FINANCING WORKING CAPITAL INVESTMENT AMONG SMALL BUSINESSES IN KANO

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ABSTRACT

This study examined financing working capital investment among small businesses in Kano using a quantitative and qualitative approach. The study used descriptive statistics to analyse data; and found that small firms mostly rely on internal sources (retained profit, early settlement discount, and delayed payment to suppliers) of finance as compared to external sources (bank loan and equity). In other cases, they rely on informal sources (private, family, friend, money counting/lenders, funds/wealthy families, rotating savings and credit associations) to finance their working capital investment requirements. These results revealed that firms experience significant information costs that prevent them from having access to traditional sources of financing. The findings of the study will be useful to the SMEs owners, financial institutions that fund SMEs and can help the policymakers to formulate strategies and programs that will support SMEs at different stages of the financial chain as well as financial researchers in Kano state Nigeria.
Keywords: Working capital financing, small business, pecking order theory, ownership structure

INTRODUCTION

Small business is a business that requires little amount of money, simple technical know-how, and few employees to start; but they are crucial to any economy because they provide employment opportunities, develop indigenous skills and technologies, build market competitiveness, and fights poverty (Ateke & Nwiepe, 2017; Ayyagari et al., 2011). In view of these essential roles of small businesses, policymakers consider their health to be important to an economy. However, small business face major challenges in getting relevant access to finance and support in various aspects. Businesses irrespective of size needs adequate funding for their routine operations (pay wages, salaries, accounts payable, and other liabilities).

Maintaining adequate working capital (WC) is not just important in the short term. Adequate money is needed to ensure long-term business continuity. Even a profitable company may fail without adequate cash flow to meet its liabilities. Working capital refers to the resources a business needs to effectively carry out its operations. Good WC management practices increases a company's liquidity and reduces risks of insolvency. Firms in different industries have different WCI requirements. The ideal level of which can be determined by comparing current results to those of previous years or to other businesses that operate in the same industry. Choosing methods of funding WCI is a financing decision that finance managers deal with, and that is crucial to long-term success of firms (Bhunia, 2010).

WC may be funded through different long-term and short-term sources of finance. Long-term sources of funds consist capital (equity from owners) and long-term debt. According to finance theory, non-current (fixed) assets and some part of permanent current assets are long-term assets from which an organization expects to derive benefit over a periods of time and, hence, is supported by long-term financing (Gitman, 2000). In this case, a company is said to be adopting a conservative WC policy. The policy of holding high levels of WC reduces risk of insolvency, and also ensure smooth operations that delivers customer satisfaction.

On the other hand, short-term sources consist trade credit, short-term loans, bank overdrafts, tax provisions, and other current liabilities that can be used to finance temporary working capital needs. Some part of permanent current asset and fluctuating current assets, which vary according to normal business activity, are financed using short-term funds. In this case, a firm is said to be adopting an aggressive WC policy (Bhattacharya, 2001). Short-term sources of funding are usually cheaper and more flexible than long-term ones; they are however, riskier for the borrower, as interest rates are more volatile in the short term, and they may not be renewed.

Easy access to finance plays an important role when businesses select the sources of financing for WCI. Yet, the trade-off between risk and return that occurs in policy decisions cannot be ignored (Gitman, 2000). Thus, effective WC management lies at the heart of a successful company, playing crucial roles in increasing shareholders' wealth and achievement of benefits from capital investment. In fact, poor WC management is a most common reason for corporate failure. Hence, it is essential that managers understand this key area of corporate finance.

Pecking order theory (Myers, 1984) explains the financing preferences of large companies. However, the theory is also applicable to small firms. Small businesses often rely heavily on trade credit as a major source of short-term finance for WC needs. This is because small businesses are likely to face problems associated with their size when accessing external finance, such as information asymmetry and higher agency costs (Burcu, 2018). As a result, small firms with limited access to long-term capital markets tend to rely more on owner financing, trade credit, and short-term bank loans to finance their operations (Olomi, 2008).

Most studies on financing and capital structure of SMEs. But there are mostly conducted in developed countries (Watson & Wilson, 2002; Zoppa & McMahon, 2002; Hussain & Matlay, 2007); only a few addressed the topic in developing countries (Aidis, 2005; Bhaird & Lucey, 2011). Research into this area in developing economies is scant. Therefore, this study investigated working capital finance practices of small businesses in an attempt to contribute to literature on financing decisions of SMEs.

