

Loan Interest Cost and the Financial Growth of Small and Medium Enterprises in Nyandarua County, Kenya

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Abstract: *Credit plays an important role in economic development and it is therefore believed that the expansion of credit programs will have a positive effect on income increase among small businesses of any economy. It helps in the diversification of livelihood, elimination of poverty and increases the skills of entrepreneurs. In Kenya, many small businesses source their credit from the informal sector and therefore their access to formal credit remains low. The focus of this study was to analyze the preference and perception of small scale business owners on the access to credit facilities so that their accessibility can be improved and that their needs for credit can be met adequately. The specific objective of this study was to determine the effect of loan interest costs on the financial growth of small and medium enterprises in Nyandarua County. The target population for the study was all the SMEs in Nyandarua County in the sectors of manufacturing, trade and service provisions which are 456 in number. The study applied stratified sampling design in coming up with a sample size of 137 respondents for the study which was a probabilistic sample of 30% among the three strata of manufacturing, trade, and service provision. Questionnaires were used as instruments for the study to collect data from financial managers and owners of these enterprises. Data collected was analyzed through descriptive analysis, content analysis, and regression analysis and emerging results presented in tables. The study found that there is a negative and significant relationship between loan interest costs and financial growth. The study recommends for the financial institutions to charge low-interest rates on their credit facilities so that many small businesses take up loans. Also, the businesses can take up other alternatives of financing that have low costs charged on loans such as SACCOs therefore increasing their ability to access credit.*

Keywords: Small and Medium Enterprises, Credit Facility, Interestcharge, Financial Growth

1. Background to the study

Small and medium enterprises (SMEs) form the backbone of every economy. However, the natures of these businesses majorly being startups are faced with the challenge of sustaining their growth due to the lack of working capital. The financial institution, on the other hand, perceives small startup business as risk enterprises and therefore remains skeptical on offering them financial support through loans (Rogaly, 2010).

Small and medium enterprises across the world almost face similar challenges on their growth paths despite their big role in social stability, contribution to gross domestic product and creation of employment. For instance, small businesses in the European Union (EU) privately owned have created about 90% of employment and contributed up to 61% on the gross domestic product (GDP). Similarly, in China privately owned enterprises have been key players in employment creation as well as significant contributors to economic development. Small businesses in Malaysia have been reported to face a major blow through the limitations of accessing loans from financial institutions (Huppi&Feder, 2015).

In the developing countries there exists asymmetry of information on the financial markets with the formal credit institutions deliberately ignoring the informal lenders. It is therefore common to find the informal businesses getting their loans from close friends, relatives, neighbors as well as people whom they are in the same profession. This in itself reduces on the transaction as well as enforcement costs leading to low default rates. On the other hand, these loans are usually small and limit the growth of these enterprises.

Small businesses also face another problem of collateral and interest rates challenges. Whereas some assets that can be accessed by small businesses are highly valued they fail to have property rights to be used as collateral to secure huge loans with the formal institution (Gichuki, Njeru&Tirimba, 2014).

In developing countries, small businesses are run by mainly people who have failed to secure formal employment leading to starting these businesses in manufacturing and in retail businesses. The entrepreneur's also running these ventures lacks the knowledge of how they can borrow to finance different undertakings of the business and projects. Others cited the lack for collateral by the struggling new enterprises to secure loans with financial institutions. The financial institutions have themselves being accused of giving loans in skewed to businesses and at very high interest rates (Morduch, 2010).

In Kenya, small businesses have also gone through the same turmoil on the financial institutions' bureaucracy on assisting them in obtaining credit facilities. They have reported that big loans to them have declined as a result of being generally described as risky enterprises (Atieno, 2011).

1.1 Credit Accessibility and Growth

Small and medium enterprises have been noted to require capital to enable them to run daily operations, venture into new products, venture into new markets as well as funding research and development for creativity and innovativeness. Studies carried out have revealed that small businesses that have been able to obtain loans from the formal institutions are able to register higher sales, report higher profits, better

Volume 8 Issue 8, August 2019

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returns on equity, and better returns on investments etc., their businesses and even able to raise their productivity from economies of scale realized. Studies also carried out by Kimuyu and Omiti (2017) have revealed that an increase to access to credit facilities by small businesses results to about 20% increase in sales and profits and also an improvement on the cash flows.

