International Journal of
Finance and Accounting
(IJFA)

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IPRJB
INTERNATIONAL PEER REVIEWED JOURNAL AND BOOK PUBLISHING

International Journal of Finance and Accounting
ISSN 2513-4311X (online)
Vol.4 Issue 1, pp 75 - 89, 2019

www.iprjb.org

EFFECT OF ACCESS TO FINANCE ON FINANCIAL PERFOMANCE OF PROCESSING SMES IN KITUI COUNTY, KENYA

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Abstract

Purpose*:* The SMEs play critical role in creating job opportunities and growth of the economy. Currently, the rate at which the new firms formed have stagnated and those with less than 5 years are closing down is very high. This has triggered research on the financial performance of the SMEs especially in areas with high levels of poverty since most studies concentrate on developed economies and urban centres. This study investigated the effect of access to finance on financial performance of processing SMEs in Kitui County.

Methodology*:* Descriptive research design was applied to conduct the study. The target population was the 25 processing SMEs in Kitui County where for each firm; the Chief Executive Officer, the finance manager and the Chief accountant were considered as respondents giving rise to a total of 75 respondents. An interview and Semi- structured questionnaires were used to collect primary data from the respondents. The data was inspected for completeness, accuracy, reliability and consistency then analysed using SPSS Version 20 Software. Descriptive statistics such as mean, and the standard deviation were computed to describe the data collected. Moreover, inferential statistics at 95% confidence level were used.

Results: The findings of the study indicated that financial performance positively correlated with the access to finance. The findings were supported by the literature reviewed by the study. With reference to the findings, various recommendations were made.

Unique Contribution to Theory, Practice and Policy: To start with, the study recommended financial institutions to create favourable policies to enable SMEs access loans easily. Secondly, the study recommended government to offer incentives and funding to SMEs at a lower cost to boost their financial performance. Finally, the study recommended more studies to identify other factors that influenced the financial performance of SMEs in Kenya.

Keywords: *Access to Finance, Financial Performance and SMEs*

1.0 INTRODUCTION

In most economies globally, Small and medium enterprises (SMEs) play a major role for their employment creation and economic growth. A report by World Bank Group (2016) indicates that formal SMEs contribute up to 45% of the total employment and 33% to Gross Domestic Product (GDP) in the growing economies. Japan has the highest proportion of SMEs among the industrialized countries accounting for more than 99% of total enterprises (EIU, 2010). SMEs in the global economy contribute a lot to employment. Between 2002 and 2010 about 85% of the total employment growth was attributed to SMEs (De Kok, Vroonhof, Timmermans, Kwaak, Snijders & Westhof, 2011). Small and medium enterprises are struggling with the aftermath effects of the 2007-2008 global financial crises which extensively hit new and growing small businesses (OECD, 2017). Demand for credit declined and it became harder for businesses to access finance (OECD, 2009). Lending by banks to SMEs declined due to the high risk involved.

In African countries, about 90% of all businesses not in the agricultural industry are micro, small and medium enterprises and are great contributors of GDP (Abor & Quarterly, 2010). For instance, 93% of Morocco's industrial enterprises are small and medium firms which account for 38% in production, 33% in investment and 30% in exports. In South Africa approximately 91% of the formal entities that are small and medium enterprises contribute between 52% and 57 % to the country's GDP. Abor and Quartey (2010) observes that Ghana's SMEs are more pronounced in the country's economy, having approximately 92% of her business entities and representing over 70% to the GDP. Financial institutions in many countries in Africa do not avail SMEs with adequate finance. In fact, studies show that about 20% of SMEs in Africa have a clear line to credit from banks. Research on SMEs growth has revealed that the rate at which small firms fail in developing economies in Africa is greater than in the already developed economies (Ihua, 2009).

