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Research Title:
The Financing of Small and Medium Enterprises (SMEs): A Comparative Study of SMEs’ Business Owners in Malaysia Based On Three Ethnic Groups

Abstract
This research investigates the influence of generic factors and cultural factors on financing decisions of Malaysian SMEs’ owners-managers. In doing this, four main determinants of capital structure; namely SMEs characteristics, owner-manager characteristics, business-lender relationship and cultural factor are elaborated. The paper also looks at how the financing decisions of SMEs businesses can affect the organization performance. Additionally, the study identifies the financing patterns of three ethnic groups. This research also looks at the way the government, economic conditions, and social pressure indirectly influencing the financing decisions of SMEs. The study addresses the following primary question: What are the factors influence the financing decisions of three different ethnic groups in Malaysia’s SMEs? The samples of this research are the SMEs in the East-Coast
region of Malaysia. A pre-pilot test of five SMEs has been conducted in the U.K in order to test the reliability and validity of the questions. A pilot study of 30 SMEs will be carried out in Malaysia. Furthermore, data collection is acquired through survey questionnaires as well as structured interviews which are analyzed using SPSS 15.0 and Nvivo.

Keywords: Sources of Financing (SOF), SMEs, SMEs Finance, Ethnic Groups, Malaysia.

Introduction

In Malaysia, SMEs which are defined as “firms with annual sales turnover not exceeding RM25 million or full-time employees not exceeding 150” (SME Annual Report, 2007) represent 99% of total business establishments in Malaysia; contributing up to 32% of GDP and 56% of total employment (SME Annual Report, 2007). This is reflected in the national development agendas, namely the Ninth Malaysia Plan 2006-2010 and Third Industrial Master Plan 2006-2015. Thus, any SMEs-related research is considered to be of paramount important in helping the government as well as the Malaysians to be more develop and competitive.

With regards to literature, to date, the literature has focused either on the capital structure determinants of the SMEs of a single country (e.g. Romano et al., 2000; Degryse et al., 2009) or cross-country comparisons (Psillaki and Daskalakis, 2009; Bell and Vos, 2009; Beck et al., 2008). The comparison studies among ethnic groups in relation to SMEs’ capital structure determinants are still rare in international research and to the best knowledge of the author,
there is none of such research had been conducted in Malaysia. Alternatively, it is mostly conducted in Western countries such as a study done by Robb and Fairlie (2007) who investigated on the capital structure of SMEs in African American firms, and Smallbone et al. (2003) that compared between ethnic minority and white business owners in the United Kingdom’s SMEs.

Theoretical Background

This study considers the theories of Pecking Order (Myers and Majluf, 1984) and Trade-Off (Modigliani and Miller, 1963). Both theories have been adopted by previous researchers as a theoretical foundation in investigating the determinants of capital structure.

Aims and Research Questions:

SMEs finance issues in Malaysia are still in the formative stage and most of the constructs of this research have not been examined empirically previously. The research aims to examine the effects of the SMEs’ characteristics, the owner’s characteristics and business-lender relationship as well as cultural factors on owner’s capital structure decision, to elaborate the indirect impact of environment dimension on owner’s capital structure decision making, to identify the financing patterns of three ethnic groups, and to look at how the financing decisions of SMEs businesses can affect the organization performance. In order to provide a formulation for the aim of the study, the primary research question is posed: What are the factors influence the financing decisions of three different ethnic groups in Malaysia’s SMEs? To arrive at an adequate answer to the primary research question, the research will test the following null hypotheses:

Hypothesis 1:

*There is no relationship between firm life cycle and the use of SOF.*
Business at different stages of life-cycle will demand for different type of finance in running the business activities (Berger and Udell, 1998; Rocca et al., 2009).

**Hypothesis 2:**

_The use of SOF is not related with firm size._

Firm size can be measured by the logarithm of sales. The firm of larger size found to be more favourable towards debt financing (Rocca et al., 2009; Beck et al., 2008; Psillaki and Daskalakis, 2009).

**Hypothesis 3:**

_The use of SOF has a no correlation with business sector._

Firms with different nature of business activities may prefer different type of SOF. For example, manufacturing, agriculture, transport and high-technology sectors found to be more reliant on external funds (Romano et al. 2000; Smith, 2009), while service sector depends more on internal funds (Coleman et al., 1999).