1.2 Statement of the Problem

Small and medium enterprises need capital for working capital, entry into new markets and development of new products as well as sustenance. With increased access to credit facilities of about 10% of firms have registered a growth of about 20% according to a survey done by Tybout (2012). This means therefore that access to capital is at the center of every venture growth.

Many small businesses have collapsed in their first five years as a result of limited access to capital that would otherwise sustain such ventures during difficult times where innovations of new products, as well as diversification into new markets, would sustain them. The challenges on accessibility resulting from high-interest rates on loans borrowed (Poutziouris, Wang, & Chan, 2016; Desai, Foley & Forbes, 2017). Studies carried out in the past have shown non-consistencies on the effect of interest charges on the accessibility of credit facilities, with some showing little effect while others showing no relationship at all between interest charged on loan and financial growth of SMEs calling for a more in-depth study.

1.3 Objective of the Study

To determine the effect of loan interest cost on the financial growth of small and medium enterprises in Nyandarua County

1.4 Research Hypothesis

H₀₁. There is no relationship between interest cost charges and the financial growth of small and medium enterprises in Nyandarua County.

2. Theoretical Review

The study was guided by pecking order theory

2.1 Pecking Order theory

This theory was pioneered by Donaldson in 1961. This theory stipulated that when a firm need to finance its project there is an order or ranking on different financial sources at its disposal. The order is in such a way that reduces risks to the firm and also reduces exposure to control (Frank & Goyal, 2013).

In the informal borrowing, a firm obtains its funds from either personal before saving or its retained earnings (Sánchez-Vidal, & Martín-Ugedo, 2015). In the formal borrowing, however, a firm would first consider internal financing first before going for external financing. In the internal financing retained earnings as well as internal equity

is given priority because of its risk-free. For external borrowing debts that attract low interests are considered before other external financing options such as external equity that can expose the firm to high risk of control (Zoppa, & McMahon, 2012). This theory plays an important role in this study by explaining how firms with adequate and reliable information make informed choices on different sources of financing, therefore, reducing the burden of the cost of loan.

2.2 Imperfect Information Theory

This theory was pioneered by George Akerlof in 2002. This theory is guided by the unequal distribution of information between the managers of the organization and the investors. This inequality acts as a guide in making key decisions concerns the raising of capital in the organization to do business. According to this theory finance managers of organization prefer to utilize internally generated capital, later would go for debt in the form of loans and finally would go for equity capital (Rothschild & Stiglitz, 2010).

Two major risks are involved in pecking order theory which involves adverse selection and moral hazard. The adverse selection comes in because the firm has more information about the project than the bank itself. Therefore it is necessary for the two parties to be at par in the disclosure of key information relating to the project in order to make a solid judgment by the bank in giving the loan. That is to inform the bank about the purpose of the loan and how it shall be paid back (Stiglitz & Weiss, 2011).

According to Bhattacharya (2009), moral hazard, on the other hand, is the risk that the borrower may divert the many given to other uses other than the intended ones. In this case, the bank may guard against the case by having someone on the board that follows through board meeting to avowing diverting money. This theory is important to the study by explaining the importance of information among borrowers in accessing credit facilities.

2.3 Resource Based theory

The theory on resource base was pioneered by Barney in 1991. The proposition of the theory is that a firm uses the resource it has in its disposal to achieve strategic competitiveness. A firm which has more resource in its disposal is, therefore, able to meet both its short term as well as long term objective. A firm would therefore easily develop new products or enter the new market niche if it has adequate and appropriate resources at its disposal (Grant, 1991).

According to Das and Teng (2010) for small business to grow they need to have resources and capital at its disposal that would enable them to an alternative means of capital for growth. Likewise, an institution that has an adequate and reliable source of information about the financial market is able to borrow at the best interest rates and also get best credit facilities. This theory is important to this current study by explaining how resources enables organizations to access the best information and therefore getting best credit facilities for its growth.

