

## Financing Preferences of Small and Medium Enterprise Owners of Sri Lanka: Does Pecking Order Theory Hold?

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### Abstract

*The objectives of this study are two-fold: first, to investigate the determinants of financing preference of small and Medium Enterprises (SME); second, to examine whether the Pecking Order Theory (POT) can explain the financing preferences of SMEs. The data was gathered from 812 Sri Lankan SME owners using a structured questionnaire. Ordinal regression model and descriptive statistics was used to analyze the data. The key findings of the study indicate that education and experience of the owner, business sector, asset value and size of the firm are to be major determinants. The prediction of POT and modified POT including bootstrap financing confirm the Sri Lankan SME's financing preferences at their future financing needs even though startup financing needs can be partly explained. The main implication of this research is explaining the financing preference of SME owners while analyzing the determinants of financing preferences from an Asian, a developing country perspective.*

**Keywords:** Small and Medium Enterprises, Financing Preferences, POT, Sri Lanka

### 1. Introduction

Financing decision, selecting one or more sources of finance mainly depends on available financial sources in the financial system, preferences of owners and accessibility to finance. This decision is one of a vital decision for any firm regardless of the size, industry, etc. This is because business continuity has a direct relationship with firm finance and its effect on ability of taking competitive advantage (Heng and Azrabijani, 2012). As a result, financing decisions are imperative for Small and Medium Enterprises (SME) similar to large enterprises as SMEs are functioning as backbone of any country specially a developing country like Sri Lanka. Sri Lankan financial system mainly consider as dualistic structure with formal and informal markets (Berensmann et al. 2002) even though some scholars consider as semi-formal market. Current formal financial system presents high level of flow of finance especially for SMEs (Durrant et al. 2004) by increasing different number of financial products while reducing the access barriers.

Moreover, SMEs can use different types and sources of financing methods especially informal sources, which differ from traditional or formal sources of finance, namely equity and debt (Osei-Assibey, Bokpin & Twerefou, 2012). As a result, the availability of financial sources or supply of financial sources for Sri Lankan SMEs is not an issue as the sources of finance seems abundant with recent development of the financial system. However, financing is still a problem for Sri Lankan SMEs' (Premarathna, 2001, White paper, 2002, Suarngi, 2012). Berensmann et al. (2002) & Tilakarathna (2012) found that Sri Lankan SME owners have very diverse financial relations with different financial institutions.

Explaining the diverse relationship, it is emphasized some SME owners may have used only one source of finance nonetheless some have three or four different sources representing both formal and informal. Similarly, Watson (2006) highlighted that lower level of external funding of SMEs' is a matter of personal choice of owner managers which are subjected to change with owner's characteristics, firm characteristics and external characteristics (Michaelas, Chittenden & Poutziouris 1999). These findings revealed that SME owners have preferred one type of sources of finance over another and avoid some sources entirely or it is suggested that the financing preferences of SME owners may determine the capital structure composition of SME (Osei-Assibey, Bokpin & Twerefou, 2012).

Pecking Order Theory is more suitable to identify the SME capital structure even though it is developed for large corporations (Mlohaolas, Chittenden, & Poutziourie, 1998, Osei-Assibey, Bokpin, & Twerefou, 2011). As outlined by Myers (1984) POT, firms adhere to hierarchy of financing preferences, where internal finance, and if external finance is required debt is prefer than equity. Hamilton and Fox (1998) highlighted that small firms could not rise all the funding they would like from financial institutions and hence there will always a deficiency between supply and demand for funding. Supporting this argument Daskalakis, Jarvis & Schizas (2013) highlighted the importance of identifying the preferences or demand of the SME owners' financing needs as owner preferences in SME play a major role and there is no separation of ownership and control (Michaelas, Chittenden & Poutziouris, 1998).

Moreover, Lam (2010) highlighted that there is a funding gap which results of differences between demand and supply of SME financing and hence attention has tend to focus on increasing accessibility on what business owner prefers. Accordingly, this study examine financing preferences of Sri Lankan SMEs or demand side behavior of SME financing in line with POT and determinants of the financing preferences of Sri Lankan SME owners at the firm start-up and future financing needs. Education and experience of the owner, business sector, asset value, and size of the firm are found to be major determinants of financing preferences of Sri Lankan SME owners. The POT and modified POT true for the Sri Lankan SME's financing preferences at their future financing needs even though startup financing needs can be partly explained through the POT. The remains of the paper are organized as follows. Section 2 discusses the literature hypothesis development. The research method is outlined in Section 3 and section 4 presents the findings and discussion. Finally, section 5 presents conclusions and areas for future research.