SME sector in Kenya operates locally, at subsistence level and on small-scale. Most of them have few employees; operate for short period, faces challenges in access to finance and their operation is within the entrepreneur's locality (World Bank, 2006). According to Sessional Paper No.2 of 2005, SMEs sector contribution to GDP in Kenya rose from 13.8% to about 18% between 1993 and 1999. Economic survey (2017) reported that lately contribution to the Kenya's GDP is approximately 33% by the sector. According to Were (2016), considering the global production capacity especially in the developed countries, it is a challenge for countries from Africa, Kenya included to use processing SMEs for poverty eradication. This is due to the stiff global competition exhibited in the processing industry. Regionally, she found that in East African countries, Kenya has the most sophisticated and largest processing SMEs. However, in terms of growth of SMEs, other countries in this region are growing relatively faster. In Kenya, processing SMEs in the informal sector outperform services SMEs in terms of growth and expansion, with 31% expansion of the former relative to 24 % expansion of the latter (Were, 2016).

Processing SMEs need to realize financial performance if they have to expand. According to Al-shami (2008) measures of financial performance are profitability and turnover. Access to finance is considered to be a major challenge hindering financial growth of start-up SMEs (Mazanai & Fatoki, 2012). According to Haron, Ibrahim, Nor and Ibrahim, (2013) credit processing by financial institutions is becoming too complex for SMEs in most growing economies and this becomes a problem in accessing the finance they require to scale up. An observation by Pretorius and Shaw (2004) was that a big number of SMEs depend on owners' contributions and family or friends support and this may not be adequate for SMEs financial growth. External finance accessibility is thus crucial in availing adequate funds for SMEs.

Statement of the Problem

Despite the importance of SMEs to the Kenyan economy, the rate at which new firms are formed, have stagnated and the already established SMEs younger than 5 years are collapsing a great deal (Ngui, 2014). The Kenya processing sector in 2015 grew at 3.5% which is lower than GDP's 5.6 % growth rate in the same year (KNBS, 2016). This means the GDP share in the processing sector has been declining with time and therefore Kenya is experiencing premature deindustrialization. For Kenya to realize vision 2030 of being an industrialized economy, then effort should be done to promote the processing industry and this can be made possible by investigating what really can improve the financial performance of processing small and medium enterprises. Access to finance is considered to be the engine behind the financial performance because without enough funds for working capital and investments no firm can survive (Agnew, 2003). However, SMEs are faced with constraints as they endeavour to access finance from financial institutions (Nyambura, 2013). Most studies are on the general performance of SMEs neglecting the fact that SMEs must be financially fit to attain financial growth and solve economic problems. Not much has been done on the effect of access to finance on financial performance of SMEs in areas that have high levels of poverty as most studies are on the developed economies and the established urban centres of developing countries. Further, most of these studies have not narrowed down to specific sectors of the economy, for instance trade, processing, manufacturing or service sectors

The main problem that led to this research was the high mortality rate of processing SMEs in Kitui County as per the data available from the ministry of industrialization Kitui Town office. For this reason, therefore, it was important to investigate the effect of access to finance on financial performance of the processing SMEs in Kitui County.

2.0 LITERATURE REVIEW

Theoretical Review

Pecking Order Theory

Initially, Pecking Order Theory (POT) was pioneered in year 1961 by Donaldson. In 1984 it was modified by Myers and Majluf making it more popular. The theory states that, in making a choice on sources of finance, managers should follow a particular hierarchy that provides the first preference to internal sources followed by external financing. The external sources give priority to debt financing then finally considers equity financing as the last option. Pronca, Laureanoa and Laureanoa (2014) asserted that small enterprises prefer internal financing to external financing. If internal funds are inadequate, then according to Proenca et al (2014) the firms prefer short- term debts to long-term debts. Informed managers go for internal financing while optimistic managers choose to maximize profit of a firm by supplementing internal financing with debt financing. (Chen, Chen, Chen & Huang, 2013)

In spite of finance costs associated with debt financing, Proenca et al (2014) pointed out managers who are risk averse will still prefer external financing. A research study by Zoppa and McMahon (2002) revealed that about 75% of SMEs makes financial decisions with conformity to pecking order theory. According to Cassar and Holmes (2003), the Pecking order theory conforms to SMEs since most of them are owner managed and thus they would not wish to dilute their businesses control. This theory is of great importance to this study because it provides an insight on sources of finance and the best modalities that can be put in place by SMEs in accessing finance.