LITERATURE REVIEW

Long-term investment and financing decisions give rise to future cash flows which, when discounted by appropriate cost of capital, determine the market value of a company. However, such long-term decisions only result in the expected benefits for a company if attention is also paid to short-term decisions regarding current assets and liabilities. Current assets and liabilities are assets and liabilities with maturities of less than one year and need to be carefully managed. Current assets may inventories of raw materials, work-in-progress and finished goods, trade receivables, short-term investments, and cash; while current liabilities include accounts payables, overdrafts, and short-term loans.

Net working capital is the term given to the difference between current assets and current liabilities. The level of current assets is a key factor in a company's liquidity position. A company must have or be able to generate enough cash to meet its short-term needs if it is to continue in business. Thus, working capital management is a key factor in the company's long-term success: without the "oil" of working capital, the "engine" of non-current assets will not function. The greater the extent to which current assets exceed current liabilities, the more solvent or liquid a company is likely to be, depending on the nature of its current assets.

Empirical studies indicates that small business managers experience problems in raising capital (Winborg, 2000; Holmes & Kent, 1991); and the concept of a financial gap is used to explain why small businesses face this problem. Despite their dominance and importance to job creation, small businesses traditionally face difficulty in obtaining formal credit or equity. Hughes (1997) found that small businesses tend to rely more on short-term debt in comparison to large businesses. This is attributed to the fact that small firms face greater problems in attracting long-term debt than large businesses.

However, the difference could also be explained by the mere preferences and attitudes of business owners and the managers towards debt capital (Bhaird & Lucey (2011).

Pecking Order Hypothesis (Donaldson, 1961) argue against the idea of companies having a unique combination of debt and equity to minimize cost of capital, contending that when companies become more profitable, the keenness for external financing reduces since internal funds would be available to execute long-term projects. If only internal finance proves insufficient, bank borrowings and corporate bonds become preferred source of external financing. The least preferred source of financing is issuance of new equity. These preferences are subject to cost of issuance and ease of accessibility to sources of financing. Retained earnings are readily accessible with no issuance costs. As for the choice between debt and equity, the cost of issuing debt is lower than that of issuing equity. It is also possible to raise small amounts of debt, whereas it is not usually possible to raise small amounts of equity (Donaldson, 1961).

Myers (1984) extended Donaldson's (1961) pecking order theory by postulating that cost of financing increases with asymmetric information; and that the order of preference stems from the existence of asymmetry of information between the company and the capital markets (Myers, 1984). Asymmetric information affects choice between internal and external financing and between issuance of debt or equity. For example, assuming that a company wants to raise funds for its new project, and the capital market has underestimated the benefit of the project. The company's managers, with their insider information, will decide to finance the project with retained earnings. This is because retained earnings are the least information that is sensitive to the source of financing. However, if retained earnings are insufficient, managers will choose debt financing in preference to issuing new shares, specifically when the market undervalues the equity. The issuance of equity would signal a lack of confidence in the board as they would feel that the share price is overvalued. The market would perceive it negatively, which may lead to a drop in the share price.

However, in the case of small businesses, the order would relate more to retain earnings and debt finance. This is because majority of owners of small businesses do not normally want to dilute their ownership claim. Therefore, the theory's application to small businesses implies that external equity finance issues may be inappropriate. Furthermore, since small businesses are not listed in the stock market, the issuance of equity would mostly be internal equity finance that is among existing managers (Zoppa & McMahon, 2002). This type of issuance would probably not surrender control.

METHODOLOGY

The paper focuses on examining working capital financing among small businesses in Kano. Financial and other information of small businesses are easily accessible in developed countries where there is a standard databases provided by the government and Private Corporation (information provider or credit rating agencies) that provide such data and information.

However, information on small businesses in developing countries is limited because of the absence of databases and effective record system by government agencies, private and even the small businesses owners themselves, as they are not required to make their financial accounts publicly available. Therefore, data were collected as part of a comprehensive survey on the financial and working capital management practices of small businesses in Kano manufacturing and marketing firms. The study was conducted in the manufacturing and marketing sectors because working capital management is essential in this sectors.

A total of 85 copies of questionnaire were distributed to financial managers/CFOs/business owners of small businesses in the manufacturing and marketing sectors in Kano because they are most likely to be involved in evaluating the working capital requirement of their respective companies. A simple random sampling was used to select the 85 firms. A cover letter attached to each questionnaire served

as an introduction to the purpose of the survey and assured the confidentiality of information supplied by respondents.

