Understanding Owner-Managers’ Preferences Towards Different Sources of Financing: The Case of Successful SMEs in Malaysia

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The increasing importance of SMEs sector in many countries, especially in developing economies, motivates a better understanding on the behavior of financing practices among SMEs. The accessibility of financing which is one of the crucial contributing factors to the SMEs success can be enhanced by developing a supportive financial framework to improve SMEs’ sustainability as well as their overall contributions to the economy. This research investigates the financial practices among successful SMEs in Malaysia based on the list of Enterprise 50 award winners from 1998 to 2010, by focusing on the owner-managers’ level of preferences towards various sources of financing. This research also explores the relationship between owner-managers’ characteristics and their level of financing preferences. Electronic surveys among 444 SMEs were conducted, yielding a response rate of 29.6%. Results show that retained earnings and banking institutions are the most preferred sources of internal and external financing among Malaysian SMEs owner-managers. Furthermore, managers’ ownership status, highest level of education and level of experience are found to have a statistically significant association with their level of financing preferences towards different sources of financing. These findings would provide valuable information to the related policy makers in developing the supportive financial framework for SME development.

Keywords: Financing preferences, successful SMEs, Malaysia

1.0 INTRODUCTION

SMEs are important to almost all economies in the world, but especially to those in developing countries. SMEs in total constitute a large proportion of the economic activity and are considered to be an engine of growth in both developed and developing countries1. In developing countries, concern on the role of SMEs in the development process continues to be at the forefront of policy debates2, as they comprise a majority of the business population in most countries and therefore play a crucial role in economic contribution2. It adds that the realization of the significant economic contribution of SMEs has resulted in increased attention focused on the sector from policy makers as well as academics. The economic potential of the SME sector makes SME development an important Government agenda. Its contribution is crucial and remains as an integral part of economic development of the country. In Malaysia, the role of SMEs in promoting endogenous sources of growth and strengthening the infrastructure for enhanced economic expansion and development has been acknowledged3 and clear policies, strategies and implementation matrices has been put up in developing this sector via an integrated approach4.

The rest of this paper is organized as follows. Section 2 elaborates review on previous studies incorporating personal characteristics of owners/managers and preferences towards different sources of financing. This is followed by research methodology and results in section 3 and section 4, respectively. Finally, section 5 summarizes this paper.

2.0 LITERATURE REVIEW

A considerable amount is known about the characteristics and behavior of SMEs. However, this knowledge continues to be imperfect and a large number of questions remain unanswered in relation to finance and SME development in developing countries5. In developing countries, research on both the supply and demand for finance among SMEs has been empirically based and pre-occupied with gathering information on the characteristics of SMEs and lending institutions, rather than on testing theoretical propositions that would improve understanding of the relationship between finance and SMEs2.

Investigation into SMEs financing choices often seeks explanation of the issue in term of firm
characteristics (firm size, age, asset structure, profitability; to name a few) without considering one important aspects of small business and entrepreneurship which is the role of the SME owner. Highlighting the need for better understanding of managerial beliefs and their relation to firm's financial practices is important. 'In small businesses and entrepreneurial firms, managerial beliefs and desires will play an especially important role in determining capital structure...models must include the role of management preferences, beliefs, and expectations if we are to better understand capital structure policy'.

Although managerial preferences might not precisely resemble the observed capital structures, information provided will offer evidence of motivations behind the financing decision. found that personal characteristics of the owner-manager play a significant role in determining his or her financing preference. Likewise, outlined two approaches used in relation to owner characteristics into owner's personal characteristics (age, gender, race, education, and experience) and owners' preferences, business goals and motivations. These characteristics may provide some additional predictive power in explaining the firm's capital structure.

Review on previous studies integrating managerial characteristics in understanding firm's financial behavior highlighted similar indicators. Gender, age, education, experience and business ownership were often used as indicators for owner-managers' personal characteristics in understanding firm's financial practices.

