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## FINANCING DECISIONS AND WORKING CAPITAL MANAGEMENT: PANACEAS TO PERFORMANCE OF SMALL AND MEDIUM-SCALE ENTERPRISES IN IMO STATE

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### ABSTRACT

*Small and medium scale enterprises (SMEs) have been highlighted as an important growth engine, a major driving force and a pathway to sustainable development. Even though many new companies have been founded, their mortality rate is quite high, especially in developing countries. Proper financial management is especially important for supporting SMEs. This study examined the role of financing decisions and working capital management in the performance of SMEs in Imo State. Multiple regression analysis was used to estimate the model. The study found that working capital management and financing decisions have considerable beneficial impact on SMEs' performance in Imo State. The study therefore recommends that in order to be competitive, SMEs owners and managers in Imo State should make sure they employ sensible financial judgments by ensuring that they have enough money for routine operations.*

**Keywords:** Financing decision, working capital management, small and medium scale enterprises, performance

### INTRODUCTION

Small and Medium Scale Enterprises (SMEs) are recognized worldwide as key sources of dynamism, innovation and flexibility. They are responsible for job creation, hence, contribute to productivity and economic growth. They alleviate poverty and serve as “kick-start” mechanisms for job creation and prosperity of nations (Berry et al., 2019). In the move towards accelerated economic growth, SMEs need to be strengthened to be globally competitive, (National Policy Framework for SME Development [NPF], 2019). The development of SME is paramount to all countries irrespective of their level of development, since SMEs have the potential to generate socio-economic benefits with minimum levels of investment (Rathnasiri, 2015).

Financial management is one of several functional areas of management which is central to the success of any small business (Meredith, 2016). Financial management is the management of finances of a business in order to achieve its financial objectives. McMahon et al. (2018) defines financial management based on mobilizing and using sources of funds: financial management is concerned with raising funds needed to finance the enterprise's assets and activities, the allocation

of these scarce funds between competing uses, and ensuring that the funds are used effectively and efficiently in achieving the enterprise's goal. Financial management as used in this study is focused on three (3) components: financing decision, investment decision and working capital management. Other constructs under financial management include dividend policy, decisions involving short-term finance, accounting information systems, financial reporting and analysis.

Financial decisions are imperative in contemporary financial thinking because of their role in achieving the objectives of corporate financial management in terms of maximizing profits and raising shareholders' wealth, while maintaining continuous growth and survival of the affect the performance of the company. The organization must make decisions that will achieve its goals of increasing the wealth of owners and increase performance. The funding decision is the application of funds when necessary in the organization (Atallah, 2017). Financing decisions are the most important decisions made by financial and non-financial institutions, which determine the optimal mix of areas in which firms seek to maximize home owner's wealth (Al-Noaimi & Al-Tamimi, 2019).

Business organizations should ideally expand by progressing through stages of growth. SMEs are the growth engine in many country. Duru (2013) states that SMEs are responsible for more than 70% of exports in nations like Malaysia, Thailand, China, and India, which is why these nations have been expanding exponentially. However, despite the large number of new businesses, especially in developing nations, their death rate is still relatively high. The introduction of measures like microcredit programmes, industrial banks, and SMEDAN to improve their performance notwithstanding, SMEs in Nigeria still face several obstacles that significantly impede their growth.

Studies have uncovered a number of causes for the high mortality and stifled growth of SMEs, including financial structure leverage, fierce rivalry, insufficient margin, low account receivables collection, inability to adopt new technologies, high personnel turnover, credit concerns, and interest rate risks (Raghvan, 2005). A closer look at these issues reveals that most have to do with how SMEs manage their finances, which makes it difficult for lenders to evaluate SMEs' risk premiums and provide credit them; SMEs are viewed as high risk ventures (ILO, 2009).

DaeSuh (2011) states that the problem is compounded by the high mortality rate of SMEs and the absence of access to professionals in most SMEs. Hence, it is vital to determine how SMEs' financial management strategies could improve their performance. Given that SMEs are considered real drivers of genuine growth and progress of countries. Therefore, the purpose of this study is to determine the effect of financial management practice on performance of SMEs in Imo State.

