Formal, informal and semi-formal sources of finance: Is there any difference amongst Cameroonian small enterprises and medium enterprises?

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Abstract

Studies on the small and medium sized enterprises (SMEs) financing do not generally distinguish them. This study aims to compare the small enterprises (SEs) financing to those of medium enterprises (MEs). The questionnaire survey of 41 SEs and 47 MEs selected and the comparison statistical test, points the fact that bank loan and informal funding sources, effectively allow significant distinction amongst SEs and MEs in Cameroon. While the formal and semi formal intermediate funding (overdraft, trade credit, and microcredit) does not allow differentiating them. Consequently SEs financing sources are more informal than MEs financing sources. Thus, the effectiveness of economic policy for SMEs is subject to a distinction between them.

Keys words: Small enterprises, Medium enterprises, Formal financing, Informal financing, Cameroon.

1. Introduction

From the last Cameroonian enterprise survey, conducted by the National Institute of Statistics (NIS), about 98 % of enterprises are small and medium-sized enterprises (SMEs) (NIS, 2009). In Cameroon, reduction of poverty is the most important agenda item in development policy. The government

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particularly positions SMEs promotion as the key subject on its agenda, in that the SMEs sector can serve as a driving force for economic growth. Then Cameroonian Government launched institutional reforms in December 2004, including the establishment of Ministry of Small and Medium-Sized Enterprises, Social Economy, and Handicrafts for the formulation of SMEs promotion policies and programs. These programs include the SMEs promotion agency and SMEs Cameroonian bank. SMEs account for 62% of permanent employees and 31% of turnover before tax of all enterprises in Cameroon (NIS, 2009). The ability of SMEs to create jobs and to contribute to development is directly related to their ability to grow. The growth and development of SMEs are restricted because SMEs face different obstacles. The World Bank Enterprise Survey (2009) for Cameroon shows that 54.0% and 56.5% of SEs and MEs respectively, reported limited access to finance as a major obstacle to their business. Mandiefe et al. (2015) found that higher financial constraints reported by Cameroonian SMEs translate into low productivity.

In Cameroon, the financial market is embryonic, very few companies are listed. Banks are reluctant when it comes to granting loans to SMEs, who are the biggest victims of bank credit rationing (Um-Ngouem, 1996). Credits for SMEs are usually short-term. We also denote the considerable contribution of informal financing networks in the Cameroonian small sized enterprises (SEs) and medium sized enterprises (MEs) financing. Informal finance are mainly informal Self-Help Groups (SHGs) or Rotating Savings and Credit Associations (ROSCAs) commonly known as *susus* in Ghana, *tontines* or *Njangui* in Cameroon. *Tontines* practice is essential in Cameroon and drains huge sums unlike other African countries where it remains marginal (Hernandez, 1997). Culture and socio economic factors explain *Tontines* practice in the Cameroon. Between formal and informal sources of financing we find the semi-formal sources of financing, consisting of microfinance institutions (MFIs) fund. The Banking Commission for Central Africa (COBAC) law, available since 2002 came to organize the microfinance sector in Central Africa.

The majority of studies on the financing of SMEs (Abdulsaleh and Worthington, 2013; Wamba and Niyansaba, 2014), do not make any distinction amongst SMEs. Given the attention paid to this essential part of the economy of developing countries, the objective of this study is to compare the importance of different financial sources for two separate groups of SMEs. So we appreciate the SEs financing compared to those of MEs. Specifically, it is about to check why MEs financing are more formal than those of SEs. The formal financing (bank loan) is less accessible for SEs, this because their probability of bankruptcy is greater than that of MEs and large enterprises (LEs), where business diversification reduces volatility of cash-flows and thus the probability of bankruptcy. SEs often turns to informal or semi-formal financing networks (Issoufou, 1992). Several other studies have shown that there is a positive relationship between the SMEs size and its debt levels (Colot et al. 2010, Degryse et al., 2012). In other words, these works demonstrates that SEs formal debt (short and long term) is lower than MEs formal debt. This study is unique in that a comparison amongst SEs and MEs financing behaviour is examined. Through this study we intend to contribute to the improvement of decision making for all SMEs categories. The rest of the paper is structured as follows: section 2 presents a literature review on SMEs financing, section 3 focuses on the method used and in section 4 we present the main results before concluding observations in section 5.