## **2. Literature Review and Hypotheses**

Capital structures or composition of different sources of finance are prospects for Small and Medium Enterprise (SME) survival and growth. Johnsen and McMahon (2005) briefed five capable theories which is more relevant in SME financing, which named as Static Trade-off Theory, Agency Theory, Growth Cycle Theory, Alternative Resources (Bootstrapping) Explanations and Pecking Order Theory (POT). Pecking Order Theory is more suitable to identify the SME capital structure compared to other theories even though it is developed for large corporations (Mlohaolas, Chittenden, & Poutziourie, 1998, Osei-Assibey, Bokpin, & Twerefou, 2011). This theory emphasize that small firms go for external sources of financing when the internal sources are found inadequate. As per Myers (1984) POT, firms adhere to hierarchy of financing preferences, where internal finance, and if external finance is required debt is prefer than equity. Further, this theory states that if firm needs more finance after debt, firms prefer hybrid securities such as convertible bonds before equity financing (De Jong, Kabir & Nguyen, 2008).

Applying this theory Gebru (2009) proved that POT holds true for Micro and Small Enterprises in Tigray regional state using logistic regression model. Additionally, an ownership type, acquisition type, level of education and reason for business startups are major determinants of SME owners' financing preferences. Holmes and Kent (1991) explained small firms usually do not have the option of issuing additional equity to the public. Further, owner-managers are strongly averse to any separation of their ownership interest and control. Therefore, application of the POT to SMEs is constrained. Osei-Assibey, Bokpin, & werefou (2011) highlighted SME's preferred internal and bootstrap financing due to low cost and less risk. This study used ordinal regression model to test the hierarchical preference ordering in Ghana. Contrast, Paul, Whittam & Wyper (2007) said that startup firms move directly from self-funding to equity as entrepreneurs consider debt to be personal liability and it is needed personal guarantee. Interestingly, Zoppa & McMahon (2002) found to what extent the POT theory appears to explain the financial structure of manufacturing SMEs in Australia.

The study concluded that POT should be modified to fully reflect the special circumstances and nuances of SME finance. Vasiliou, Eriotis & Daskalakis (2009) highlighted the importance of methodology when testing the POT. Further, they highlighted that POT analysis should not rely only on the mean-oriented regression quantitative analysis to test the POT, as it refers to a distinct hierarchy. Daskalakis & Jarvis (2013) found that firms heavily rely on their internal funds, not raise new equity outside the family, and use more long term finance by employing new methodology suggested by Vasiliou, Eriotis & Daskalakis (2009).

## **2.1 Hypothesis Development**

### **2.1.1. Gender**

Gender plays a significant role in behavior of humans in financing decisions (Verhuel & Thurik, 2001, Carter & Rosa, 1998). Morris et al. (2006) examined why women entrepreneurs avoided external funding and found that a strong desire not to be obligated to others. Similarly, Hokkanen et al. (1998) highlighted that females rely more on personal savings to finance their business. This is because they do not avoid taking debt, nonetheless they are less willing to put up collateral, or personal guarantees (Coleman, 2000).

H1: Women SME owners are the most conformances to POT.

### **2.1.2. Level of Education and Training undergo by the Owner**

Acquisition of education qualification implies the successful completion of course, school or a training programme (Welmilla et al., 2011) and completion implies progression of humans. Education and training related to finance increases the knowledge of available sources of finance, their advantages, and disadvantages, therefore, it is positively related to the firm's usage of leverage (Coleman, 2007). Further, explained by Storey (1994) higher level of education provides greater confidence in dealing with bankers and other external parties when they are applying for such facilities.

H2: The less educated SME owners are the more conformances to POT.

H3: SME owners without training exposure are the more conformances to POT.

### **2.1.3. Experience of the owner**

Experience which measured by the number of years in an industry is also help to access on external credit (Cole, 1998). Moreover, expanding this relationship further, Nofsinger & Wang (2011) explained that prior experience of the industry positively correlated with the share of external financing levels available to SMEs as owner manger experiences which helped to overcome barriers inherent to SME access on external financing. Welmilla et al. (2011) highlighted that prior experience changes their perception, knowledge, etc. and hence more like to have external financing.

H4: SME owners without experience are the most conformances to POT.

### **2.1.4. Age of the Firm**

Age, standard measure of reputation (Abor & Biekpe, 2009) can use to overcome the problem of creditworthiness and asymmetric information problem (Diamond, 1989). With the number of years in the sector increases the reputation, experience and skills of people (Welmilla et al., 2011) and hence firm accessibility on external financing increases (Green et al, 2002). This is further supported by Quartey (2003), Osei-Assibey, Bokpin, & Twerefou (2011) & Hall et al. (2004) who concluded the significant positive effect of firm age on the ability to access external finance.