## LITERATURE REVIEW

### Concept of Financing Decision

Financing decisions are those concerned with determining funding sources needed to finance investment (Eka, 2018). It is the process of obtaining funds to meet a firm's long-term investment requirement (Smith et al., 2020). According to Eka et al. (2018), financing decisions relate to the financing –mix of an organization. As such, it is concerned with borrowing and allocation of funds required for investment decisions. It is the process of deciding the source, use, and measures to control funds in a business to gain maximum advantage (Frazer, 2016). In line with sources of

capital, Faff (2016) argues that organisations require different forms of capital at different stages of their life cycle. As such, financial resources can be classified into internal sources and external sources. Zuhroh (2019) emphasized that while internal sources of funding come from the organisation's operational results, external sources are generated from outside the organisation, such as debts and the issuance of new shares.

Pilbeam (2018) argues that internal sources of funding are cheap and can range from profit and sale of existing assets. Conversely, regarding corporate organisations, Baker (2020) emphasized that external sources can range from shares, long-term bank loans, trade credit, and factoring. Choosing a method of financing is not an easy decision, even though there is no general standard. Robinson (2020) argues that every company has to analyze the suitable method for creating a proper mix between self-financing and external financing. Hence, the analysis requires sophisticated financial methods that allow the creation of financial projections under different scenarios (Hassani & Hassani, 2016).

### **Concept of Working Capital**

Jakpar et al. (2017) defined working capital as current assets that support routine operations of companies. In its broadest sense, working capital is defined by resources necessary for a firm to finance its operational needs, which go from the acquisition of raw materials to receipts from sale of finished products. A company's working capital can be measured as the difference between its current assets and liabilities, in monetary units. With this, it is possible to verify if the firm can pay its short-term obligations.

According to Agyei-Mensah (2021, p. 423), "the policy of working capital refers to company policies concerning levels desired from each category of current assets and how current assets will be financed." For Ismail (2017a), the behaviour of working capital is extremely dynamic, requiring efficient and quick models for assessing the company's financial situation. A need for investment in poorly dimensioned turnover is certainly a source of commitment to companies' solvency, with repercussions on its economic position and profitability. Working capital is responsible for the operating cycle of companies because its movement reflects on the company's equity status. The capital of turnover undergoes transformation and each transformation has the objective of making capital always return greater than the value of the beginning of the operating cycle.

### **Concept of Small and Medium Scale Enterprise**

SMEDAN (2005) sees small scale enterprises as businesses with 10 to 49 employed individuals and an annual turnover of N5m to N49 million, and those that are medium scale as having 50 to 199 employees and an annual turnover of N5m to N499 million. SMEs are non-subsidary, independent firms which employ fewer numbers of employees and this number varies across countries. According to the European Union (EU), SMEs are categories of micro, small and medium-sized enterprises which employ fewer than 250 persons and which have an annual turnover not exceeding 50 million Euros (Mba and Cletus, 2014).

According to Etuk et al. (2014), SMEs are defined based on certain criteria including, turnover, number of employees, profit, capital employed, available finance, market share and relative size within the industry. Onugu (2005) viewed SMEs as business enterprises whose total costs excluding land, is not more than two hundred million naira (N200, 000,000.00). In Japan, SMEs are a type of industry with a paid up capital and a number of employee (Bakare & Babatunde, 2014). The Small and Medium Industry Equity Investment Scheme (SMIEIS), describes SME as

any enterprise with a maximum asset base of N500 million, excluding land and working capital and with the number of employees not less than 10 or more than 300 (Eniola et al., 2015).

### **Financing Decision and SMEs' Performance**

Feras et al. (2021) examine the impact of financing decision ratios on firms' accounting-based performance, using firm size, firm age, and leverage as control variables. The results showed that the impacts of total debt to total assets and short-term debt to total assets are significant and negative on return on assets and return on equity. However, the impacts of long-term debt to total assets are significant and flattering on both return on assets and return on equity. The research has implications for the higher authorities and management to enhance the quality of their financial structure. In contrast, that research has some limitations because of employing a small number of factors to study the impacts of financing decision ratios.

Ugwueze et al. (2019) assessed effects of financing decisions on operational performance of pharmaceutical firms in Nigeria. Long Term Debt (LTD), and Short Term Debt (STD) were regressed against the dependent variable: Turnover (TNV). Hausmann test was conducted to choose between Fixed Effect and Random Effects model. Results justified the use of Fixed Effect model. Test results indicate positive but non-significant contributions of LTD on turnover; and that STD has positive significant contribution on turnover of pharmaceutical firms in Nigeria. The study conclude that firm needs to choose a suitable financial decision at certain proportion to be better off and recommends that it is important for corporations to retain much of their profits for re-investment as this will make funds readily available to them and avoid the problem of working capital shortages. This will equally enhance efficiency and productivity, expansion and diversification and even automation and modernization.