2. Literature review

2.1. SMEs and Financial growth cycle

Berger and Udell (1998) are at the origin of the financial growth cycle model. According to this model, financial needs and the financing options available for SMEs change throughout the various phases of a firm's lifecycle. Then, at different stages of the firm's growth cycle, different financing strategies are required. In general, because of the unique features that characterize SMEs during the start-up phase, such as informational opacity (Berger and Udell,1998) and the lack of trading history (Cassar, 2004), SMEs in this stage depend heavily on insider funding sources. The main limitation of this approach is that it is not applicable to all SMEs operating in different industries.

The SMEs financial growth model, contrasts with the hypothesis given under pecking order theory (POT). The POT developed by Myers (1984), suggests that the capital structure decisions of a firm are a function of the firm's age. As postulated by this theory, internal sources of funding are prioritised while the use of external sources is delayed until the internal sources are exhausted. As such, when seeking funds, a firm prefers internal equity to external debt, short-term debt to long-term debt, and external debt to external equity. Therefore, the order of preference for the financing sources for a firm should follows internal equity, issuing debt, and then issuing equity (Sogorb-Mira, 2005). Signal Theory, developed by Ross (1977) leads to conclusions similar to the approach of the POT. All these approaches and that of the agency theory (Jensen and Meckling, 1976), aimed at reducing the information asymmetry, which leads to contracts inefficiency between the lender and the SEs or MEs.

2.2. Information asymmetry, SEs and MEs financing

A model of imperfect information, uncertainty and credit rationing was earlier published by Dwight and Russell (1976). The model shows that the loan market is composed of borrowers who detain more information about their likelihood of default than the lenders.

One of the reasons size may play a role in the financing behaviour of firms is asymmetry of information. Most SEs are said to be less transparent with information. This is because most SEs keep their operations private, lack publicly available information such as detailed financial information and have no credit history which providers of external finance can use to assess their creditworthiness and monitor their performance. This result in higher cost of lending to SEs which makes it difficult for SEs to obtain bank loan (Berger and Udell, 1998). As such, SEs are less likely to use external finance than MEs and LEs. Then asymmetry of information results in adverse selection and moral hazard problems which can constrain SE's access to finance. Adverse selection problems arise when providers of external finance have incomplete information about the quality of project by SEs. Adverse selection may arise when a pool of riskier borrowers are willing to access external financing. On the other hand moral hazard problems arise when management of SEs fail to perform as expected and when providers of external finance fail to effectively enforce the agreed contracts.

2.3. Formal, informal and semi-formal financing for SEs and MEs

Internal source of funding (equity financing, retained earnings etc…) Equity capital can be raised either internally or externally. Internal equity is funds obtained from the current owner–manager(s), family, and friends or from the retained earnings within the firm. External equity, however, is capital acquired from external channels other than the existing partners and their relatives. Ou and Haynes (2006) determined two situations when SMEs pursue financing from equity capital sources in order to meet expansion needs. The first case is when SMEs face financial distress coupled with a lack of alternative sources of finance. The second case is when cash outflows exceed the cash inflows generated from regular sources.

Debt financing: Capital structure decisions, relate to the use of either equity or debt or both. In order to keep full ownership and control of their businesses, SMEs owner–managers may prefer to seek debt financing rather than external equity. Wu et al. (2008) have identified three significant differences between debt financing for SMEs and that of LEs. First, unlike managers of LEs who usually have the choice of broader range of debt financing resources, SMEs tend to be more attached to commercial lenders, especially institutional lenders, as a source of short-term debt financing that can be renewed for long-term debt. Second, as information asymmetry problems are more acute in SMEs than in LEs, long-term lending relationships are important for SMEs in order to deal with the resultant agency problems along with signalling, monitoring and bonding (the provision of guarantee or collateral). Third, in concentrated owner–managed SMEs, and contrary to what the agency theory suggests, it is not clear whether debt can lower the agency costs that result from information asymmetry arising due to different motives of owners and managers.