Empirical Review

A study by Cassar and Holmes (2003) on factors affecting capital structure and SMEs financing had an objective of establishing the effect of organizational capacity on financing of SMEs. The study found that in developing economies, poor marketing, accounting, auditing, financial management and legal counsel services and other essential services that SMEs may require when facing financial institutions may result in SMEs unable to access and afford such services. The study concluded that for SMEs to have ease in accessibility to finance they should embrace, financial reporting and internal auditing processes.

Macharia (2012) pursued a study with an objective of determining the extent to which accessibility to finance affect small and micro enterprise investments in Ongata Rongai Town. The findings of the study where that an average of 40% of these finance came from family and friends, 30% came from business savings and 24% came from financial institutions. Further, the study revealed the obstacles faced by SMEs in accessing funds were their collateral requirements, guarantors' requirements, banks procedures in vetting and cost of loans. Recommendation for the study was that banks should provide better environment for small firms to access loans.

Nyambura (2013) in a study to find out determinants of investments in the informal venture capital market in Kenya revealed that in developing economies, where financial institutions have remarkable progress, SMEs are still faced with obstacles as they endeavour to access finance from these institutions. According to the study, even though SMEs constitute the largest number of customers for commercial banks, finances extended to them are mainly short term and hence denying them long term investments. Recommendations were that the government should think of a fund for SMEs to access loans at low cost.

Mugo (2012) conducted a study to assess determinants of women entrepreneurs' financial performance in Nairobi Central Business District (CBD). The objectives of the study were to gauge their access to finance, to examine effect of budgeting on their performance, assess challenges in record keeping and to examine working capital management influence on performance. The study identified finance being the main impediment influencing women entrepreneurs' performance. It recommended that a product special to women entrepreneurs should be developed by banks to improve their access to loans.

A study by Kinyua (2014) to establish factors that determine SMEs performance in Nakuru town Jua Kali Sector with an objective to examine what role is played by finance, found out that finance accessibility positively affected performance of SMEs. The study recommended that the financial institutions should improve availability of funds in this sector by improving their lending conditions and requirements.

Conceptual Framework

Dependent Variable **Independent Variable**

Access to Finance

- Sources of Capital
- Accessibility to Loans

→

Financial Performance of processing SMEs in Kitui County

- Profitability
- Turnover

Figure 1:Conceptual Framework

3.0 METHODOLOGY

Research Design

This study adopted descriptive research design. The population targeted by the study comprised Chief Executive Officers and officers in the Finance/Accounts department of all the 25 processing SMEs in Kitui County as per the data available in the ministry of industrialization in Kitui town. In this study, all the 25 processing SMEs in Kitui County as per the data available in the ministry of industrialization in Kitui town were considered. For each firm, all the 25 Chief Executive Officer were considered for the study. The 25 Finance Managers and 25 Chief Accountants were selected as respondents to represent the finance/accounts department translating to 22% of the officers in that department. The study therefore comprised of a total of 75 respondents. Primary data was collected through an interview guide conducted to CEOs and structured questionnaires administered to the Finance Managers and Chief Accountants. The CEOs' interview was used to obtain data that was supported by information available in the firm records. Both descriptive and inferential statistics were used in this study. Collected data was cleaned and coded to measure completeness of the information obtained. Statistical program for Social Sciences (SPSS) was used to statistically analyse the data. Inferential statistics involving relationship analysis adopted the regression model. Presentation of data was by use of tables and figures which includes pie charts and bar charts. Frequency distribution and percentages were used to present the participants' demographics. The study used mean and standard deviation of each variable to provide more meaning to the data.