Therefore, we hypothesize that:

**H<sub>01</sub>:** Financing decision has no significance effect on performance of SMEs in Imo State.

### **Working Capital Management and SMEs' Performance**

Abimbola et al. (2021) investigated effects of effective management of working capital on financial performance of SMEs in Nigeria. The data for the study was spawned from annual reports published by listed SMEs in Nigeria. The proxy for financial performance was profit after tax (PAT) while that of the independent variables include inventories, trade and other receivables, gross profit and monetary policy rates. The study revealed that positive but insignificant relationship exist between working capital (trade and other receivables). The study recommends that government should revisit the interest rate on SMEs loans to enhance accessibility and affordability which in the long run promotes the development of the sector and the nation at large.

Umar and AbdulQadir (2021) examined effects of working capital management on financial performance of non-financial companies quoted on the Nigerian Stock Exchange over the period 2014–2018 using a panel research design. The study's findings are consistent with the theoretical position that all aspects of working capital management have significant effect on financial performance.

Therefore, we hypothesize that:

**H<sub>01</sub>:** Working capital management has no significance effect on performance of SMEs in Imo State.

### Theoretical Framework

This study is anchored on the trade-off theory (Robichek & Myers, 1966) which suggests the existence of a perfect capital arrangement that increases a company's worth. The theory opined that management will define a target leverage ratio and then progressively move towards it. De Wet (2006) showed that firms choose target leverage ratios based on a trade-off between the advantages and disadvantages of higher leverage. Tax, financial distress costs, and agency costs are three elements that influence choice of target leverage ratio (De Wet, 2006).

Therefore, managers pick the debt and equity ratio that strikes a balance between the costs of debt and its benefits, such as tax advantages. The debate over the Modigliani-Miller theorem gave rise to the first iteration of the trade-off theory. An advantage for debt was developed when corporate income tax was added to the initial insignificance since it protected earnings from taxation (Hackbarth et al., 2007). This implies 100% debt financing because the firm's objective function is linear and there is no debt offset cost. Myers' concept of the trade-off merits examination in a number of ways.

Firstly, the aim of trade-off theory is not immediately obvious (Ju et al., 2005). Evidence-based credit is possible, but only if a structure is included. That framework is used in numerous ways across various works. Secondly, contrary to the position of the theory, tax systems are incredibly complex. Depending on whether sections of the tax code are applied, various hypotheses regarding the objective can be achieved (Baral, 2004). Trade-off theory is relevant to this study because it explains why businesses typically use a combination of loan and equity financing. It illustrates the connection between agency expenses and the price of financial hardship. The trade-off theory of capital structure makes it a point to explain why firms often have a mix of debt and equity financing.

### METHODOLOGY

This study adopted a survey research design. The choice of survey design lies in the fact that it focuses on obtaining subjective opinion of respondents and aims at drawing accurate assessment of the entire population by studying samples derived from the population (Osuala, 2005). The population of the study comprised of 18, 126 registered SMEs in Imo State, Nigeria (SMEDAN Report, 2021). A sample size of 391 was determined using the Taro Yamane formula for sample size determination. Statistical analyses include frequency distribution tables, simple percentages and Regression. A total number of 391 questionnaire were administered to respondents and 369 were duly recovered for analysis which represents 94%. Short descriptive analyses are presented for clarity.

The model specification:

$$\text{Perf} = \beta_0 + \beta_1\text{FND} + \beta_2\text{WCM} + \varepsilon$$

Where:

Perf	=	SME's Performance
FND	=	Financing Decision
WCM	=	Working Capital Management
$\beta_0$	=	Constant
$\beta_1 - \beta_2$	=	Régression coefficients
$\varepsilon$	=	Regression error

## DATA ANALYSES AND RESULTS

### Descriptive Analysis

Data were collected through a structured questionnaire sent to the selected 391 manufacturing, trade and service SMEs. However, due to non-response and incomplete responses, 22 questionnaire were excluded from the analysis. Therefore, only data gathered from 369 respondents was used in the final analyses. Table 1 below provides a summary of descriptive statistics of the variables.