2.4 Empirical Review

2.4.1 Interest Cost

Green, Kirkpatrick, and Murinde (2006) covered agribusiness firms in Uganda where 512 small firms were tested on the relationship between interest cost and financial performance. The descriptive results of the study established that 89% of the respondents were of the view that indeed interest costs affected accessibility to credit facilities only 11% found it not a hindrance. Small business does require small capital compared to bigger firms, therefore due to economies of scale small firms get their loans at higher interests because they are also considered risky ventures. The study concluded for a firm to grow steadily, they have to access finances to the formal sector which is considered riskier. The study, however, failed to use correlation well as regression analysis to test the strength of the relationship between the interest costs on financial growth as well as its level of significance. Therefore this study had the objective of establishing such levels of significance as the strength of the relationship.

In a study carried out by Aryeetey, Hettige, Nissanke, and Steel (2007) in Malawi to find out the effect of interest charges on accessing credit facilities, the results of the study from 415 business owners found that 92% of the respondents believed the high-interest cost was a major hindrance to accessing credit facilities. The reason associated with the small business holder being left out is their fear for exploitative interests charged on borrowed

capital. The study, in this case, was studied in a country with a different financial regulatory system and therefore necessitating a study to be carried out in a country like Kenya with the different regulatory framework.

Grace and Tomola (2008) carried out a study on the role of access to finance on financial performance in Lagos consultancy firms. The study adopted a casual research design where 423 questionnaires collected data from the owners of these firms. The study established that access to finance had a weak positive relationship with financial performance. The study, however, carried out in an urban setup with different macro as well as the macro environment to a rural setup. Therefore this study aim at establishing the effect of interest cost on the growth of firms in the rural setup

A study by Ochanda (2014) sought to find out the factors affecting financial growth among small businesses in Nairobi, Kenya. The study sampled 97 Small firms in the retail business. The study carried out descriptive statistics on the data collected from questions seeking to find out if interest charges had an effect on financial access and growth. The study established that indeed high-interest rates discouraged access to credit facilities as shown by 92% of the respondents. However, the study only carried out descriptive statistics and not inferential statistics to indicate coefficient correlation, a case which will be achieved by this study.

Table 2.1: Summary of Literature Review and Gaps

Author	Focus of study	Major Findings	Knowledge Gaps
Green, Kirkpatrick, and Murinde (2006)	The role of microcredit on the financial growth of small and medium enterprises in Uganda.	95 % of the respondents revealed that interest costs affected accessibility to credit facilities	The study failed to use correlation well as regression analysis to test the strength of the relationship between the interest costs on growth as well as its level of significance
Aryeetey, Hettige, Nissanke, and Steel (2007).	Access to finance and growth among rural small businesses in Malawi	Small business holders are being left out in formal financing sector due to their fear for exploitative interests charged on borrowed capital.	The study only used descriptive statistics therefore not being conclusive on the level of significance as well as the coefficient of correlation.
Ochanda (2014)	Factors affecting financial growth among small businesses in Nairobi, Kenya.	92% of respondents noted that high-interest rates discouraged access to credit facilities	The study only used descriptive statistics therefore not being conclusive on the level of significance as well as the coefficient of correlation.

Source: Researcher (2019)

2.5 Conceptual Framework

The following figure is a diagrammatic representation of the relationship between loan interest and the financial growth of small and medium enterprises in Nyandarua County and the measures/ indicators relating to the variables.

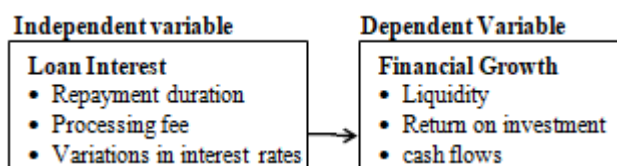


Figure 2.1: Conceptual Framework
Source: Researcher (2019)

The conceptual framework above illustrates that loan interest being measured through: repayment duration, loan processing fee and variations in interest rates whereas

financial growth is measured through liquidity of business and return on investment.

3. Research Methodology

3.1 Research Design

The study adopted a descriptive research design as well as case effect design. This research design method was used because it enhanced the reporting of facts as they happened without alterations done on the data. Also case effect shows how independent cases impact on dependent cases.