**Hypothesis 4:**

_The use of SOF is not related with asset structure._

Asset structure means total tangible assets as a proportion of total assets. Firms with more tangible assets found to be positively associated with the long-term debt ratio (Rocca et al., 2009; Degryse et al., 2009). Conversely, it is found to be negatively associated with short-term debt ratio.

**Hypothesis 5:**
Profitability has no relationship with the use of SOF.

Profitability is defined as the ratio of income before taxes over total assets or called as a Return on Asset (ROA). Higher profitability firm usually tends to use internal financing as much as possible and then raise debt only when additional finance is necessary (Psillaki and Daskalakis, 2009; Rocca et al., 2009; Degryse et al., 2009).

Hypothesis 6:

Owner's age has no effect on the use of SOF.

The age of the owner-manager may influence the financing style of the business. Young owner may prefer to use debt financing, in contrast with older owner who favours towards internal financing (Romano et al., 2000; Bell and Vos, 2000).

Hypothesis 7:

There is no relationship between the use of SOF and owner’s education.

Education can be acquired through formal or informal ways. Educated owners found to be more articulate and more likely to persuade the banks that they have a viable proposition. (Scott, 2006; Smith, 2009).

Hypothesis 8:

The use of SOF has no correlation with security.
The issue of security is one of great economic importance. Security or collateral is needed in order to increase the chances of getting an external financing. Enterprise with lesser security will prefer to use internal funds instead of debt finance (Degryse et al., 2009).

**Hypothesis 9:**

*The use of sources of finance is not related with information asymmetry.*

For SMEs financing, information asymmetry between the firm and the lender is very important as well. The more the asymmetries of the information, the harder for the company to obtain the external financing; and this situation will indirectly increase the use of internal financing (Rocca et al. 2009; Bell and Vos, 2009).

**Hypothesis 10:**

*Ethnicity has no relationship with the use of SOF.*

Ethnic discrimination will affect the preference of SOF among entrepreneurs especially ethnic- minority entrepreneurs. Ethnic-minority business owners are said to prefer finance using internal funds instead of external funds (Robb and Fairlie; 2007; Smallbone et al, 2003).

**Hypothesis 11:**

*The use of SOF has no impact on the organisational performance.*

Performance of the firm can be measured through firm growth, high productivity, and fully utilization of resources. In fact, the performance of the firm is highly dependent on the correct usage of SOF.
Conceptual Framework

The proposed research model is shown in Figure 1. The model is an adaption of the model proposed by Romano et al. (2000).
Research Methodology

The population of this research will include SMEs in the east-coast region of Malaysia. The list of companies will be taken from SME Corporation of Malaysia. For data collection, secondary data and primary data will be used. Secondary data includes all the journals, books and reports relevant to the study. At an initial stage, a conceptual model and hypothesis will be generated from the secondary data. Further, a pre-pilot test of five SMEs is conducted in the UK to test the reliability and validity of the questions. A pilot study of 25 SMEs and five academicians will be carried out in Malaysia. The primary data collection will be based on quantitative and qualitative methodologies. The quantitative research of 300 samples will be used to test the proposed hypotheses; while, the qualitative research of 20 samples will be used for closer insights into the topic. The structural equation modelling (SEM) using SPSS 15.0 will be used to test the proposed hypotheses and the qualitative data will be analysed by using Nvivo.
Limitations of the Study
There are several limitations in this study. Firstly, the literature on SMEs SOF is not so extensive and most of the issues are comparatively new to the context and it might cause shortcomings in author’s assumptions and findings. Second, the samples in this study consist only SMEs which are registered with SME Corporation Malaysia and that the author may not be able to make generalisations on the ethnicity financing patterns. Finally, the author may have to deal with a variety of constructs in order to give an overall perspective instead of focusing on one issue.

Conclusion
The study provides a better understanding of the determinants of capital structure and the consequences of the financing choices in the specific context of SMEs in Malaysia. Importantly, this study highlights the differences and similarities among three major ethnic groups in their financing patterns. This research emphasises the variable of ethnicity which has received little attention in the literature.

References


