

“The Role of Financial Institutions in the Growth of Small and Medium Enterprises in Dilla Town, Ethiopia”

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Abstract

This research article deals with financial institutions` contribution to the growth of Small and Medium Enterprises in Dilla town, Ethiopia. It tried to examine two separate but interrelated issues. On the one hand, it seeks to show the place of Small and Medium Enterprises in financial institutions overall objective/s. On the other hand, tries to identify the major constraints of the growth of Small and Medium Enterprises (SMEs) in Dilla town, Ethiopia. Some of the questions that the research addressed include: what roles do financial institutions, specifically banks and Micro finance institutions play in the growth of SMEs in Dilla town?; what forms of financing are available in financing the financial needs of SMEs in Dilla town? Are the financial institutions services accessible and affordable for the SMEs? etc. The research makes use of descriptive, explanatory quantitative research methodology and has come up with five major findings. The first is lack of access to financial services is the major factor that negatively affects the growth of small and Medium Enterprises in Dilla town. The second finding is most small and Medium Enterprises have achieved some level of growth. Thirdly, it found out that Financial Institution contributed almost nothing for the growth of SMEs in Dilla town; rather the demand for the products and services of SMEs is the major factor for their growth. The fourth one is the major factor that affect SMEs` access to finance is collateral inadequacy followed by bureaucratic problem. The last major finding is that Small and Medium Enterprises usually use their own saving to finance their business activities. The overall conclusion of the study is that further support from financial institutions is critical for SMEs found in Dilla town, Ethiopia so that they can grow and expand.

Keywords: SME, Financial Institutions, MFI

Background of the Study

Small and medium enterprises /SMEs/ and financial institutions are vital contributors to the overall performance of an economy. SMEs play a crucial role in developing the economy and in creating employment (Asmelash, 2002:1) Furthermore, SMES are at the forefront of technological innovation and export diversification. Similarly, financial institutions play an indispensable role in firms' growth and thus industrialization and economic growth. They provide a sound medium of exchange and facilitate trading. Encourage mobilization of resources through savings and allocate resources to activities with high returns, monitor investments, spread risks by offering a diversity of financial instruments. Moreover, they provide financial assistances to fulfill the varied needs of enterprises (Ageba&Amha, 2006). The term SMEs covers a wide range of definitions varying from country to country and from the sources reporting SME statistics. Although there is no universally agreed definition of SME, some of the commonly used criteria are the number of employees, value of assets, volume of sales and size of capital or turnover (Beyene, 2002). Whatever the definition, and regardless of the size of the economy, the growth of SMEs is becoming increasingly crucial to economic growth. To this end, this study significantly places at its main focus the examination of financial institutions role in SMEs growth in Ethiopia particularly in Dilla Town.

Background of the Organization

Established in 1912 by Dege Azimach Bedecha Eudo, Dilla is a town in Southern Ethiopia. It is the capital of South Gedeo zone of the SNNP regional state. According to the town`s Micro, Small and Medium Enterprises/SMEs/ department there are around 100 small and medium Enterprises in the Town. The Town has loaned over 4.7million Br.3000 individual involved in small and medium enterprises according to Town Administration. The Town will give loans to people who are interested in engaging in the Manufacturing, Construction, Service, Trade and Urban Agriculture KifleGiso 2014. The Town has designated 146million sqm of land for production, marketing and warehouses and also 3000 people are expected to receive loans. The major sectors which they are engaged in are manufacturing, construction, trade, service and urban-agriculture. The fast growing SMEs are those which engage in construction and

manufacturing sectors. The Town is good for Investment as well as for the growth of small and medium Enterprises.

Statement of the problem

SMEs constitute the back bone of an economy. The SMEs sector plays a vital role in the industrial development of a given country. At the same time SMEs serve as a training ground for emerging entrepreneurs. It is within this context that SMEs development becomes focal attention for governmental as well as non-governmental organizations. Hence, financial institutions should contribute for the development of SMEs. Commercial Bank of Ethiopia and Micro financing Institutions such as Dilla Credit and Saving Institution are among such Institutions. Evaluating the performance of these financial institutions with regard to their contribution to the growth of SMEs and indicating solutions to related problems is therefore important.