H5: lessor the firm age (maturity) are the more conformances to POT.

### **2.1.5. Size of the Firm**

Size of the firm is an important measurement when determining the financing (Gregory et al., 2005) even though there is no standard measurement to identify the size of the firm. Total asset value, sales or numbers of employees (Osei-Assibey, Bokpin, & Twerefou, 2011) are used as an instrument to measure the size of the firm. Pandula (2011) divided SME as small SME and large SME based on their size. Size of the firm influences capital structure of SMEs (Cassar, 2004, Lopez-Gracia & Aybar-Arias (2000). Further, POT assumes a negative relationship between firm size and leverage as information asymmetries are higher with SMEs (Chen, 2004).

H6: Smaller the firm sizes are the more conformances to POT.

### 2.1.6. Asset Value

Collateral plays a significant role in access to debt financing. SME who has more fixed assets can provide collateral easily and hence easy of accessing debt financing as they can secure loans (Bradley, Jarrell, & Kim, 1984). Ono and Useugi (2009), Esperanca et al. (2003) highlighted positive relationship between the use of collateral and the strength of the borrower-lender lending relationship and easier SME access to external sources of financing.

H7: Lessor the assets value is the more conformances to POT.

### 2.1.7. Ownership Structure

Business organizations can be classified as sole proprietorship, partnership and company (Gebru, 2009). Researchers argue that SME owners prefer sole proprietorship and select internal sources of financing before going external sources which confirm the POT because they do not want to lose ownership control over their businesses (Osei-Assibey, Bokpin, & Twerefou, 2011, Hamilton and Fox, 1998). Classification of business organization as per intrusion is shown in Table 1.

H8: The Lower level of SME intrusion, operationalized by forms of ownership structure, the more conformances to POT.

### 2.1.8. Business Sector

The inter industry differences reflects differences in asset type and intensity (Hamilton & Fox, 1998). Johnsen & McMahon (2005) highlighted that cross industry differences in financing behavior do exist in SME financing (Mackay & Phillips, 2005, Michaelas, Chittenden & Poutziouris, 1999). Basically, service sector is differing from manufacturing and or construction in terms of financing needs and choices. Silva &Carreira (2010) highlighted that service sector which has less physical resources cannot provide collateral when they access to external financing. Hence, sectors which need less physical assets prefer more internal finance than external finance.

H9: The Lower levels of physical resources, operationalized by forms of business sector, the more conformances to POT.

## 3. Research Method

Our target population was composed of SME entrepreneurs in Sri Lanka from 10 to 99 employee size. The sample is composed by 812 business owners and data was collected using Questionnaire survey. The form of telephone and e-mailed survey was carried out in year 2015, January as cross sectional in time horizon to collect data. The questionnaire which consists of closed-ended questions was initially developed in English, then, it is translated to Sinhala, Further, the questionnaires were piloted prior to their first use by given to 5 academic experts in SME field and 5 SME owners and were then progressively refined after each collection in the light of experience.

### 3.1 Ordinal Regression Model

The ordinal regression model was used to analyze the data to achieve first research objective. SPSS Ordinal Regression procedure, or PLUM (Polytomous Universal Model), is used when dependent variable has several categories of possible outcomes that can be ranked, which can be influenced differently by variation in the independent variables (Greene, 2008). This model is used to analyze the determinants of financial preferences of Sri Lankan SME owners, separately for start-up finances and future financing.

$$Y^*_{ij} = \beta x_{ij} + \varepsilon \quad (3.1)$$

$Y^*$  in simplified equation of the above, represents the latent variable denoting the unobserved propensity of SME owner  $i$  for selecting external finance  $j$ . The variable  $x$  is a vector of explanatory variables representing specific owner specific, enterprise level and external characteristics. The coefficient  $\beta$  is the parameter to be estimated.

Although  $Y^*$  is unobserved, observed ordinal relationship is as follows,

$$0, \text{ if } Y^* \leq 0 \quad = \text{Own Savings / Retained Earnings} \quad (3.2)$$

$$1, \text{ if } 0 < Y^* \leq \mu_1 \quad = \text{Bootstrap Finance} \quad (3.3)$$

$$Y = 2, \text{ if } \mu_1 < Y^* \leq \mu_2 \quad = \text{Short term Debt} \quad (3.4)$$

$$3, \text{ if } \mu_2 < Y^* \leq \mu_3 \quad = \text{Long term Debt} \quad (3.5)$$

$$4, \text{ if } Y^* > \mu_3 \quad = \text{Equity Finance} \quad (3.6)$$

The  $\mu_{1,3}$  are unknown parameters to be estimated with  $\beta$ .