Trade Credit: Trade credit is an important mechanism for financing inter-firm trade. It is defined as the credit granted by a selling firm to finance another firm’s purchase of the seller’s goods. Firm is look like borrower and lender. Trade credit could also help to reduce the asymmetric information (Berlin, 2003). Financial economists have proposed explanations. Those explanations view trade credit as a method of monitoring and enforcing loan contracts to relatively risky SMEs, diverting goods is harder than diverting money (Berlin, 2003).

Microfinance: Schreiner (2001) defined microfinance as formal schemes designed to improve the well-being of the poor through better access to saving services and loans. The impact studies of microfinance on poverty are organized around two complementary issues: the effectiveness of microfinance programs to reach their target audience (*outreach*) and to fight against poverty. On the first point, it has been repeatedly shown that if the beneficiaries of microcredit programs are indeed part of the poor and excluded from traditional financial systems populations, they do not belong mostly to the most vulnerable populations that are for example the owner-managers of SEs and MEs which also benefit their impact (Labie et al., 2010). COBAC (2002) distinguishes three categories of MFIs, *Category one* are institutions that collect savings and deposits and lend them on exclusively to their members. This category includes associations, cooperatives and credit unions**.** *Category two* are institutions that collect savings and deposits and lend them on to third parties. This category groups limited liability companies that function more like mini banks. *The third category* is made of lending institutions that do not collect savings and deposits. They include micro credit and project finance institutions.

Informal finance: Informal finance is defined as contracts or agreements conducted without reference or recourse to the legal system to exchange cash in the present for promises of cash in the future (Schreiner, 2001). The virtues of informal finance (slashed transaction costs, supply of not just loans but also savings and implicit insurance, services sensitive to constraints faced by women, substitution of confidence in character for physical collateral, socially enforced and/or self-enforced contracts, and sequences of repeated transactions) are more favorable for SEs than MEs.

The informal arrangements in Africa financing have changed over time to adapt to the current context of the country. Servet (1995) distinguishes *tontines* depending on the composition, the duration, the nature of relationships between members, the type of use of the funds collected and the nature of commitments. He suggests a typology of *tontines*. There are *tontines* with associative character that operate on the principle of mutual benefit. There are also tontines in which members are attracted by the financial return; contributions here can reach large sums. We find in this type of tontine business men and women who are owner-managers of SMEs. In general, members are well known, allowed to regain confidence in the group and reduce the asymmetry of information amongst members. Finally, professional *tontines* bring together people working in the same company or industry. SEs and MEs can equally receive funding from public administration and leasing, or through venture capital (Abdulsaleh and Worthington, 2013).

2.4. Some empirical evidence on SEs and MEs source of financing

The World Bank enterprise survey country profile report (2009) indicates that 16.2% and 20.4% of SEs and MEs respectively, not needing a loan, 16.7% and 40.6% of SEs and MEs respectively use bank loan to financed investments. For internal financing, 75.6% and 62.9% of the SEs and MEs investments financed internally. For trade credit financing, 12.6% of SEs investments and 10.4% of MEs investments are financing by trade credit.

Petersen and Rajan (1994) argued that as firms grow, they develop a greater ability to enlarge the circle of banks from which they can borrow. They then provided evidence that firms dealing with multiple banks and credit institutions are nearly twice as large as those with only one bank. In the case of Ghana, Abor (2008) found that small firms have greater problems to access credit than large firms. A study by Fauré (1992), on the Ivorian SMEs, highlights the essential role of self-financing, confirms the scarcity of official credit, but also the important place of informal channels. Several others studies have highlighted the importance of *tontines* in Sub-Saharan Africa SMEs financing (Issoufou, 1992; Gnanounou, 1992)