4.0 DATA ANALYSIS AND PRESENTATION

4.1 Background Information

The researcher sought to establish the overview of the processing SMEs in Kitui County and therefore, inquired about the duration the firm had been in operation and the number of employees in the firm.

4.1.1 Duration of the Firm in Operation

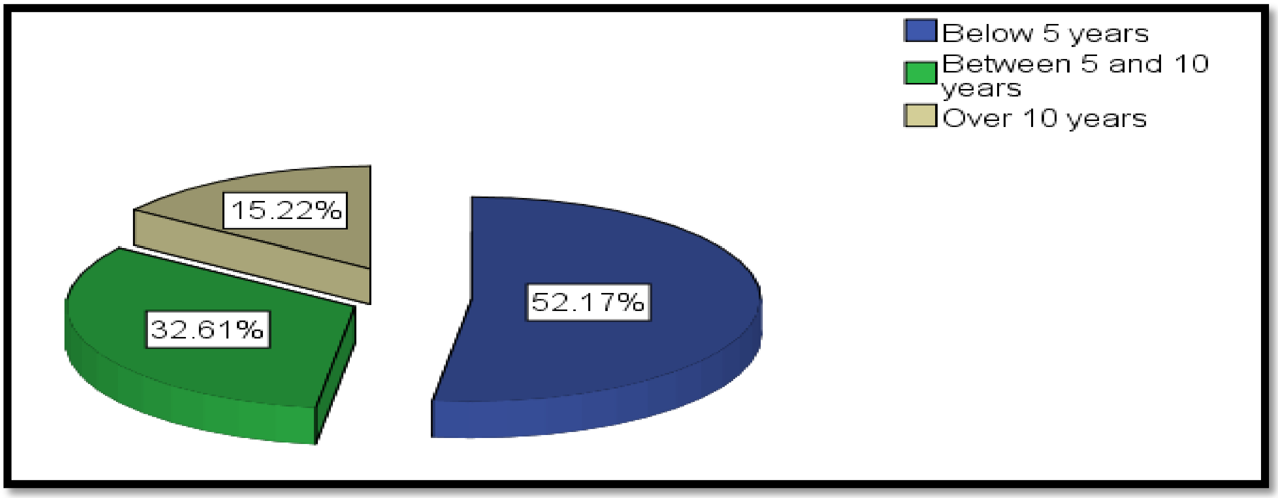

Figure 1: Duration of the Firm in Operation

International Journal of Finance and Accounting
ISSN 2513-4311X (online)
Vol.4 Issue 1, pp 75 - 89, 2019

4.1.2 Number of Employees in the Firm

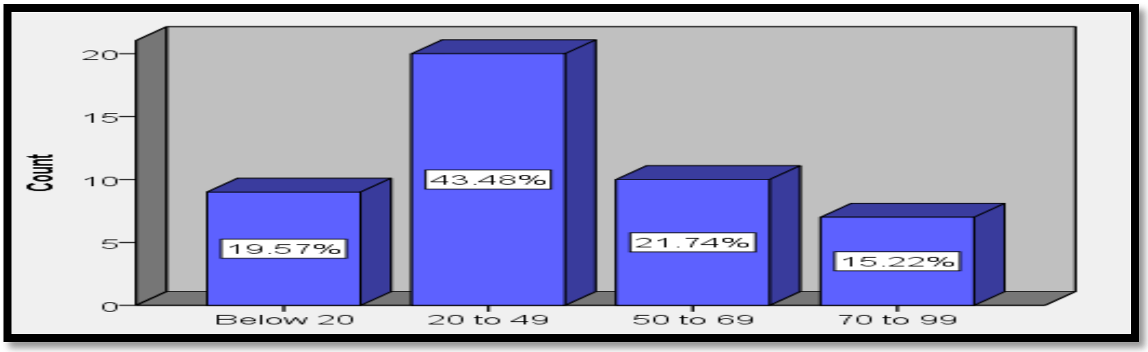

Figure 2: Number of Employees in the Firm

4.2 Access to Finance

4.2.1 The Interview Results

The summary of the findings with regard to the access to finance was presented in the tables below.