3.2 Target Population

456 SMEs in manufacturing, trade, and provision of services in Nyandarua County was targeted for the study. Therefore

the study will target 456 owners and managers of these SMEs.

Table 3.1: Population for the study

Category	Size
Manufacturing	304
Trading	100
Service provision	52
Total	456

3.3 Sampling Design

The study applied a probabilistic sampling design where 30% of the stratum size was considered for the study. From the sampling done 137 respondents were included to provide data as justified by Mugenda and Mugenda (2008), to be adequate and representative of the targeted population.

Table 3.2: Sampling Technique

Category	size	Percentage	Sample size
Manufacturing	304	30%	91
Trade	100	30%	30
Services providers	52	30%	16
Total	456		137

Source Author (2019)

3.4 Data Collection Instrument

Primary data was used in the study and collected using a questionnaire. The questionnaire consisted of closed and open questions. The closed questions had likerts, open questions were to give more in-depth on the matter of inquiry.

3.5 Validity and Reliability of Research Instrument

3.5.1 Validity of Research Instrument

Validity of research instrument relates to how the research instruments captures what the research aimed at achieving in terms of the questions asked and their relevance to the current study. The study consulted research experts experienced in the same field as well as the university supervisors to ensure that the questions that were asked specifically addressed the concern of the study.

3.5.2 Reliability of Research Instrument

Reliability of research instrument shows the extent to which if similar research instrument and procedures followed remains constant as to whether they would yield consistent results. The study ensured achieving of this consistence by testing the results of the constructs through Cronbach α at 0.8, where the Cronbach α obtained was less than 0.8 on an indicator it was dropped and vice-versa.

Factor	Number of indicators	Cronbach α
Loan interest	3	0.8

Source :Researcher (2019)

3.6 Data Collection Procedure

The data in the study was collected with the assistant of two research assistants. Before data collection, a letter was sent to the financial managers of the institution requesting them to help in providing data required for the study. The research

assistants dropped questionnaires and picked them later after they were filled by the respondents selected. Where there were challenges in filling them the respondents was to be called and offered needed support.

3.7 Data Analysis and Presentation

Data collected was analyzed through descriptive, content analysis as well as inferential statistics. Through descriptive analysis, data was analyzed with the help of SPSS version 21 to generate mean, frequency and percentages. Content analysis was also carried out through a thematic approach whereby key concepts from the open questions that required the respondents to give their own view were noted. Finally through inferential analysis relationship between independent and dependent variable and levels of significance was established. To carry out inferential analysis a regression model was considered as shown below.

$$Y = \beta_0 + \beta_1 X_1 + \epsilon$$

Where: Y represented Financial Growth, β_1 represented coefficient for independent variables, X_1 represented interest rate cost whereas ϵ was the error term.

4. Research Finding and Discussions

4.1 Gender

The study aimed at establishing the gender of the respondents. The results are as shown in table 4.1 below.

Table 4.1: Gender of the Respondents

Gender	Frequency	Percent (%)
Male	74	61
Female	47	39
Total	121	100

Source: Researcher (2019)

Results of the study in table 4.1 revealed that the majority of the small businesses were owned by men as indicated by 61% on the above table, only 31% of the businesses were owned by women. Similar studies Davidoff and Hall, (2013), indicated that slowly the culture of male dominance in businesses with women left to do domestic chores is soon fading away

4.2 Age bracket

The study aimed at establishing the age bracket of the respondents. Table 4.2 below shows the age bracket of the respondents.

Table 4.2: Age bracket

Age bracket	Frequency	Percentage (%)
Under 20 years	8	7
21-35yrs	39	32
36-50	50	41
Above 50years	24	20
Total	121	100

Source: Researcher (2019)

It was revealed from the study in table 4.2 that people of the age between 36 and 50 years were the major owners of the small businesses in Nyandarua county as indicated by 41%, ownership of the businesses among the small businesses was followed by owners aged 21 and 35 years as indicated by 32%, others of above 50 years owned only 20% of the small businesses. This study shows that many people start their businesses when they are energetic and innovative enough mainly when they are below 50 years of age. Barney (2001), concurs with the findings of this study when he opined that adults in the middle age are innovative and creative enough to start-up businesses, unlike old people.

