advancing. At the same time these entrepreneurs need to establish linkages with their partners in the business and with the lending institutions that could help them build their knowledge on financial services available, on management of funds and other business skills. Such associations could prove important for the SMEs in accessing fund where one SME could even act as a guarantor for another.

There is also a felt need for the SMEs to improve on their provision of information by proper book keeping coupled with the auditing of their accounts. Furthermore, they need to separate their business operations from those of the entrepreneur/family.

5.5 Suggested Further Research

Research on both large and small enterprises in Kenya to help come up with the existing discrepancies between the two and therefore to try bridge the financing gaps that exist. This would also help in coming up with a standard definition of SMEs that can be applied by all financial market players allover the country. It would also help regulate how different lending institution deal with the SMEs.

Research can also be done on the financial market deepening to look at the reachability of the financial services to the informal sector. Due to the impact the SME sector has on economic development, funding of this sector is crucial and therefore a further research on how far the policies made at the government level and by the NSE on SME listing have been implemented.

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