4.2.1.1The Amount of Equity

Table 1: The Amount of Equity

Range of Equity (Kes)	Frequency
0 – 1M	5
1 – 3 M	10
3 – 6 M	7
Above 6 M	3

The study found out that majority of the processing SMEs had owners contributing capital to a tune of between 1M and 3M.

4.2.1.2 The Accounts Maintained

Table 2: The Amount of Equity

Type of Account	Frequency
Bank	15
Saccos	1
Microfinance Institutions	9

The table above depicts that most processing SMEs in Kitui County maintains bank accounts and this is where they could access finance

4.2.1.3 The Annual Borrowing

Table 3: The Amount of Equity

Range of Borrowing	Frequency
0 – 0.5 M	4
0.5 – 1 M	16
1 – 2 M	3
Above 2 M	2

The researcher sought to establish approximate loans these SMEs acquired from financial institutions on average annually and the findings as per the table above was that majority range was 0.5M and 1M and just a few could borrow above 2M.

4.2.2 Questionnaire Results

The researcher aimed to measure the extent to which the respondents agreed with the given statements on access to finance. The respondents indicated on a Likert scale of 1-5 where; 1- strongly disagrees, 2- disagree, 3- neutral, 4- agree and 5- strongly agree. The degree of satisfaction was an average of above 3 and degree of dissatisfaction was below 3. The descriptive statistics for the statements are presented in the table below.

Table 4: Descriptive Statistics for Access to Finance

Statements	Mean	Std. Deviation
Loans from banks are readily available and accessible for start-ups firms	2.67	1.266
Financial institutions exhibit reluctance in extending long term finance to existing SMEs	3.24	1.336
Interest rate capping has improved access to finance for your firm.	3.02	1.358
Regulatory and administrative environment is an obstacle in accessing finance.	2.70	1.348
SMEs are capable of paying loans on time.	2.33	1.317
Accessibility to finance has a great influence on financial performance of your firm.	3.28	1.393

The findings revealed that the financial institutions exhibit reluctance in extending long term finance to existing SMEs, interest rate capping had improved access to finance to SMEs and accessibility to finance had great influence on financial performance of the SMEs with a mean of 3.24, 3.02 and 3.28 respectively and standard deviation of 1.336, 1.358 and 1.393. Therefore, the respondents were satisfied with the three factors though the level of satisfactory differed significantly across SMEs since the standard deviation is more than one. The findings are

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ISSN 2513-4311X (online)
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relevant to the study since they help us to evaluate the challenges in access to finance by the SMEs in Kitui County.