Where, 0 = own savings (startups) or retained earnings (future financing), 1 = bootstrap finance, 2 = short term debt, 3 = long term debt, 4 = equity finance. Own savings only considered in startup financing and retained earnings only considered in future financing needs. The other sources are common to both startup and future financing. A positive value indicates that one unit change in any of the explanatory variable increases the odds of being in a higher category. A negative value indicates that one unit change in any of the explanatory variable decreases the odds of being in a higher category. Equation 3.7 represents the final equation to be estimated with ordered probit model.

$$Y_{ij} = \beta_0 + \beta_1 \text{Age} + \beta_2 \text{Size} + \beta_3 \text{Asset Value} + \beta_4 \text{Ownership Structure} + \beta_5 \text{Business Sector} + \beta_6 \text{Gender} + \beta_7 \text{Experience} + \beta_8 \text{Training} + \beta_9 \text{Education} \quad (3.7)$$

Second objective of this study was tested as per the suggested methodology by Vasiliou, Eriotis & Daskalakis (2009). First, it is considered mean value of the preferences and lower the mean value, the more preferable the financing sources. Then, it suggests that importance of testing the statistical differences between ranked orders. Chi-square tests carried out for potential statistical difference between the degrees of preference for each pair of consecutive sources. The null hypothesis indicates that there is no difference in the degree of preference between the financing sources in each pair. Using the chi-square, we test the probability that the observed N for each source of pair is statistically different from the expected N. Even though there is a significant difference between different sources, this would not necessarily mean that the conventional Pecking Order does exist. Then, we again consider the sample who selected own savings at startup and retained earnings at future financing as their first choice and tested the frequency of other sources of finance.

#### **4. Data Analysis and Discussion**

This section presents analysis and discussion of the findings under the two research objectives and results of each objective will further separate and present under startup financing and future financing.

##### **4.1 Factors affecting Financing Preferences of SME Owners in Sri Lanka**

The ordered logit regression results for determinants of startup and future financing preferences were presented in Table 3 and 4.

###### **4.1.1. Startup Financing**

Gender, education of the owner, experience of the owner prior start to the business, Owner's training relates to the business, ownership structure and business sector were considered factors under startup finance. Age of the firm, size of the firm and asset value factors were dropped as those factors are important only when firm is on-going.

All the other factors constant, the probability of seeking for external finance for SME owners who are first degree holders is 0.472 times higher than an owner who has post graduate qualification. Therefore, SME owners that are less educated depend on external sources of finance at startup stage. Hence, the hypothesis on the relationship between SME owner's education level and financing preference is rejected. Similarly, Osei-Assibey, Bokpin & Twerefou (2011) found highly educated micro entrepreneurs is less likely to prefer formal finance and highlighted the result is quiet surprising, counter intuitive and consistent with most previous studies thus making it difficult to assign any plausible reason for this outcome. Further, holding all other factors constant, that the probability of seeking for external finance for SME owners whose ownership structure is partnership which has medium intrusion is 0.396 times higher than private companies which have maximum level of intrusion. This indicated that SME owners with partnership form of business prefer to use external sources of finance. Therefore, the hypothesized relationship between ownership structure and financing preference is not supported.

###### **4.1.2. Future Financing**

Gender, education of the owner, experience of the owner prior start to the business, owner's training relate to the business, ownership structure and business sector, age of the firm, size of the firm and asset value are the considered factors under future financing. According to the results in Table 4, five factors namely first degree under education, experience, wholesale under business sector, 31 to 50 employees under size, 301 to 500 thousand & 501 to 700 thousand assets value were found to be statistically significant. Holding all other factors constant, that the probability of seeking for external finance for SME owners has the first degree is 0.568 times higher than owners who have post graduate qualification. Therefore, SME owners that are less educated depend on external sources of finance at future financing need. The hypothesis on the relationship between SME owner's education level and financing preference is rejected.

Meantime, the probability of seeking for external finance for SME owners who had prior experience in similar business sector is 0.220 times higher than owners who have no prior experience related to the business before startup. The hypothesis on the relationship between SME owner's experience and financing preference is therefore accepted. SME owners who have prior experience related to business depend on external sources of finance at their future financing need. On the other hand, there is 0.258 times lessor than probability of seeking for external finance for SME owners who are in wholesale business sector compare to manufacturing business sector. SME Owners who are in wholesale business sector is less likely to prefer higher category or external financing methods than owners who represent manufacturing sector.