**Table 1: Result of Descriptive Analysis**

	Minimum	Maximum	Mean	Std. Deviation	Kurtosis	
	Statistic	Statistic	Statistic	Statistic	Statistic	Std. Error
PERF	2.89	5.00	4.268	.503	-.537	.310
FND	2.94	5.00	4.409	.520	-.168	.310
WCM	2.00	5.00	3.861	.714	-.988	.310

Source: SPSS output (2022)

Based on the output from the SPSS result relating to the descriptive statistics, SMEs performance is high as it has a Mean value of 4.268, which exceeds the median value. The Standard Deviation (SD) was 0.5 which showed an average dispersion. SMEs performance represents a normal distribution because the Z value of kurtosis is  $(-0.537/0.310) -1.73$ , it is in between the acceptable range of positive 1.96 and negative 1.96. So, it is significant at 0.05 level of significance.

**Table 2: Correlation between each independent variable and the dependent variable.**

		PERF	FND	WCM
PERF	Pearson Correlation	1		
	Sig. (2-tailed)			
FND	Pearson Correlation	.503**	1	
	Sig. (2-tailed)	.000		
WCM	Pearson Correlation	.449**	.485**	1
	Sig. (2-tailed)	.000	.000	

\*\* . Correlation is significant at the 0.01 level (2-tailed).

Source: SPSS output (2022)

According to the correlation analysis in Table 2, all both financing decision and working capital management positively and significantly relate to SMEs' performance at 0.01 levels of significant.

**Table 3: Multiple Regression Analysis**

Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	1.921	.243		7.922	.000
	FND	.301	.066	.311	4.581	.000
	WCM	.126	.049	.179	2.557	.011
	R	.574				
	R Square	.329				
	F	23.430				
	Sig	.000 <sup>b</sup>				

Source: SPSS output (2022)

According to the R squared value is 0.329 and it implies that the 32.9 percent of variation in SMEs performance is explained by the selected financial management practices variables in this study. The  $F$  value in the ANOVA Table tests whether the overall regression model is a good fit for the data.  $F$  value is 23.43 and significant value is 0.000 which is lower than 0.05 levels of significance. So, it implies that regression model fits to the data.

### **DISCUSSION OF FINDINGS**

The regression result from the first hypothesis shows that there is a 0.301 regression coefficient value with 0.000 level of significance between financing decision and SME's performance. The value is lower than 0.05 levels of significance as such the null hypothesis is rejected i.e financing decision have a positive significant effect on SMEs performance in Imo State. The result is similar to the findings of Ugwueze et al., (2019) who assessed the effect of financing decisions on operational performance of pharmaceutical firms in Nigeria.

Regression coefficient results from the second hypothesis shows that there is a 0.126 positive effect of working capital management on SMEs performance in Imo State. Significant value shows 0.01 at 0.05 levels of significance. So, it can be concluded that there is a significant positive effect of working capital management on SMEs performance in Imo State. This findings is in tandem with the findings of Umar and AbdulQadir (2021) that examines the effect of working capital management on the financial performance of Non-financial companies quoted on the Nigerian Stock Exchange.

### **CONCLUSION AND RECOMMENDATIONS**

This study was conducted to determine the effect of financing decisions and working capital management on performance of SMEs. According to regression results, financing decision have a positive significant effect on SMEs' performance in Imo State. Regression results also indicate that there is a significant positive effect of working capital management on SME' performance in Imo State.

Financial decisions are important because of the need to maximize returns to various organizational constituencies and because of the impact such a decision has on organizations' ability to deal with the competitive environment. Owners/managers of SMEs in Imo State should ensure they make use of prudent financial decisions so as to achieve competitiveness.

In light of the importance of financing decisions and working capital management among entrepreneurs, government agencies in Imo State such as SMEDAN, ministry of commerce and industry need to further accelerate their efforts to educate entrepreneurs, especially young entrepreneurs, to ensure that they possess adequate level of financial management knowledge before starting their business. Although various awareness and training programmes exist, their approaches might need to be improved so as to better foster SMEs performance.

Also, manager/owners of SMEs in Imo State should implement efficient working capital management system to ensure that SMEs have enough funds for routine operations, which also suggests consideration for other sources of financing, such as cooperative societies, for optimum performance needed by SMEs to annex the potentials for sustainable growth and development.

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