4.2.3 Major Source of Finance

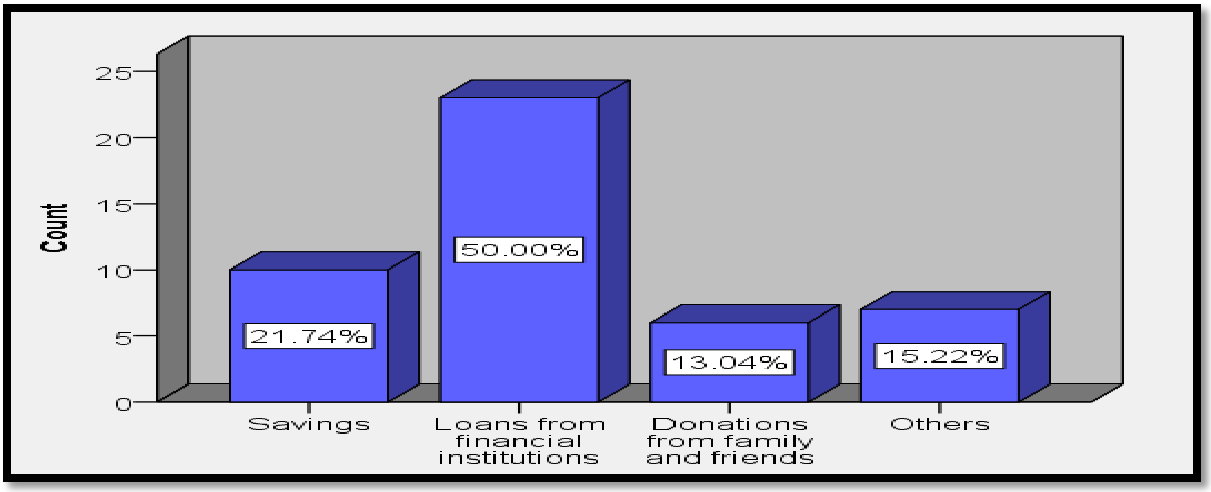

Figure 3: Major Source of Finance

4.3 Financial Performance

4.3.1 The Interview Results

The findings of the interview process revealed the turnover of firms performed averagely in the past few years.

Table 5: Profitability Trend

The Trend	Frequency
Upward	10
Downward	6
Unstable	8
Stagnant	1

The researcher found out that for the past three years a majority 10 firms recorded an upward profitability trend, 8 unstable trend, 6 a downward trend and 1 stagnated.

4.3.2 Questionnaire Results

In order to measure the financial performance of the processing SMEs, the researcher asked set of statements to the respondents using a Likert Scale of 1-5; where 1- strongly disagrees, 2- disagree, 3- neutral, 4- agree and 5- strongly agree. The degree of satisfaction was an average of above 3 and degree of dissatisfaction was below 3. The responses obtained were aggregated to allow for computation of descriptive statistics shown in the table below.

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Table 6: Descriptive Statistics for Financial Performance

Statements	Mean	Std. Deviation
Our firm's financial performance is superior.	3.33	1.431
The firm possesses competitive advantage over other firms in the industry.	2.93	1.289
Our firm as compared to others is highly profitable.	2.83	1.403
The business has realized upward trend in total revenue over the past 3 years.	3.02	1.390
Financial performance enhances SMEs to make better investment decisions	3.04	1.414
Financial performance reduces agency problems.	3.00	1.461

The results revealed that the financial performance of the firms was superior, the business had realized upward trend in total revenue over the past 3 years, financial performance enhanced making of better investment decisions and reduced the agency problems since the average is above 3. Nevertheless, the respondents disputed that the SMEs possessed competitive advantage over other firms in the industry and were highly profitable when compared to others. Moreover, the degree of satisfaction and dissatisfaction differed significantly across the firms since all the standard deviations were more than 1.