The hypothesis on the relationship between SME owner's business sector and financing preference is therefore accepted. Similarly, Johnsen & McMahon (2005) highlighted that SME being in the wholesale trade industries less likely to have debt and Abor (2005) concluded wholesale industry more prefer short term debt compared to manufacturing industry. Similarly, the probability of seeking for external finance for SME owners who had number of employees in between 31 to 50 is 0.399 times lessor than owners who had number of employees in between 51 to 99. SME Owners who has number of employees in between 31 to 50 is less likely to prefer higher category or external financing methods than owners who represent number of employees 51 to 99. The hypothesis on the relationship between SME owner's size of the business and financing preference is therefore accepted. The probability of seeking for external finance for SME owners who had assets value in between three hundred and one thousand to five hundred thousand and five hundred thousand to seven hundred thousand are 0.273 and 0.250 times lessor than owners who had assets value in between seven hundred one thousand to one million. SME owners who has assets value in between 301 to 500 and 501 to 700 thousand is less likely to prefer higher category or external financing methods than owners who has assets value 701 to one million. The hypothesis on the relationship between SME owner's assets value of the business and financing preference is therefore accepted.

## **4.2 Existence of POT**

### **4.2.1. Start-Up Financing**

The results of financing preferences at startup have shown in Table 5. According to the value order of different sources of finance are share issues (0.24) and then owner savings or self- financing (1.09), short term debt (1.35), bootstrap financing (1.39) and finally long term loans (1.46). More than 95% of respondents do not use share capital as their sources of finance, we can remove share capital as a source of finance. Also as a result mean value does not reflect the true order of the preferences. Hence, frequency distribution was taken into account and as per the findings, self-finance (79.1%), long term debt (28.8%), short term loans (20.3%), bootstrap financing (12.80%) and share capital (4.70%) which is different to mean value results as the order of financing preference. Hence, the statistical differences between own savings and long term loans, short term loans and bootstrap finance which has shown the order as per the frequency analysis are tested.

### **4.2.2. Statistical Difference of Startup Financing**

To test statistical difference in preference between different pairs of consecutive sources, following hypothesis are developed based on the results of the study.

H1: There is statistically significant difference in preference between self-finance and long term debt finance.

H2: There is statistically significant difference in preference between long term debt finance and short term debt finance.

H3: There is statistically significant difference in preference between short term debt finance and bootstrap finance.

Table 6 presents the  $\chi^2$  values and the corresponding probabilities for all pairs at startup finance.

According to the results, the null hypothesis that there is no statistically difference between each group of the pairs is rejected for the first two pair of sources, suggesting that respondents prefer:

- Self-finance over long term debt
- Long term debt over short term debt

The results show that there is a clear hierarchy between the first three financing sources preferred as first choice.

### **4.2.3. Sample Who Selected Own Savings as the First Choice (Startup Financing)**

The sample who selected own savings as their first choice and test the frequency of other sources of finance and Table 7 summarize the results of the findings.

As per the Table 7, small sample who selected self-financing as first choice ranked second choice as long term loans (34%), third as short term loans (21.70%) and then final choice as bootstrap finance (13.10) similar to the large sample findings. This shows that Sri Lankan SME financing preferences at startup can be partly explained by POT theory as SME owners prefer internal to external and debt over equity. Nonetheless, contrasts to the POT Sri Lankan SME owners prefer long term debt over short term debt at startup. Moreover, modified POT with bootstrap financing also not satisfied with the findings of the study as bootstrap is recorded as the fourth. In line with the findings, Irwin and Scott (2010) highlighted that own personal savings is the main source of financing method among most of the Asian SME owners who based in UK.

This is due to difficulties faced by SMEs when accessing to external finance at their startup as they have no financial track records to present or they do not want to become a borrower (Michaelas, Chittenden & Poulzouris, 1998).

### 4.3 Future Financing

As per the Table 8, mean value calculation preferences share issue (0.16), retained earnings (1.34), own savings (1.50), bootstrap financing (1.66), short term loans (1.75) and long term loans (1.88) respectively. However, frequency distribution shows, order of preference is self-financing (Retained earnings and own savings) (83.90%), bootstrap financing (19.8%), short term debt (16.9%) and long term debt (10.5%).

#### 4.3.1. Statistical Differences of Future Financing

To test statistical difference in preference between different pairs of consecutive sources, following hypothesis are developed based on the results of the study.

H1: There is statistically significant difference in preference between retained earnings and own savings.

H2: There is statistically significant difference in preference between own savings and bootstrap finance.

H3: There is statistically significant difference in preference between bootstrap finance and short term debt finance.