4.3 Level of Education

In this section, the study sought to find out the levels of education of its respondents. Table 4.3 below shows the level of education of the respondents.

Table 4.3: Level of Education

Level of education	Frequency	Percent (%)
Primary school	46	38
Secondary school	50	41
college\university	25	21
Total	121	100

Source: Researcher (2019)

The results of the study in table 4.3 revealed that majority of the small business owners had secondary school education as indicated by 41%, this was followed by 38% of the respondents who had primary school education and finally only 21% of the respondents had university/college level of education. This result indicates that most of the small and medium enterprises owners in Nyandarua County had limited levels of education to make key financial decisions in their businesses. Nassimbeni (2001) opined that individual education level is a key ingredient in making entrepreneur decisions in businesses and thus have a huge impact on society as a whole.

4.4 Source of Money Used To Start Business

In this section, the study sought to find out the different sources of funds that the owners of the small businesses in Nyandarua County used to start-up their businesses. The study revealed that the business owners got their start-up capital from Personal saving, Friends and relatives, Group lending (Chama), Bank loan and Trade credit. Cassar (2014), concurs with the study findings when he postulated that capital for starting businesses can be gotten from friends, banking institutions, personal savings or credits.

4.5 Interest Rates

This section sought to find out how the interest rate charged affect the accessibility of credit in the financial growth of small and medium enterprises in Nyandarua County. In this case, the following areas were covered.

4.6 Credit period for Loans

In this section, the study sought to find out whether the credit period given on the loan is enough to pay back the

principal and the earned interest. The results are shown in table 4.5 below.

Table 4.5: Credit period given

Time	Frequency	Percent (%)
Yes	24	20
No	97	80
Total	121	100

Source: Researcher (2019)

The table 4.5 showed that majority of the respondents felt that the financial institutions were not giving borrowers enough time to make-up the payments as shown by 80%, whereas only 20% felt that the period they are given is enough. Similarly, Williamson (2017), noted that the loans contracts drawn by financial institutions on long-term basis attracts high monitoring costs and therefore rationing on the amount of credit given as well as time.

4.7 Compounding Costs

This part of the study sought out if compounding costs or interest charges on the borrowed money was affecting their access to credit. Table 4.6 presents the findings.

Table 4.6: Compounding Costs

Time	Frequency	Percent (%)
No	30	25
Yes	91	75
Total	121	100

Source: Researcher (2019)

The table 4.6 above show that many financial institution giving loans were discouraging borrowing by charging too high interest on money borrowed as shown by 75% of the respondents, only 25% felt that the interest charged were fair. Similar studies by Bottomley (2013), noted that the cost charged on borrowed capital is high enough to cover for administration costs, especially in rural areas.

4.8 Hidden Charges

This part of the study sought to find whether there were other hidden costs including processing fees on loans that affected borrowing. The results are shown in table 4.7 below.

Table 4.7: Hidden Charges

Time	Frequency	Percent
Yes	103	85
No	18	15
Total	121	100

Source: Researcher (2019)

The table 4.7 above shows that there were other hidden costs discouraging borrowing as they made the costs of borrowing to go high as shown by 85% of the study only 15% felt okay with other processing costs. Similar studies by Bottomley (2013), noted that the cost charged on borrowed capital is high enough to cover for administration costs especially in rural areas, therefore other costs are hidden by the banks as administration costs.

4.9 Factors of Interest Rates Influence on Borrowing Ability

The study aimed at determining the extent to which respondents agreed on statements regarding interest cost charges on borrowing ability. Table 4.8 below shows the extent to which interest rate factors influence accessibility to credit from financial institutions.

Table 4.8: Factors of Interest Rates Influence on Borrowing Ability

Statement	Mean	Std Dev
Credit period given was enough	1.32	.846
Compounding costs are high or vary	4.83	.654
Hidden costs are there	4.03	.754

Source: Author (2019)

Results of the study in table 4.8 as indicated on the table above shown a disagreement that 'credit period given was enough' from a mean of 1.32; it was agreed compounding costs were high as shown by a mean of 4.83; finally they agreed that there are hidden costs that have an effect on borrowing as shown by a mean of 4.03. Similar studies by Aryeetey, Hettige, Nissanke, and Steel (2007) in Malawi to find out the challenges faced by small business to access credit facilities found from 92% of the respondents that high-interest cost was a major hindrance to accessing credit facilities.