These indicators are selected to be used in this study and presented as follows:

Gender

Few studies found evidence to support the argument that there is no significant relationship between decision makers' gender and their financing preferences. Likewise, also highlighted that the owner's gender is found to be not significant within models predicting the use of various credit products and SMEs' access to bank finance. In contrast, found that female owners are found to be less likely to use debt capital compared to male owners.

In addition, and also point out that manager's gender may have an influence on capital structure and firm's financing. Furthermore, concluded that owner-managers' characteristics (including gender) have an influence on the use of external advice and, in turn, would reduce the difficulties in raising finance among UK SMEs. On the other hand, found a mixed relationship between gender and financing at different stages of business life.

Age

Managers' age appears to be a significant factor in explaining firm's financing pattern where younger managers tended to have significantly lower start-up capital than older managers. Likewise, found a relationship between manager's age and business financing, concluding that middle age managers have better knowledge of the financial market and are more likely to take advantages of bank financing. Another study by found similar yet contrasting results where older SME owners are less likely to seek or use external financing while younger managers are found to use external financing actively. In contrast, and found that managers' ages are not statistically significant with the level of debt used. Also found that the age of the firm's Chief Executive Officer (CEO) is not a significant predictor of a firm's debt use.

Level of Education

In term of manager's level of education, point out that an entrepreneur with a better formal education is more likely to employ formal financing. Likewise, managers with attainments in higher education are also found to be more likely to take advantage of bank financing. Another study by found that less educated SME owners are found to use external financing actively, while more educated SME owners are found to be less likely to seek or use external financing. Similarly, found some evidence of manager's education to be positively related to external loans, as level of education reflects better human capital and correlates more positively with a firm's access to debt capital (and also associated with the refusal of finance). In addition, found that the only significant personal characteristics variable in predicting the use of bank financing is educational qualifications which indicate that the banks are more likely to lend to owner-managers with formal qualifications. Likewise, in their study found that owner's education attainment is significantly related to firm's financing preferences. Finally, found the owners' level of education to be major determinants of their financing preferences. Less educated SME owners rely more on their internal sources even if there are possibilities for external finance, while more educated owners are found to make use of external finance scheme even if internal sources are not exhausted.

In contrast, studied the effect of manager's level of education on the firm's leverage ratio, finding that although not statistically significant managers with a lower level of education use more debt than those with a higher level of education. Additionally, also found evidence to support the argument that there is no significant relationship between decision maker's levels of education and their financing preferences. Owner-
managers’ education level was found to have no significant influences on sources of finance used by SMEs in the UK. Nevertheless, owner-managers with a higher level of education having less difficulty in obtaining finance for their business compared to those with a lower education level who were found to be more frequently employed finance from friends and family and home remortgaging.

Likewise, a study by found that, although not statistically significant, educational qualifications have a positive relationship with the use of external financing. SME owner-managers with any type of qualification are more likely to approach external funders than respondents without qualifications. This is similar to the findings of where it was proven that owner-managers’ education have an influence on the use of external advice among UK SMEs and, in turn, would reduce the difficulties in raising finance among them. also found evidence to prove that owner-manager’s educational level was not found to influence the amount of debt supplied to Chinese SMEs significantly.

Experience

Managers’ experience, on the other hand, can also be considered as a measure of reputation and private entrepreneurs who run businesses with a long history are more likely to choose formal financing. The experience signals better human capital and increases firm’s access to debt capital where managers with a greater level of business experience are found to take advantage of bank financing. found that owner-managers’ experiences are significantly and positively related to the level of firm leverage. Work experience is also associated with a lower level of perception of financial barriers to start-up.

However, it is proven that there is only a weak and insignificant gender influence of work experience on perceived financial barriers among entrepreneurs in UK. In contrast, managers’ experience is found to have no significant effect on the use of debt but does show evidence of a positive correlation between these. Likewise, previous entrepreneurial experience is found to have a positive (though not significant) impact on an individual’s willingness to seek external funding. Another study by found that managers’ experience not associated with in firm’s debt to asset ratio and firm’s growth.