Research Objective

The study has the following general and specific objectives.

General Objective

The general objective of the study is to analyze the role of financial institutions /banks and micro finance institutions on the growth of SMEs in Ethiopia, particularly in Dilla Town.

Specific Objectives

- 1) To examine the performance of financial institutions in Dilla Town with regard to the growth of SMEs;
- 2) To identify the major constraints of growth of SMEs in Dilla Town; and
- 3) To identify the major sources of finance for SMEs;

REVIEW OF LITERATURE:

Understanding the many roles that banks play in the firm's growth is one of the fundamental issues in theoretical economics and finance. Banks play an important role in economic development through mobilization of funds from within and outside the country and channeling such funds to various sectors of the economy. The efficiency of the process through which

resources are channeled into productive activities is crucial for growth and general welfare. Banks are one part of this process. The banking sector specifically commercial banks, have several ways to get involved in SMEs financing, ranging from the creation or participation in SMEs finance investment funds, to the creation of a special unit for financing SMEs within the bank. Banking sector services provided to SMEs take various forms, such as: short term loans; repeated loans, where full repayment of one loan brings access to another, and where the size of the loan depends on the client's cash flow; very small loans or bank overdraft facilities are also appropriate for meeting the day to day financial requirements of small businesses (Proclamation No. 626 /2009). Although the formal financial institutions have taken various measures to strengthen their operation and expand their services, they could not address the financial needs of micro and small enterprises satisfactorily. Microfinance as a development tool provides financial services and products such as very small loans, savings, micro-leasing, micro insurance and money transfer to assist the poor in expanding or establishing their businesses. The Dilla Credit and Saving Institution (DCSI) operates in the SNNP region, and aims to fill the gap of formal institutions by meeting the needs of small scale borrowers in income generation schemes (MulgetaNegash, 2014). The issue of what constitutes an SME is a major concern in literature. According to the ministry's definition Small Enterprises are business enterprises with a paid-up capital of more than Birr 20,000, but not more than Birr 500,000. Large and medium scale manufacturing enterprises have been classified as business establishments with more than ten employees using automated machinery. The Ethiopian Revenue and Custom Authority (ERCA) also defined enterprises for the tax purpose as enterprises having below ETB 1million annual turnovers as Small enterprises, from ETB 1million to ETB 4 million annual turnovers as medium, and above ETB 4 million annual turnovers as large enterprises. And this definition of SMEs is used in this research.

General Constraints to SMEs' Growth

Despite their potential role to accelerate economic growth and reduce poverty, in most developing countries, SMEs face a wider range of constraints and problems and they are unable

to address the problems they face on their own. The constraints relate, to the legal and regulatory environments, access to markets, finance, business information, business premises (at affordable rent), the acquisition of skills and managerial expertise, access to appropriate technology, access to quality business infrastructure and in some cases discriminatory regulatory practices (FDRE,1997&Gebreeyesus, 2009).

In Ethiopia MSEs have been confronted by various problems which are of policy, structural and institutional in nature. To start with, lack of smooth supply of raw materials, serious marketing problems, lack of working premises and lack of sufficient capital are the major challenges for small and medium scale enterprises to start and grow/expand.

Research Methodology

Quantitative research methodology was utilized to do the research. This study uses descriptive type of study which has the purpose to describe the existing situation about the relationship between SMEs and Financial Institutions. The researchers used a convenient sampling technique for selecting the sample from the total population. All Small and Medium Enterprises (SMEs) currently registered with the trade and industry bureau of Dilla Town constitute the study population. From the existing records of this bureau there are 100 SMEs in the town. From this 100 SMEs 50 of them are taken as sample. In other words the sample size of the study is 50 SMEs. For a Small and Medium Enterprises of 100 and a sample size 50, the sampling fraction is $\frac{1}{2}$ i.e researcher select one person out of every two in small and medium enterprises. Random number needs to be used only to decide on starting point. Both primary and secondary sources of data used for the study. Secondary sources of data which are relevant to the study such as books, journal articles and official publications were consulted. This study utilized structured questionnaire to collect data from sample SMEs as it is appropriate. In this study data is presented and analyzed manually. Tables, graphs and percentage are used for data analysis and illustration.