The survey was conducted from February 2022 through March 2023. It must be noted that the Kano business community is not accustomed to this type of survey. Despite their non-familiarity with survey instruments, the questionnaire were presented in-person, and appointments were scheduled in advance to increase response rate. Fifty (50) usable responses were received, giving a response rate of 59 per cent, which is comparable to similar surveys.

Data collected were presented and analysed using descriptive statistics and inferential statistics (percentage analysis). Additional rigor in the analysis was possible through an interview conducted with eight of the survey participants. In the interview, data on extent of trade credit, short-term borrowing, traditional sources (bank loans and bank overdrafts), equity finance, retained profits, politician's empowerment programs and informal finance as sources of finance among the Kano manufacturing firms were gathered and examined.

FINDINGS AND DISCUSSION

Descriptive Statistics The findings of this study showed that, when it comes to WC financial decision-making, no small business is the same. All business owners have their own financial goals, concerns, perceptions, and funding sources. The financial issues of the participants and their background characteristics are summarized in Table 1. The survey instrument contained a number of variables to test for significant differences based on the firms' characteristics.

Table 1: Legal Entity and Ownership Type

Legal entity	No. of Companies	% of Companies	Ownership Companies	No. of Companies	% of Companies
Sole proprietorship	32	64	Family owned	38	76
Partnership	13	26	Non-family owned	12	24
Private Limited Co.	5	10			
Total	50	100		32	100

Source: survey Data 2023

Ownership and Structure

The findings presented in Table 1 showed that 64 per cent of small businesses are owned by sole proprietors, followed by partnership ownership accounting for 26 per cent, while private limited companies represent 10 per cent of the sample. Sole proprietorship is the common ownership structure among small businesses in Kano. The culture in Kano is that most people prefer to fully own their businesses or have people whom they know very well, such as friends, especially relatives, to join them because of trust issues and the fear of losing control of their enterprises. More so, they perceive it as being safer for their businesses. Furthermore, majority of sampled firms (76%, n=38) are family-owned businesses, and some 24 per cent (n=12) are non-family owned businesses. The informal and family organization of most SMEs in Kano constitutes a barrier for potential investors that find the lack of information and professionalism in Kano SMEs to be a major constraint (Forsinetti, 2012).

Industry

The sample was spread across five industries, as shown in Table 2. 18 per cent of the companies are in the textile industry, 20 per cent in the food products industry, 22 per cent are in cell phone business, 28 per cent are in furniture industry, while 12 per cent are in agribusiness. The sampled companies were classified by the number of years they have been in business.

Table 2: Type of Industry

S/N	Industry	No. of Companies	% of Companies
1.	Furniture	14	28
2.	Agribusiness	6	12
3	Textiles	9	18
4.	Food Product	10	20
5.	Cell Phones	11	22
6.	Total	50	10

Source: Survey Data 2023

Size and Age

Years of operations of the sampled firms was classified into five categories as shown in Table 3. Based on participants' feedback, 8 per cent have been in for business between 0 and 5 years (n= 4), 18 per cent have been in business for between 6 to 10 years (n=9), while 34 per cent have been in business for between 11 to 15 years (n=17), and 26 per cent have been in business for between 16 to 20 years (n=13), and lastly 14 per cent have been in business for over 20 years(n=7). For long-established companies, operating in Kano for many years gives them a competitive edge by becoming more efficient over time and gaining customers loyalty as firms discover what they are good at and learn how to do things better (Arrow, 1962; Jovanovic, 1982; Ericson & Pakes, 1995). It is also important for these companies to be specialized and find ways to standardize, coordinate, and speed their production processes, as well as reduce costs and improve quality. This in return, will enable them make informed decisions on working capital management.

Table 3: Classification of companies by Age and Assets

Age of Company	No. of Companies	% of Companies	Total Asset	No. of Companies	% of Companies
0-5	4	8	Up to N100,000	6	12
6-10	9	18	N101, 000-N500,000	11	22
11-15	17	34	N501,000-N1M	7	13
16-20	13	26	N1.1M-N1.5M	3	6
Above 20	7	14	Above N1.5M	23	46
Total	50	100		50	100

Source: survey Data 2023

Financing Preferences

The surveyed firms were asked the reason they require WC finance. Table 4 shows that 50 per cent associate the need to irregular demand or increase demand for their goods. When a company is experience increased demand for its goods, usually they tend to invest more to meet the demand. Hence, more WC financing will be required. The finding also showed that 40 per cent of the sampled firms believe that irregular payment of debts is a major determinant of WC financing need.