Ownership Structure

Finally, ownership structure is another important determinant of capital structure in SMEs. It is negatively related to external equity and positively related to internal equity. also found that ownership structure is statistically significant in the future financing model indicating a relationship between this particular variable and firm’s financing preferences. As level of interference increases due to the ownership changes, firm’s preferences for formal financing also increase. In this case, firms are found to try to minimize intrusion into their business by opting for formal financing rather than equity-type of financing. However, indicates that the organization type provided no explanatory power with regard to the proportion of leverage in the firm.

3.0 RESEARCH METHODOLOGY

An electronic survey was chosen to supports the accomplishment of data collection process, not only for increasing the response rates but also increasing the reliability of analysis and findings. A web survey is chosen for this study as this particular type of electronic survey facilitates a more refined appearance and has the flexibility to provide survey capabilities far beyond e-mail and paper surveys.

Detailed and careful planning should be undertaken to develop a reliable instrument. The final version of the questionnaire was constructed comprising four different parts and accessible via a designated link. The link for the final version of the questionnaire was sent via e-mail to the selected sample within a list of Enterprise 50 winners from 1998 to 2010. The main survey resulted in a total of 120 responses received, representing a response rate of 29.5%. This rate was deemed to be appropriate as the average response rate for surveys among SMEs in Malaysia is 15.6%.

4.0 RESULTS

In terms of the preferences towards different sources of financing among SMEs managers, results revealed that retained earnings were the most preferred sources of internal financing among SMEs managers followed by shareholders own contribution and funds from related companies (parent, subsidiaries or associate companies). When it comes to external funding, banking institutions, trade/supplier credit and government funds were found to be the most preferred sources of financing. Other sources of financing (DFIs, cooperative financing, leasing and factoring) were found to be least preferred by the SME managers, with equity investments being the least preferred source of financing. Conclusion can be drawn on the five most preferred sources of financing as follows:

<table>
<thead>
<tr>
<th>Rank</th>
<th>Source of financing</th>
<th>Sources</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Banking Institutions</td>
<td>External</td>
</tr>
<tr>
<td>2</td>
<td>Retained Earnings (Net Income Retained for Reinvestment)</td>
<td>Internal</td>
</tr>
<tr>
<td>3</td>
<td>Shareholder’s Own Fund/ Contribution</td>
<td>Internal</td>
</tr>
<tr>
<td>4</td>
<td>Trade/Supplier Credit</td>
<td>External</td>
</tr>
<tr>
<td>5</td>
<td>Government Funds/Schemes</td>
<td>External</td>
</tr>
</tbody>
</table>
Table 2 above indicates that the most preferred sources of financing among SMEs managers are a mix of external and internal sources of financing. This list provides a clearer insight into the level of financing preferences towards various sources and types of financing available for small business particularly in the case of Malaysian SMEs. Managers of SMEs appear to find external funding most preferable from banking institutions, suppliers and also from the Government. Otherwise, they would use internally sought sources of financing from retained earnings or providing their own funds to provide much needed funding. Descriptive results also indicate that generally SMEs depend more on debt over equity-sources of financing. This is demonstrated by overall Debt-to-Equity ratio (DER) to be approximately 57 to 43. This figure shows that firms mainly seek for external debt-sources of financing over internal funds. The proportion of debt financing is also found to be equally divided into short and long-term debt financing which shows that firms generally use both types of debts in financing their business activity. The following eight items were found to have the highest proportion in the firm’s liability and equity. These items are presented as follows:

Table 3: Proportions of type of financing in the firm’s liability and equity

<table>
<thead>
<tr>
<th>Rank</th>
<th>Type of financing</th>
<th>Types</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Account Payable</td>
<td>Debt</td>
</tr>
<tr>
<td>2</td>
<td>Retained Earnings (Net Income Retained for Reinvestment)</td>
<td>Equity</td>
</tr>
<tr>
<td>3</td>
<td>Shareholder’s Own Fund/Contribution</td>
<td>Equity</td>
</tr>
<tr>
<td>4</td>
<td>Trade/Supplier Credit</td>
<td>Debt</td>
</tr>
<tr>
<td>5</td>
<td>Share Capital</td>
<td>Equity</td>
</tr>
<tr>
<td>6</td>
<td>Capital Reserved</td>
<td>Equity</td>
</tr>
<tr>
<td>7</td>
<td>Bank Overdraft</td>
<td>Debt</td>
</tr>
<tr>
<td>8</td>
<td>Long-term Debt</td>
<td>Debt</td>
</tr>
</tbody>
</table>

This study also seeks to investigate whether there is statistically significant associations between owner/manager characteristics and their financing preferences. This specific objective was translated into a general hypothesis as follows:

H1: There are statistically significant relationships between manager characteristics and their financing preferences towards different sources of financing.

Discussions on the results are divided into 15 sub-hypotheses to represent the testable association between five independent variables of manager characteristics with three dependent variables relating to managers’ level financing preferences towards IEF, DF and EEF. A summary of the results is presented as follows:

Table 4: Summary of bivariate correlation coefficient test results

<table>
<thead>
<tr>
<th>Dependent Variable</th>
<th>Independent Variable</th>
<th>Reject/ Accept HO</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manager’s preference on Internal Equity Financing (IEF)</td>
<td>AGE (H1.1), EDU (H1.3), EXP (H1.5)</td>
<td>Reject HO</td>
</tr>
<tr>
<td>Manager’s preference on Debt Financing (DF)</td>
<td>GENDER (H1.12), OWN (H1.14)</td>
<td>Accept HO</td>
</tr>
<tr>
<td>Manager’s preference on External Equity Financing (EEF)</td>
<td>EDU (H1.4), EXP (H1.6), GENDER (H1.12)</td>
<td>Reject HO</td>
</tr>
</tbody>
</table>

In summary, owners/managers preferences towards three different sources of financing did not have a statistically significant relationship with their age, experience and gender. This indicates that their preferences on different sources of financing were not related to these three variables.

Manager’s level of education is found to have a statistically significant negative relationship with their preferences toward EEF and not with the other two sources of financing. This result shows that the more knowledgeable the owner-managers are, their preferences towards EEF is lower. This is perhaps due to the nature of equity-financing that perceived to be exposing the business towards external interference to the business operation. Finally, a manager’s ownership status is found to have a statistically significant positive relationship with their preferences towards all three sources of financing. Business ownership provides authority among owner-managers on types of financing used in their business. As the owner-managers of the business, their ownership status was found to have a relationship with sources of financing used for their business. The statistically significant relationships between manager’s ownership status and level of education, with managers’ financing preferences towards different sources of financing are in line with previous studies (see 9, 14, 15, 16, 19, 20, 21, 24, 25, 29).

5.0 SUMMARY AND CONCLUSIONS

Within the findings of this study, owner-managers of successful Malaysian SMEs are found to have preferences towards debt financing. Their preferences were found to have a statistically significant relationship with their ownership status and also their level of education. This understanding of financial practices of SMEs in general and particularly the successful
Malaysian SMEs, may assist policymakers in providing an enhanced financing environment for SMEs, focusing on the provision of accessible and adequate financing to meet the demands of SMEs.

SMEs play a very important role in a nation’s economy and have become one aspect of a national government agenda to enhance SME development. Increased understanding on financial practices among Malaysian SMEs can create better awareness of the factors influencing their financing decisions and provide useful insight into the financial behavior of these SMEs. These would eventually increase the awareness of their financial needs. Development of policies related to the financial assistance and creation of conducive financial environment for the SMEs would be enhanced accordingly.

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