DATA ANALYSIS: Based on Primary Data Survey

Table 1 Age of business

Item	Frequency	Percent
Less than one year	10	20
1-5 years	20	40
5-10years	14	28
10 years and above	6	12
Total	50	100

Age of business is one of the factors that affect the growth of SMEs. Because, as age of business increases there is a potential to get experience and increased market share. In this regard, the researchers tried to identify the age of the SMEs found in Dilla Town. As indicated in the above table the greatest number of SMEs, 40 %, are between 1 and 5 years of age. 28 % of the SMEs are between 5 and 10 years age; while 20% are less than one year. Only 12%, a very small portion of the SMEs, are ten years and above years of age. This indicates most SMEs are of a recent establishment.

Table 2 Nature of business activities

Item	Frequency	Percent
Trade	15	30
Manufacturing	10	20
Services	5	10
Construction	15	30
Others	5	10
Total	50	100

Trade, manufacturing, services and construction are the major areas of business operation that SMEs usually engage in. In this connection, the researcher tried to identify the area of business activity that most SMEs in Dilla Town are engaged in. As the table above (table 2) shows that most SMEs, 10%, are engaged in manufacturing followed by trade, 30% Construction, 30% and services, 10%. Only 10 % of the SMEs are engaged in other sectors.

Table 3 type of ownership

Item	Frequency	Percent
Sole proprietorship	20	40
Partnership	20	40
Private Limited company	9	15
Others	1	5
Total	50	100

There are a number of business ownership types. In Dilla Town, as table 3, above, depicts most SMEs are sole proprietorship and partnership, 40% each. Private Limited covers 15percentand other form of ownership covers 5 percent. This might be because SMEs prefer to operate individually rather than in partnerships; or the conditions for operating in partnership are not conducive.

Table 4 loans taken at least once

Item	Frequency	Percent
Yes	18	36
No	32	64
Total	50	100

It is argued that access to finance is a major determinant of growth of SMEs. Hence, the researcher tried to find out whether SMEs in Dilla Town have got enough access to loan services of financial institutions (Banks and Microfinance institutions). However, as the above table shows only 36 % of them got loan service at least once; while the majority, 64 %, of them never got loan from financial institutions. This implies the majority of SMEs are not beneficiaries of loan services of financial institutions.

Table 5 Awareness about Financial I Services

Item	Frequency	Percent
Yes	45	90
No	5	10
Total	50	100

Awareness about the services which public institutions such as government banks and micro financial institutions provide is important for business institutions. In this regard, the researcher tried to found out SMEs level of awareness about the services of financial institutions in Dilla Town. The result, as shown in table 5 is 90 percent. This is encouraging but not enough; since 10 percent of them are still not aware. This shows that financial institutions (banks and micro financial institutions) and other concerned government bureaus need to work on awareness creation so that SMEs would be able to get loan and other services and increase their operational capacity and growth.

Table 6 Loan selection Criteria

Item	Frequency	Percent
Collateral	15	30
Third party guarantee	10	20
Business plan	20	40
Others	5	10
Total	50	100

It is a common practice that financial institutions ask for some sort of precondition/criteria in order to give loan service. These preconditions could be either collateral, third party guarantee or business plan. The researcher tried to identify the most commonly used criteria that financial institutions in Dilla Town use to give loan service. As indicated in the table above (table: 6) business plan (40 %) and collateral (30%) are the most commonly used criteria. Third party guarantee and others cover 20 and 10 percent respectively; less important as compared to the first two.