3. Method

3.1. The sample

The list of Cameroonian SMEs identified during the NIS enterprise survey is our sampling frame. We have associated with it a list of SMEs with financial statements available on at least four financial years (including year 2008), over the period 2003-2008. From Enterprise survey SMEs list, we select SMEs that accounting leading to the establishment of a formal financial statement, we have 3871 SMEs. This number is considered to be large for a sample size. Since the study is based on comparing the proportions of SMEs using financial sources, the proportion of SMEs with access to such financing in the population of the Enterprise Survey is around 37.4 %. The formula for determining the required sample size is: $n = 4p\ (1\ \text{-}p)\ /\ E * E$; where p is the proportion and E the margin of error that is authorized. In our case, $p = 0.374$, $E = 10\ \%$ after calculation, we find $n = 93.64 \approx 94$ SMEs. Subsequently, we conducted a counting and sorting among SMEs and SMEs that do not present difficulties in terms of information available are retained, the number selected for the survey is 121 SMEs. From 121 selected SMEs, our goal is to have a sample of 94 SMEs. Finally our sample consists of eighty-eight (88) SMEs (forty-one (41) SEs and forty-seven (47) MEs). Thus (thereby) the six (06) missing SMEs (94-88 = 06) correspond to non-responses during the survey of SMEs selected for our sample (ratio = 6.4 % and less than 20%, acceptable). The sample is stratified (SEs and MEs), SMEs with financial statement (82 %) are more represented in Yaoundé (18%) and Douala (64%). The MEs represent (85.4 %) and SEs (81.1 %). These overall stratum proportions are between 5 % and 10 % maintained in the sample. The main characteristics of SEs and MEs of our study are presented in Table 1 below.

Table 1. SEs and MEs characteristics

Characteristics		SEs		Mes	
		Number	Frequency	Number	Frequency
Town	Douala	16	39%	30	64%
	Yaoundé	17	41%	15	32%
	Others	8	20%	2	4%
	Total	**41**	**100%**	**47**	**100%**
Year of creation	1997-2003	20	49%	24	51%
	1986-1996	14	34%	17	36%
	Before 1986	7	17%	6	13%
	Totaux	**41**	**100%**	**47**	**100%**
Legal status	Sole proprietorship	16	39%	2	4%
	Limited partnership	22	53%	30	64%
	Partnership	2	5%	13	28%
	Others	1	2%	2	4%
	Total	**41**	**100%**	**47**	**100%**
Industry	Manufacturing cereal products	10	24%	4	9%
	Paper making and paper products, printing and publishing.	6	15%	6	13%
	Construction	18	44%	16	34%
	Others	7	17%	21	44%
	Total	**41**	**100%**	**47**	**100%**

Source: Author from survey data and NIS (2009)

3.2. Variables and data sources

The data of this research are from Enterprise survey, SMEs financial statements and a survey. Our questionnaire survey was preceded by a pre-survey. This pre-survey aims to enhance our questionnaire and to reassure on the reliability of data to be collected. Our questionnaire survey contains control issues aimed to assure that the data collected through the survey questionnaire are identical to those collected during the NIS Enterprise Survey and those contained in SMEs 2008 financial statements. This survey is necessary because the financial statements and the Cameroonian enterprise survey does not allow for certain data, including those related to SMEs financing. Most of the work on SMEs financing rely on financial statements (balance sheet and income statements), yet these financial statements do not provide all the information on SMEs funding sources especially when they are coming from informal channels. From the value of short-term debt that appears on the balance sheet, it is not always easy to discern the origin of short-term debt (overdraft, microcredit from MFIs, or trade credit). The survey data allows us to measure the variables defining the source of funding use for SEs and MEs. These variables are presented and defined in Table 2 below.

Table 2. Definition of variables

Variable	Definition
SEs	Firms with 5 to 19 employees and an annual turnover of USD $36363 to $181818.
MEs	Firms with 20 to 99 employees and an annual turnover of USD $181818 to $1818181.
Internal source of funding	A dummy equal to 1 if the firm use internal source of funding to finance its asset and zero otherwise
Bank loan	A dummy equal to 1 if the firm use bank loan to finance its asset and zero otherwise
MFIs	A dummy equal to 1 if the firm use microcredit to finance its asset and zero otherwise
Overdrafts	A dummy equal to 1 if the firm use very short term loan to finance its asset and zero otherwise
Leasing	A dummy equal to 1 if the firm use leasing to finance its asset and zero otherwise
Venture capital	A dummy equal to 1 if the firm use venture capital to finance its asset and zero otherwise
Trade credit	A dummy equal to 1 if the firm use trade loan to finance its asset and zero otherwise
Government initiative	A dummy equal to 1 if the firm use government initiative to finance its asset and zero otherwise
Family and relatives	A dummy equal to 1 if the firm use funds from relatives and family to finance its asset and zero otherwise
Tontines	A dummy equal to 1 if the firm use tontines to finance its asset and zero otherwise