H4: There is statistically significant difference in preference between short term debt finance and long term debt finance.

Table 9 presents the  $\chi^2$  values and the corresponding probabilities for all pairs at future finance.

According to the results, the null hypothesis that there is no statistically difference between each group of the pairs is rejected for the first two pair and the last pair of sources, suggesting that respondents prefer:

- Retained earnings over self-finance
- Self-finance over bootstrap finance
- Short term debt over Long term debt

The results show that there is a clear hierarchy between the first three financing sources preferred as first choice.

#### 4.3.2. Sample Who Select Retained Earnings as the First Choice for Future Financing

In order to have better conclusion this study further, considers sample of 427, who selected retained earnings as first choice and consider the rest of the financing sources they preferred and their frequencies which summarize under Table 10. As per the results under Table 10, by confirming the large sample results, this small sample select own savings (45.70%) as their second choice, bootstrap finance (20.10%) as the third, short term debt (15.90%) as fourth and as the last one, long term debt (11%). In line with the POT explanation, future financing preferences of Sri Lankan SMEs confirm the POT and modified POT which means original POT explanation with bootstrap finance without considering share capital for the study.

## 5. Conclusion and Implications

This study investigated the determinants of financing preference of Sri Lankan SME owners in light of POT using structured questionnaire technique and by taking information from 812 SME owners representing all districts in Sri Lanka. The first research question was “what are the factors affecting to Sri Lankan SME owners financing preferences”. Education of the owner and ownership structure have shown significant effect on Sri Lankan SME owner’s financing preferences at startup. Moreover, education of the owner, experience of the owner, business sector, asset value and size of the business in term of number of employees have shown significant effect on SME owner’s financing preferences at their future need.

The second research question which was “to identify whether the Pecking Order Theory (POT) can explain the financial structure of Sri Lankan SMEs” finds that order of finance at startup partly follow the pecking order explanation as they prefer internal to external and debt over equity. Nonetheless, Sri Lankan SME owners prefer long term debt to short term debt and finally bootstrap finance. However, financing preference at future needs followed POT explanation and modified POT explanation including bootstrap finance.

### **5.1 Policy Implications**

This study clearly showed the preferences and factors which lead to such preferences and hence it is policy maker’s duty to facilitate on accessibility and availability of those different financing sources.

According to the findings, small business owners are more preferred internal sources and therefore, the challenge for policy makers is to provide an environment in which owners are able to retain sufficient profits in their business. Moreover, promotion of leasing companies, venture capitalists and traditional banking system to provide credit supports, low cost credit negotiation and project monitoring, credit guarantee and equity investment schemes that help SMEs. Apart from that, findings on SMEs’ financing preferences shared some valuable information on the nature of capital structure of SMEs in Sri Lanka. This information would help SMEs in Sri Lanka about the importance of making the right decisions when it comes to balancing the mix of financing sources hence valuable insight to general SMEs on managing their firm’s capital structure.

### **5.2 Limitations and Recommendations for Future Research**

There are many limitation associated with this study even though it is contributed to the literature significantly. This study examines SMEs regardless of their industry characteristics. Therefore, it might be advantageous to focus on a sample from one particular sector. A structured questionnaire may not provide a detail understanding about the situation and hence it would be better to have more in-depth qualitative further investigation. Further, the range of independent variables used in this study is insignificant. Therefore, it is recommended to consider other variables such as owner belief, culture, etc. in future research. Further, it would be interesting to expand the survey to provide a longitudinal study. Lastly, research in this area can be developed by conducting a comparative study of the Sri Lankan situation on financial preferences among SMEs in other developing countries, Asian countries and developed countries, etc.

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### Tables and Figures

**Table 1 : Classification of Business Organizations**

Form of Business	Intrusion	Unlimited Liability
Sole Proprietorship	Minimum	Maximum
Partnership	Medium	Medium
Company	Maximum	Minimum

Sources: (Gebru, 2009)

**Table 2: Description of Explanatory Variables**

Variables	Description	Hypothesized sign
Age of the firm	Less than 1 year, 1–3 years, 4-6 years, 7-10 years, 10-15 years and more than 16 years.	+
Size of the firm	Number of employees 10–30, 31–50, 51–99.	+
Asset Value	less than 100,000, 100,001–300,000, 300,001–500,000, 500,001–700,000, 700,001–1,000,000, above 1,000,000	+
Education of the owner	Up to G.C.E O/L, G.C.E A/L, Diploma, First Degree, Postgraduate Qualification, Other	+
Experience of the owner	No experience, Had prior experience	+
Skill Training	Yes owner received skill training, No	+
Gender	Female, Male	-/+
Ownership Structure	Sole Proprietorship, Partnership, Company	+
Business Sector	Services, Wholesale, Retailing, Agriculture, Manufacturing and Other	-/+