Table 4. Reason for the Need of Working Capital Finance

S/N	Reason	No. of companies	% of companies
1.	Irregular Demand	25	50
2.	Irregular Production	7	14
3.	Irregular Payment of Debtors	17	34
4.	Irregular supply by creditors	1	2
5.	Irregular Government Policies	-	-
	Total	50	100

Source: survey Data 2023

The need for working capital small businesses were classified into five categories as shown in Table 4. Based on the participants' feedback, 50 percent of the companies need working capital for irregular

demand, 14 percent for irregular production, 34 percent for irregular payment of debtors, 2 percent for irregular supply by creditors, none of them needs it for irregular government policies.

Table 5: Working Capital Policies

S/N	Policies	No. of companies	% of companies
1.	Aggressive policy	24	48
2.	Coservative policy	18	36
3.	Matching policy	8	16
	Total	50	100

Source: survey Data 2023

Table 5 shows the responses on their WC policies. The result shows that 48 per cent of the companies use aggressive policy; 36 per cent use conservative policy, while 16 per cent use matching policy. In financing WCI, companies use different policies. However, conservative approach bears a low risk and low profitability as the working capital is mainly financed by long-term finance sources that require higher interest payment. Aggressive approach mainly uses short-term funds to finance WC. Therefore, it bears high liquidity risk along with high profitability. It is normal for small businesses to adopt aggressive policy of WC financing as the majority of them are using short-term sources of finance.

Short- term sources provide benefits to small businesses, including nominal interest rate on short-term debt and lower interest rates on long-term debt. Moreover, using short-term debt, business owners could borrow only the amount needed for the period, and, therefore, the interest cost is only paid on the money that is actually used (Burcu, 2018). This is especially important for firms that have seasonal fluctuations in their current assets. However, this policy entails increased risk of liquidity and cash flow problems.

Table 6: Start-up Capital Sources

	Sources	No. of companies	% of companies
1.	Compensation from previous job	7	14
2.	Owner's savings	21	42
3.	Loan from family/friends	9	18
4.	Bank loans	-	-
5.	Empowerment fund from Government	3	6
6.	Start-up grant scheme	4	8
7.	Bank overdraft	-	-
8.	Trade credit from suppliers	6	12
	Total	50	100

Source: survey Data 2023

The sampled firms were also asked about their sources of funds during start-up phase and financing their current needs. Their responses regarding these different sources of funds is expected to provide indications as to whether the financing pattern follows a pecking order. Small businesses use different financing patterns at various stages of the business cycle. As previously indicated, prior studies suggest that small businesses tend to use private sources of financing at the start-up due to difficulty of accessing external sources of funds. This is as a result of their inability to provide viable business plan or collateral. Our results support this notion.

The findings in Table 6 show that majority (42 per cent; n=21) of the start-up funds for small businesses in Kano, come from loans from owner's saving, 18 per cent (n=9) of the funds come from loan from family and friends, while 14 per cent of funding comes from compensation received from previous jobs; 12 per cent come from trade creditors; 8 per cent of fund come from start-up grant scheme; 6 per cent come from empowerment from government. The results show that no fund come from bank loans and bank overdraft, which means that small business owners face difficulties in getting finance from formal institutions (banks). Consistent with literature (Beck, 2007), the findings showed that venture capitalists and business angels are not common sources of funds at the start-up stage of small businesses in Kano.

Table 7: Sources of Finance for Current Needs

	Sources	No. of companies	% of companies
1.	Retained Earnings	8	16
2.	Trade Discount	11	22
3.	Trade Credit	159	30
4.	Bank Overdraft	-	-
5.	Short-Term Bank Loan	4	8
6.	Sale of Asset	-	-
7.	Long-Term Loan	2	4
8.	Issue More Equity Finance	-	-
	Total	50	100

Source: survey Data 2023

The results in Table 7 demonstrated that small businesses rely mostly on retained profit with the higher percentage of 36 %. This indicates that it is the most preferred source of financing current WC needs. The second most preferred source is trade credit with 30%. Trade discount is third option where trade discounts are offered to customers to encourage early settlement which has 22 %. Also, receiving payment from customers on time reduce the amount of investment that will be required to finance receivables, thus reducing the WC requirement. Short-term borrowings (bank overdrafts and bank loans) are also used (but ranked below the internally generated source) to finance current business needs.