Table 7 Affordability of criteria

Item	Frequency	Percent
Yes	28	56
No	22	44
Total	50	100

The level of affordability of loan criteria which financial institutions require from SMEs to give loan is very important. However, as table 7 depicts, the criteria are said to be affordable only by 56% of the SMEs. The remaining 44 % believe that the criteria are not affordable. This shows a considerable size of SMEs are not benefiting from loan services of financial institutions due to the fact that the criteria are not affordable to fulfill.

Table 8 Adequacy of loan funds

Item	Frequency	Percent
Yes	20	40
No	30	60
Total	50	100

Business enterprises such as SMEs use loan services which banks and micro financial institutions provide to finance their investment and operating activities. So, identifying the adequacy of these loan funds is appropriate. As depicted in table 8, most SMEs, 60 percent, are of the opinion that the loan fund which SMEs are able to get from financial institutions is not adequate to cover their financial needs. 40 percent of the respondents believe it is adequate. This indicates SMEs demand for finance is not met.

Table 9 Factors negatively affect the growth of SMEs

Item	Frequency	Percent
Access to financial services	16	32
Access to market	12	24
Managerial and entrepreneur skill	7	14
Availability of raw materials	7	14
Legal and administrative problems	8	16
Total	50	100

The growth of business enterprises could be effected by several internal and external factors. The researchers tried to list out the most common ones and identify their level of influence. As table

9 shows, lack of access to financial services (32%) is found to be the most important factor that hindered the growth of SMEs in Dilla Town. Access to market comes second with 24 percent. Legal and administrative problems cover 16 percent; while managerial and raw material problems cover 14 percent each as problem for growth.

Table 10 Level of approval of the efficiency of Financial Institutions

Item	Frequency	Percent
Excellent	0	0
Very good	13	26
Good	29	58
Poor	8	16
Very poor	0	0
Total	50	100

Financial institutions are the major formal sources of loan for SMEs. Financial institutions, particularly micro finance institutions, are also expected to provide other non-financial support services to SMEs. Measuring SMEs` level of satisfaction about these services of financial institutions is important. As indicated in table (10), most SMEs (58 percent) rate the performance of financial institutions as good. 26 percent of the SMEs rate the service as very good. 16 percent said it is poor. The result shows financial institutions need to improve their performance.

Table 11 Growth achievement

Item	Frequency	Percent
Yes	33	66
No	17	34
Total	50	100

Growth is a major objective of almost all business enterprises. But, not all businesses achieve this objective due to several internal and external factors. The above table (table: 11) shows this fact. As indicated only 66 percent of the SMEs have achieved some level of growth. The data shows most SMEs are growing and are achieving their objectives.

Table 12 Reasons for the growth

Item	Frequency	Percent
Marketing and managerial efficiency	13	26
Support from financial institutions	9	18
Favorable legal and administrative environment	11	22
High demand	17	34
Total	50	100

Growth could be achieved as a result of a number of factors. Hence, it is important to identify the driving factors of growth of SMEs. The researchers tried to find out the factors that enabled SMEs to grow. As table 12 depicts the greatest number of SMEs have grown because of high demand for products (34%). 26 percent due to marketing and managerial efficiency which is internal to the businesses. Favorable legal and administrative environment contributed to 22 percent. Surprisingly, support from financial institutions contributed 18 percent to the growth of SMEs. This shows financial institutions role in the growth of SMEs in Dilla Town is significantly below expectation.

Table 13 growth as expectation

Item	Frequency	Percent
Yes	20	40
No	30	60
Total	50	100

Even if most SMEs in Dilla Town are growing the table above shows most of them are not growing as expected. While only 40 percent say their growth is as per their plan, the large portion, 60 percent, believe their growth is below expectation. This indicates that businesses could grow but usually not as per their expectations. Identifying the reasons behind this useful. The following table shows these reasons.