Table 3: Parameter Estimates: Startup Financing

Demographic Factors		Estimate	Std. Error	Wald	df	Sig.	95% Confidence Interval	
							LB	UB
Threshold	[Second choice = 1.00]	-.634	.282	5.060	1	.024	-1.186	-.082
	[Second choice = 2.00]	.421	.280	2.258	1	.133	-.128	.971
	[Second choice = 3.00]	1.099	.282	15.189	1	.000	.546	1.652
<u>Gender</u>								
Location	[Male]	.045	.172	.068	1	.794	-.293	.383
	[Female]	0 <sup>a</sup>	.	.	0	.	.	.
<u>Education</u>								
	[Up to O/L]	.128	.230	.311	1	.577	-.323	.580
	[Up to A/L]	.403	.218	3.434	1	.064	-.023	.829
	[Diploma]	.436	.231	3.568	1	.059	-.016	.888
	[First Degree]	.472	.241	3.835	1	.050*	.000	.945
	[Post graduate Qua.]	0 <sup>a</sup>	.	.	0	.	.	.
<u>Experience</u>								
	[No experience]	.075	.092	.663	1	.415	-.105	.255
	[Had experience]	0 <sup>a</sup>	.	.	0	.	.	.
<u>Training</u>								
	[No Training]	.102	.097	1.090	1	.296	-.089	.293
	[Had Training]	0 <sup>a</sup>	.	.	0	.	.	.
<u>Ownership</u>								
	[Sole Proprietorship]	.244	.129	3.567	1	.059	-.009	.497
	[Partnership]	.396	.178	4.958	1	.026*	.047	.745
	[Company]	0 <sup>a</sup>	.	.	0	.	.	.
<u>Business Sector</u>								
	[Services]	-.014	.117	.014	1	.905	-.243	.215
	[Wholesale]	.214	.125	2.910	1	.088	-.032	.459
	[Retailing]	.186	.221	.713	1	.399	-.246	.619
	[Agriculture]	.057	.151	.142	1	.706	-.239	.353
	[Manufacturing]	0 <sup>a</sup>	.	.	0	.	.	.

Notes: \* significant at the 5 per cent level

**Table 4: Parameter Estimates: Future Financing**

Demographic Factors		Estimate	Std. Error	Wald	df	Sig.	95% Confidence Interval	
							L. Bound	Upper Bound
Threshold	[Second choice F = 1.00]	-.361	.300	1.442	1	.230	-.949	.228
	[Second choice F = 2.00]	.381	.300	1.612	1	.204	-.207	.970
	[Second choice F = 3.00]	.645	.301	4.601	1	.032	.056	1.234
	[Second choice F = 4.00]	1.147	.302	14.387	1	.000	.554	1.739
<u>Gender</u>								
Location	[Male]	.035	.161	.047	1	.828	-.280	.350
	[Female]	0 <sup>a</sup>	.	.	0	.	.	.
<u>Education</u>								
	[Up to O/L]	.268	.225	1.423	1	.233	-.172	.709
	[Up to A/L]	.301	.210	2.043	1	.153	-.112	.713
	[Diploma]	.251	.224	1.254	1	.263	-.188	.691
	[First Degree]	.568	.229	6.137	1	.013*	.119	1.017
	[Post graduate Qua.]	0 <sup>a</sup>	.	.	0	.	.	.
<u>Experience</u>								
	[No experience]	.220	.089	6.090	1	.014*	.045	.395
	[Had experience]	0 <sup>a</sup>	.	.	0	.	.	.
<u>Training</u>								
	[No Training]	-.046	.092	.247	1	.619	-.227	.135
	[Had Training]	0 <sup>a</sup>	.	.	0	.	.	.
<u>Ownership</u>								
	[Sole Proprietorship]	-.079	.124	.407	1	.524	-.322	.164
	[Partnership]	-.183	.166	1.221	1	.269	-.508	.142
	[Company]	0 <sup>a</sup>	.	.	0	.	.	.
<u>Business Sector</u>								
	[Services]	.010	.113	.008	1	.929	-.211	.231
	[Wholesale]	-.258	.120	4.607	1	.032*	-.494	-.022
	[Retailing]	.142	.198	.513	1	.474	-.247	.531
	[Agriculture]	-.220	.144	2.324	1	.127	-.502	.063
	[Manufacturing]	0 <sup>a</sup>	.	.	0	.	.	.
<u>Business Experience</u>								
	[Less than 1 year]	.085	.243	.123	1	.726	-.392	.562
	[1 – 3 years]	.076	.137	.308	1	.579	-.192	.344
	[4 – 6 years]	-.056	.119	.217	1	.641	-.289	.178
	[7 – 10 years]	.020	.128	.025	1	.874	-.230	.271
	[more than 11 years]	0 <sup>a</sup>	.	.	0	.	.	.
<u>No. of Employees</u>								
	[10 - 30]	.002	.148	.000	1	.991	-.288	.292
	[31 – 50]	-.399	.185	4.635	1	.031*	-.762	-.036
	[51 – 99]	0 <sup>a</sup>	.	.	0	.	.	.
<u>Asset Value</u>								
	[Less than 100]	-.021	.168	.015	1	.901	-.350	.308
	[101 – 300]	-.079	.130	.369	1	.544	-.333	.175
	[301 – 500]	-.273	.131	4.351	1	.037*	-.529	-.016
	[501 – 700]	-.250	.121	4.303	1	.038*	-.487	-.014
	[701 – 1000]	0 <sup>a</sup>	.	.	0	.	.	.