4.10 Coefficients

The strength and direction of the relationship between the independent variable interest costs and the dependent variable (financial growth) was tested using Pearson's correlation coefficient. Table 4.9 below shows the correlation coefficient.

Table 4.9: Regression Coefficients

Model	Unstandardized Coefficients		Standardized Coefficients	Sig.
	B	Std. Error	Beta	
(Constant)	12.371	6.686		.0359
Interest cost	-.195	.388	.255	.0239

a. Dependent Variable: Financial Growth

b. predictors : (interest rates, literacy levels, the location of business and demand of collateral)

Proposed regression model was: $Y = a + B_1 X_1 + \epsilon$

Therefore after the determination of the coefficient the model becomes

$$12.371 - 0.195 X_1 + \epsilon$$

From the above model results in table 4.8, putting interest cost at constant the financial growth was 12.371. However, with a 1% increase in interest charges, this leads to a decline in financial growth by .195% this relationship was negative in nature and significant at 0.0239. This result concurs with ones carried out by Ochanda (2014) when he posited that indeed high-interest rates discouraged access to credit facilities.

4.11 Hypothesis Testing

The study aimed at testing the following hypothesis: *There is norelationshipbetweeninterest cost and the financial growth of small and medium enterprises in Nyandarua County.* However, from the coefficients obtained from regression analysis, it was established that interest cost charged on loan had a negative significant relationship on the financial growth of small and medium enterprises in Nyandarua County. The strength of the relationship was 0.195 which was significant at 0.0239 through a 95% confidence interval.

5. Summary of Findings, Conclusions, and Recommendations

5.1 Summary of the Study

It was established that interest rate discourages borrowing among businesses in Nyandarua County. It was also found that financial institutions are not giving borrows enough time to make repayment which results in low financial growth.

5.2 Conclusions of the Study

It was concluded that the high-interest rate has a negative relationship with access to financial growth among firms in Nyandarua County. With high compounded charges and the short-repayment period the borrowers were unable to make repayments for borrowed capital, therefore, shying away from taking such facilities.

5.3 Recommendations of the Study

The study recommends financial institutions to charge low-interest rates on their credit facilities so that many small businesses take up loans. Also the small businesses source from other sources of financing that have low costs charged on loans such as SACCO, that are normally lowly charged and therefore increasing their ability to access credit.

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Appendix: Questionnaire

Part A: Background Information

- 1) Indicate your gender
 Male
 Female
- 2) In what age bracket are you?
 Under 20 years
 21-35yrs

- 36-50
 Above 50years
- 3) Indicate your marital status
 Married single
 Windowed
 Single
 Others (specify) _____
- 4) What is your level of education?
 No education
 Primary school
 Secondary school
 college\university
- 5) Were you in any other employment before starting this business?
 Yes
 No
- 6) What was the source of money you used to start this business?
 Personal saving
 Friends and relatives
 Group lending (Chama)
 Bank loan
 Trade credit
 Others (specify) _____
- 7) Have you ever taken a loan from?
 Yes
 No
- 8) If yes, How would you rate your ease to access the loan (Bank-Loans)
 Very easy access
 Easy access
 Difficult access
 Very difficult access
 No access

Part B: Interest Rates and Financial Growth

- 9) How often do you take a loan?
 Quite often
 Rarely
 Very rarely
 Never
- 10) Is your business able to meet the current interest rates on loans?
 Yes
 No
- 11) Do compounding interest charges affect obtaining loans
 Yes
 No

Use the following key to answer the questions that follow. Tick only one box under the number.

- 12) Key
 Strongly Agree
 Agree
 Neutral
 Disagree
 Strongly Disagree

- 13) The following influence my borrowing ability

Statement	1	2	3	4	5
Loan processing costs					
Hidden costs					

Repayment periods					
variation of the interest rates after one has borrowed					

Part C: Financial Growth

14) Please rate the extent to which the following areas on financial growth have improved in the past five years

Statement	1	2	3	4	5
Cash flows					
Liquidity					
Return on investment					