Table 14 Reasons for failure to grow as expectation

Item	Frequency	Percent
Lack of market	20	40
Lack of access to finance	16	32
Unfavorable legal and administrative environment	7	14
Lack of raw material	7	14
Total	50	100

As discussed in the research the growth of SMEs is important both for the businesses and the country at large. Because it is only when they grow that they can contribute for employment and economic growth and transformation of the country at large. But, most SMEs in Dilla Town are not growing as per their plan and expectations. The reasons are lack of market, 40 percent; lack of access to finance, 32 percent; unfavorable legal and administrative environment, 14 percent and lack of raw material 14 percent. From this we can conclude lack of market is the most critical factor that affected the growth of SMEs followed by lack of access to finance. Lack of raw material and unfavorable legal and administrative environment also contribute to failure to grow as expectation; though in a minor degree compared with the market and finance.

Table 15 Factors affecting access to finance from Financial Institutions

Item	Frequency	Percent
Bureaucratic problem	15	30
Collateral inadequacy	21	42
High borrowing cost	9	18
Fear of inability to repay	5	10
Total	50	100

Financial institutions are the major formal sources of financial services for any business organization including SMEs. But accessing these services is not always an easy task due to several reasons. The researchers tried to identify these factors that affect SMEs access to finance in Dilla Town. As indicated in table 15 above, collateral inadequacy is the major factor that

affects access to finance. It contributed 42 percent followed by bureaucratic problem, 30percent; high borrowing cost, 18 percent and fear of inability to repay 10 percent.

Table 16 special services financial institutions provide for SME

Item	Frequency	Percent
Training and counseling	23	46
Reschedule loans	15	30
No	12	24
Total	50	100

As discussed in this research financial institutions are also meant to provide other services particularly to SMEs in addition to loan in order to help them competitive in the market. Table 16 shows that 46 percent of the SMEs have got training while 30 percent got loan rescheduling service. 24 percent didn't get any special service from financial institutions. From this it is possible to conclude that financial institutions need to improve their performance in this regard.

Table 17 mechanisms that SMEs usually use to finance their activities

Item	Frequency	Percent
Borrowing from banks	10	20
Own saving	18	36
Borrowing from microfinance institutions	10	20
Borrowing from relatives, <i>iqub</i> , associations	12	24
Total	50	100

Understanding the role of financial institutions in the growth of SMEs requires identifying the major source of finance which they usually use. The above table indicates that most SMEs, 36 percent, use their own saving rather than borrowing from banks or microfinance institutions. Borrowings from informal sources (relatives, *Iqub* or associations) come 2nd with 24 percent. While borrowing from banks and microfinance institutions come 3rd with 20 percent each. This shows that financial institutions are not the primary sources of finance for SMEs in Dilla Town.

Table 18 Information about shut down off SMEs due to lack of support

Item	Frequency	Percent
Yes	19	38
No	21	42
Total	50	100

In order to understand the level of financial problem that SMEs experience the researchers tried to find out the number of SMEs that are terminating their business due to financial problem. One of the ways to know this is asking SMEs. Accordingly, as table 18 shows 38 percent of them said that they know SMEs that terminate down due to lack of finance. 42 percent said they didn't. This shows the level of impact of financial constraint on SMEs in Dilla Town is significant.

Summary and Conclusion

Currently there is a wide consensus about the strong relation between the growth of Small and Medium Enterprises and socio-economic development on the one hand, and the need to provide/fulfill the necessary conditions for their growth/development such as the provision of adequate financial services on the other. In the light of this and as part of its objectives which it sets at the beginning, this research article tried not only to uncover the major constraints of the growth of SMEs in Dilla Town but also analyzed the drivers of SMEs growth and tried to identify means of finance that SMEs usually use. In this connection the study analyzed major issues pertinent to SMEs and financial institutions performance.

- Collateral inadequacy and bureaucratic problem are found out to be the major constraints of access to loan from financial institutions and hence for the growth of SMEs.
- It is also found out that the demand for SMEs products and services is the major driver of the growth registered by SMEs. But most SMEs are not growing as their expectation.
- It is clear that this growth would have been better had it not been for the financial constraints. The result indicates that SMEs are not operating in full capacity and utilize the market potential (the demand for their products and services).

- Unless this situation is improved it would be difficult to expect SMEs in Dilla Town to play their roles described in the development strategy- employment creation, export diversification and contributing for the socio-economic development of the nation.

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