Source: Author from survey questionnaire and NIS (2009)

3.3. Statistic test

Given the qualitative data of this study, statistical analysis is at two complementary levels. A descriptive analysis is completed by a statistic test. Percentages are also use to rank the different financial sources.

- We first conduct a descriptive analysis of SEs and MEs financing. The calculation of the proportion of SEs using a source of financing is obtained and compared to that of MEs using the same source of funding. The results allow us to observe trends on possible differences between SEs and MEs concerning the financial sources used.
- In order to validate or invalidate the trends from the calculation of percentages, we then proceed to the statistical test comparing proportions of different sources of funding used by SEs and MEs.

The assumptions of the comparison test of proportions and the decision rule are summarized in Table 3 below.

Table 3. Comparison test assumptions

Comparison test	The decision rule of comparative statistical tests is as follows :
$\mathbf{H_0}$ **:** Proportion (X) = Proportion (Y) Diff = 0	
$\mathbf{H_1}$ **: * bilateral** Proportion (X) $\neq$ Proportion (Y) Diff $\neq$ 0 $\mathbf{H_1}$**: * unilateral** **-** Proportion (X) < Proportion (Y) Diff < 0 **-** Proportion (X) > Proportion (Y) Diff > 0	• With respect to the statistic used : If $t_{cal} > t_{read}$, then reject H_0; If $t_{cal} < t_{read}$, then accept H_0. • With respect to the calculated probability : If p > *Threshold*, then accept H_0; If p < *Threshold*, then reject H_0.

Source: The Author from comparison test statistic

4. Results

4.1. A separate classification of Cameroonian SEs and MEs funding sources

From Table 4 below, the reinvested earnings are the first funding source of SEs (100%) and MEs (100%). Secondly, the SEs used short-term debt (overdrafts, trade credit) or even *tontines.* It is difficult to determine an order of preference for SEs because the percentage of SEs using these funding sources is identical (85.37%) for various funding sources. By cons when observed following the ranking of sources of funding for MEs, there is overdraft (89.36%), then trade credit (82.98%). In fourth position comes the bank loan (72.34%). The first boundary is observable at this level. We note the preponderance of informal channels in the SEs financing, which is not the case for MEs that are primarily oriented towards formal financing channels. Indeed bank loans occupy the fifth position in the SEs financing (36.59%), and then this position is occupied by *tontines* in financing MEs (51.06%). Financing from semi-formal channels, occupying the sixth position for both SEs (31.71%) and MEs (31.91%).

Table 4. Comparison test results

Financing sources	Ses		t-value	Mes	
	Number	Frequency		Number	Frequency
Internal source of funding	41	100,00%	0.0	47	100,00%
Bank loan	15	36,59%	-3.4457***	34	72,34%
MFIs	13	31,71%	0.0575	15	31,91%
Overdraft	35	85,37%	-0.5599	42	89,36%
Leasing	1	2,44%	-0.4636	2	4,26%
Venture capital	0	0,00%	-0.9333	1	2,13%
Trade credit	35	85,37%	0.5839	39	82,98%
Government initiative	1	2,44%	0.0967	1	2,13%
Family and relatives	2	4,88%	0.1383	2	4,26%
Tontines	35	85,37%	3.6246*	24	51,06%
Total SEs			**41**		
Total MEs			**47**		

***, **, and * significant at 1%, 5% and 10% respectively. **Source:** Author, using the comparison test results

4.2. A Large load of bank loan by Cameroonian MEs

It is clear that the proportion of SEs (36.59%) used bank loans is lower than MEs (72.34%) that use the same funding source. The proportions are significantly different at 1% significance level. This can be justified to the extent that the MEs have more assets that can serve as collateral. The quality and quantity of information available justifies a greater rationing of SEs (Van Caneghem, and Van Campenhout, 2012). This result is identical to those of different authors. (Colot et al. 2010; Atupele, 2013; Kenmegni, 2012).