4.3.3 Annual Turnover of the Firm

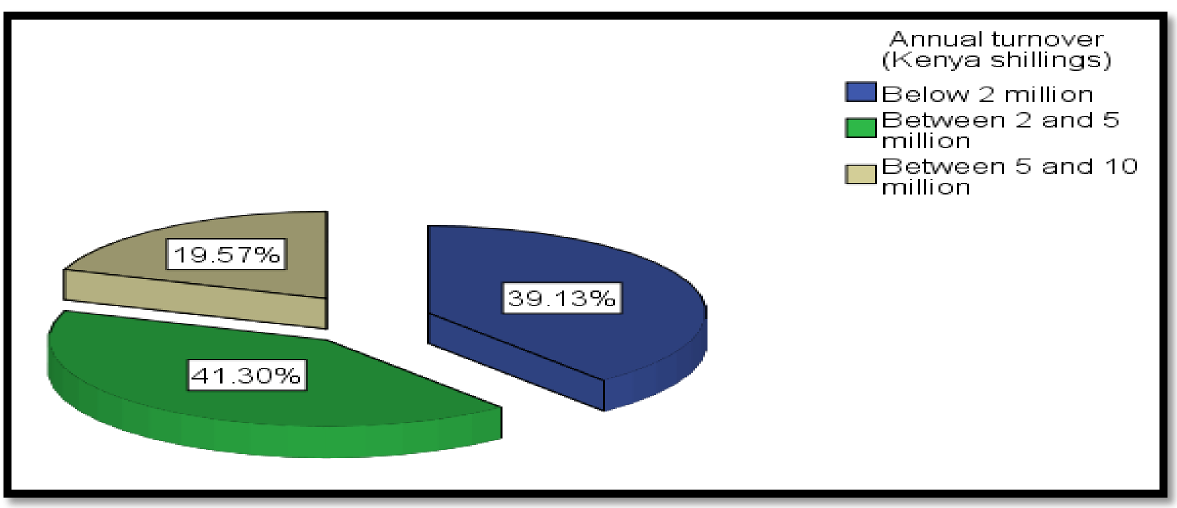

Figure 3: Annual Turnover of the Firm

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ISSN 2513-4311X (online)
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4.4 Regression Analysis

4.4.1 Model Summary

Table 7: Model Summary

R	R Square	Adjusted R Square	Std. Error of the Estimate
.726[a]	.823	.798	1.21668

a. Predictors: (Constant), Access to finance

From the table above, the correlation coefficient denoted as R of 0.726 indicates that financial performance and access to finance have positive correlation. Moreover, relationship is strong since the correlation coefficient of 0.726 is greater than 0.5. The coefficient of determination denoted as R Square of 0.823 implies that the explanatory variables account for 82.30% of the changes in the financial performance of the SMEs ceteris paribus while when adjusted for the degrees of freedom it explains about 79.80% of the changes in financial performance. The value for the disturbance term is 1.21668.

Table 7: ANOVA Table

	Sum of Squares	df	Mean Square	F	Sig.
Regression	.891	1	.891	20.602	.042[b]
Residual	65.134	44	1.480		
Total	66.025	45			

a. Dependent Variable: Financial Performance of processing SMEs
b. Predictors: (Constant), Access to finance

At 95% confidence level, the significance value of 0.042 is less than the alpha value of 0.05 therefore the study concludes that the regression model is significant. This implies that the model can be used for prediction and forecasting the financial performance of the SMEs with respect to the independent variable.

Table 7: Regression Coefficients

	Unstandardized Coefficients		Standardized Coefficients		
	B	Std. Error	Beta	T	Sig.
(Constant)	2.778	1.309		2.122	.039
Access to finance	.228	.294	.116	.776	.032

Dependent Variable: Financial Performance of processing SMEs

From the table above, the regression coefficients are explained at the confidence level of 95%. The study established that the access to finance positively influenced the financial performance of the SMEs in Kitui County. A unit increase in the level of access of finance triggered 0.228 units increase in financial performance of the SMEs. The influence on financial performance was significant since the significant value of 0.039 is less than the Alpha value of 0.05.

5.0 SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

Discussion of Findings

The study aimed to investigate the effect of access to finance on financial performance of processing SMEs in Kitui County. The effect of access to finance on financial performance was evaluated by use of an interview to the CEO and questionnaires administered to the Finance manager and Chief accountant of the 25 processing SMEs in Kitui County.

Discussion on Access to Finance

The interview found out that all the firm's owners had contributed capital to some extent and the rest was acquired from financial institutions mainly commercial banks. Most processing SMEs in Kitui County maintain accounts with banks as opposed to SACCOs and MFIs and therefore depend mainly on bank loans to access finance. The CEOs reported reluctance by banks and complicated procedures in acquiring these loans and this post an obstacle in the firms' accessibility to finance.

The findings from the questionnaire revealed the major source of finance for processing SMEs was short term loans from financial institutions and followed by savings and then donations from family and friends. Moreover, the study established that the decision by the government to cap the interest rate improved the access to finance for the SMEs since cost of borrowing was hugely reduced. To that effect therefore, the processing SMEs felt that the regulatory and administrative environment was favourable for accessing finance. The findings further reported that SMEs lacked the capability to pay loans on time.