Participants perceive that financial institutions insist on collateral as part of their short-term borrowing. This finding is consistent with that of Chittenden and Hutchinson (1996), where access to short-term and long-term debt for SMEs was found to be strongly related to collateral. Therefore, firms that have low fixed assets base and or more intangible assets would find it difficult to access bank loans (Myers, 1984). The findings also showed that the least preferred source to finance WC is by issuing more equities.

This evidence is consistent with Myer's (1984) pecking order, in that firms would generally use retained profits, followed by debt and, as a last resort, raise external equity capital. These findings align with reports of previous studies (eg. Hussain & Matlay, 2007). Among the common reasons cited for the observed financing preferences of SME owners is the desire for independence and maintain control (Chittenden & Hutchinson, 1996; Padachi et al., 2012). The reluctance to dilute control is confirmed by the survey results, where the business owners and managers consider issuing equity as a last resort.

Another possible reason firms in Kano prefer internal sources compared to external sources is that small businesses have difficulties arranging for acceptable collateral. As high as 90 per cent of participants perceive that financial institutions insist on collateral as a condition for receiving short-term and long-term borrowings.

Informal Sources

The literature review highlighted the importance of informal investment as a major solution to the problem of access to finance faced by small firms. From the interviews, conducted with 15 business owners and managers, a number of informal sources of financing WC were identified among Kano small businesses. The finding indicate that, the structure of informal financial sources for small entrepreneurs in Kano is predominated by “love capital” (mainly private, family, and friend savings), money counting/lenders, funds/rich families, rotating savings, and credit associations, while the percentage of business angels and venture capital financing is low.

According to some of the participants, it is difficult here for companies like ours to have access to finance from banks and other financial institutions easily as they require a lot of paperwork (business plan, collateral or guarantors, etc.). So, most of the time, if there is not enough money in the business, we use funds from family members or a friend through a simple arrangement as we have a personal relationship and do not need any formal introduction. In comparison to banks and other formal sources, family/friends normally have fewer requirements or even non.

Similarly, some participant said that, we found money counting/lending as an alternative way for us to finance our day-to-day operations as it is easy and very fast to secure loan money from a lender with a daily instalment payback rate. Though money counting/lending bears a high-interest rate from 15, 20,30 percent up to 40 percent, it helps us as business owners to meet our business needs. Because borrowers and lenders are typically acquainted with one another, it makes it like a home-free run for us to borrow without black and white agreements.

Ultimately, the key evidence of the mentioned analysis is that in Kano, informal financing is oriented to borrowers who have some kind of personal relations with lenders or know each other very well. The finding also showed that small businesses that attract informal financing in Kano prefer substantially internal sources (private, family, a friends' money) in comparison with external money counting/lending, business angels, and venture capital investments.

CONCLUSION AND IMPLICATIONS

This paper has shown, to some extent, that small businesses in the Kano are facing difficulties in getting access to financing working capital requirements. The findings indicated that these businesses mostly rely on internal sources of finance. In some cases, however, they have to rely on informal sources in financing their working capital requirements. Major forms of financing working capital requirements preferred are current liability, cash credit, retained earnings, and equity/long term loans.

Besides, the study found that some companies do not have any specific method in determining their working capital requirements. Therefore, a conclusively, in Kano, small businesses prefer internal sources of finance and current liability to finance their working capital investment. Currently, working capital management remains a fairly new concept as there are a number of small businesses in Kano that do not have clear working capital policies.

The findings of this study could become a very important tool for business owners and managers to understand the best techniques on how to manage their working capital financing investment based on the type of their businesses and structure. The Kano State Government and other state house of assemble in Kano should come up with a laws on the use of some simple assets (such as vehicles, machinery, livestock, account receivables, among others) to be used as collateral for small businesses to enhance access to loan.

The Rural Development Bank (RDB), established as an autonomous public enterprise to support SMEs in loan services, could also use the findings to help formulate a program to support small businesses at different stages of the financial chain. This support should, therefore, include a process to help them transition from an informal to formal status and provide them with management and governance support to better understand and improve their businesses. The use or set up of dedicated agencies to provide that support would definitely be crucial to small businesses in Kano.

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