About overdrafts and trade credit, there is a slight difference of the proportions of SEs and MEs. SEs (85.37%) and MEs (89.36%) use of overdrafts and SEs (85.37%) and MEs (82.98%) use trade credit. The proportions of overdraft and trade credit use between SEs and MEs are statistically equivalent. Short term debts are advantageous for both SEs and MEs. Short-term debt is also an efficient way to deal with asymmetry information problems as firms have to repay the debt and any associated charges over a shorter constant period (Myers, 1977). The reputation and the credit history which older firms establish over the years in doing business reduce the problem of information asymmetry and help the firms to easily access external financing (Petersen and Rajan, 1994; Diamond, 1989).

4.3. A more informal financial behaviour of Cameroonian SEs

About the use of resources from informal financing channels, it is observable that the proportion of SEs (85.37%) using informal resources is more important than MEs (51.06%). A test of whether the proportions of informal financing use between SEs and MEs are statistically equivalent show that the proportions are significantly different at 1% significance level. The involvement of SEs owner-managers in the *tontines* has more influence on SEs funding than for MEs. This is especially true because, in a soleproprietorship, opacity of information is very important, SEs owner-managers can easily confuse the origin and destination of their financial resources (only the leader mastery its business funding sources). This is rarely with MEs where the partnership legal status is closer to LEs. Indeed, (39%) of SEs are held by owner-mangers against (4%) of MEs. Furthermore the characteristics of informal finance (Strengthening of ties between members of the same community or perform the same activity, solidarity to deal with the unexpected), are more favorable to the development of activities controlled by an owner-manager.

4.4. Neutrality of SEs and MEs for semi-formal financing

The percentage of SEs (31.71%) using MFIs funding is substantially equal to that of MEs (31.91%). A test of whether the proportions of MFIs financing use between SEs and MEs are statistically equivalent show that the proportions of MFIs financing use are equivalent. The use MFIs services by SEs and MEs is similar. This can be justified to the extent that the relationship between bank and microfinance is more confused in Cameroon. We note bank entry into microfinance directly "downscaling", generally as a mini bank (*category two* of banking commission classification), and indirectly, "the partnership with microfinance institutions" on one hand and the incursion of MFIs in the formal financial system directly, the "upscaling" and indirectly, "partnership relations" on the other hand (Seck, 2009). This does not encourage the demarcation of MFIs target in the Cameroonian context.

5. Conclusion

The study investigated the use of different financing by SEs and MEs in Cameroon. Specifically, we investigated whether there are differences in the use of formal, informal and semi formal financing between SEs and MEs or not.

The results indicate that, there are significant differences in the use of bank loan and *tontines* between SEs and MEs. SEs use less bank loan financing and more informal financing compared to MEs and further analysis indicates that there is similarity in the use of MFIs financing by SEs and MEs. SEs use less bank loan because of information asymmetry problems which translates into high costs of lending, making it difficult for SEs to access external finance.

The results of this study suggest some policy implications: SEs that have difficulties in accessing bank loan should be identified, followed, assisted and policy interventions that target the identified SEs such as special financing schemes should be introduced to help SEs easily access bank loan. Policy makers need to implement policies directed at encouraging SEs to have audited annual financial statements so as to reduce information asymmetry problems faced by such SMEs. This can be implemented together with the first intervention by supporting the targeted SEs through capacity building on the advantages of having good detailed financial records and training them so that they can acquire proper financial management skills. The results may call for policies that take into account different groups of SMEs. For instance, it is possible to set up within the recently created Cameroonian's SMEs bank, separate divisions for very small-sized enterprises (VSEs), SEs and MEs. The state must strengthen and intensify the process of SMEs formalization, through their transition from the informal sector to the formal sector. This study provides a starting point. For more comprehensive, further comparatives studies can consider SEs and MEs financial structure, with larger sample from a wide range of sectors. Researchers can also focus on quantitative analysis of SEs and MEs leverage over a long observation period.

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