Notes: \* significant at the 5 per cent level

**Table 5: Frequency and Mean values of Startup Financing**

Sources	Mean Value	First choice (%)	Second choice (%)	Third choice (%)	Fourth choice (%)	Fifth choice (%)
Self-Financial	1.09	79.1	8.7	2.8	0.9	0.1
Bootstrap	1.39	3.4	24.1	11.5	12.8	0.4
Short Term Loans	1.35	3.8	21.6	20.3	6.5	0.1
Loan Term Loans	1.46	13.1	28.8	16.2	6.7	0.1
Share Issues	0.24	0.1	0.1	0	0	4.7

Sources: Field Survey Data - 2015

**Table 6: Startup Finance - Chi-Square of Consecutive Pairs**

Pairs of consecutive sources	Pearson Chi-Square	P Value
Self - Finance vs Long term Debt Finance as first choice	460.408	0.00*
Long term Debt Finance vs Short term Debt Finance as first choice	4.839	0.03**
Short term Debt Finance vs Bootstrap Finance as first choice	1.151	0.28

Notes: \* significant difference at the 1 per cent level \*\*\* significant difference at the 5 per cent level

**Table 7: Frequency Distribution of Sample who Prefers Self-Finance**

Sources	First choice (%)	Second choice (%)	Third choice (%)	Fourth choice (%)	Fifth choice (%)	No selection (%)
Self- Financing	100	0	0	0	0	0
Bootstrap Financing	0	26.8	11.7	13.1	0.3	48.1
Short Term Loans	0	23.7	21.7	7.5	0.2	47
Loan Term Loans	0	34	19.3	7.5	0.2	39.1
Share Issues	0	0.2	0	0	4.5	95.3

Sources: Field Survey Data – 2015

**Table 8: Frequency and Mean values of Future financing**

Sources	Mean Value	First choice (%)	Second choice (%)	Third choice (%)	Fourth choice (%)	Fifth choice (%)
Self- Financing	1.50	31.3	28.3	10.1	3.6	3.2
Retained Earnings	1.34	52.6	25.2	5.5	2.6	0.5
Bootstrap Financing	1.66	1.4	8.3	19.8	9.5	10
Short Term Loans	1.75	3.6	13.9	19.1	16.9	3.7
Loan Term Loans	1.88	11.2	16	17	9.9	10.5

Sources: Field Survey Data - 2015

**Table 9: Future Financing - Chi-Square of Consecutive Pairs**

Pairs of consecutive sources	Chi-square	P Value
Retained Earnings vs Self-finance as first choice	403.827a	0.00*
Self-finance Finance vs Bootstrap Finance as first choice	5.076a	0.02**
Bootstrap Finance vs Short term Debt as first choice	.413a	0.52
Short term Debt vs Long term Debt as first choice	3.796a	0.05*

Notes: \* significant difference at the 1 per cent level \*\*\* significant difference at the 5 per cent level

**Table 10: Frequency Distribution of Sample who Prefers Retained Earnings**

Sources	First choice (%)	Second choice (%)	Third choice (%)	Fourth choice (%)	Fifth choice (%)
Self -Financing	0	45.70%	12.2	4.7	3.3
Retained Earnings	100	0	0	0	0
Bootstrap Financing	0	11	20.1	10.1	9.1
Short Term Loans	0	17.8	19.9	15.9	3.3
Loan Term Loans	0	19	19.2	10.3	11

Sources: Field Survey Data - 2015