However loans from banks were not readily available and accessible to start-up processing SMEs. The SMEs claimed that the processing of credits from the financial institutions was an uphill task and the conditions were unfavourable. The financial institutions extended little or no capital to the SMEs due to their inability to demonstrate their credit worthiness. Further, the financial institutions exhibited unwillingness to extend long term finance to the existing processing SMEs. The SMEs cited the collateral requirements, guarantors' requirements, the techniques followed by banks to vet applicants and the costs of the loans as the obstacles to accessing finance.

The regressions results revealed a positive influence of access to finance on the financial performance of the processing SMEs. The findings are supported by another study by Kinyua (2014) who established that the accessibility to finance positively affected the performance of SMEs. Further, Macharia (2012) disputed the statements that loans from banks are readily available and accessible for start- ups and SMEs are capable of paying loans on time as reflected in study findings.

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Discussion on Financial Performance

Financial performance of processing SMEs in Kitui County was found to have an upward trend according to the CEOs. This was measured through turnover and profitability index over a period of three years. Turnover was found to have performed averagely over the past three years with minimal positive change realized. Profits were found to be improving over the three years but a few firms experienced unstable trend and downward trend while one firm maintained its profitability over the three years. Khrawish (2011) supported the findings of the questionnaire that revealed that SMEs had superior financial performance which increased the growth of revenue over the past 3 years. Further, the financial performance of SMEs led to better investment decisions and reduced the agency problems; assertions supported by Al-shami (2008). Finally, the findings differed with khrawish (2011) who postulated that SMEs had competitive advantage over other firms which increased their turnover.

Conclusion

The research concluded that loans are not readily available and accessible to processing SMEs in Kitui County. The SMEs expressed their worry that the banks were reluctant to offer them long term investments to boost the firms. Also, the study concluded that the interest capping policy by the government should be adhered fully by financial institutions to the interests of the SMEs in Kitui County. Further, the study concluded that the favourable regulatory and administrative environment had been created by the government for the SMEs to thrive and grow. Moreover, research concluded that the major source of finance for the SMEs is the loans from the financial institutions, business savings, and donations from family and friends.

The study concluded that the SMEs had a superior financial performance. The SMEs were in a position to manage the finances well to meet their objectives. Further, the research concluded that competitive advantage was not applied by the SMEs to edge out their competitors which hindered their profitability index. Additionally, it was concluded that the better decisions were made due to proper financial performance by SMEs which translated reduced agency problems in the SMEs. Finally, the study concluded that over the past 3 years, the SMEs had realized upward growth in the total revenue.

Recommendations

The study recommended banks to create favourable policies to enable processing SMEs to access finance through loans easily. This is likely to boost the financial performance of the SMEs since they will have enough financial resources to invest. Further, the banks should create infrastructure to allow for better transaction with the SMEs. Accessibility to finance easily by the SMEs will trigger improved financial performance thus creating job opportunities to the youths. It was recommended that government should offer funding to processing SMEs at lower cost to boost their financial performance. Also, sound financial and regulatory policies such as interest capping should be formulated and implemented to enhance accessibility of finance for SMEs across the county. Provision of information on the trends of financial performance of SMEs was recommended to be key in assessing the performance.

Based on the findings and conclusions of the study, studies are recommended to be carried out to determine factors considered by the financial institutions when financing processing SMEs. The criteria followed should be well elaborated so that SMEs can access the funding easily to run their operations effectively and efficiently. Moreover, this study concentrated on the influence of access to finance on the financial performance of processing SMEs in Kitui County, other studies are recommended to identify other factors that influence the financial performance of the SMEs in other parts of the country. This will necessitate comparison of research results and improved financial performance of processing SMEs in Kenya.

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