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An investigation into the impact of the usage of debt on the solvency of SMEs in the Buffalo City Municipality, South Africa

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This research investigated the impact of the usage of debt on the solvency of SMEs in the manufacturing sector in the Buffalo city municipality. To achieve this objective, the research hypothesized that SMEs have a difficulty accessing debt finance from financial institutions and also that the usage of debt has a negative impact on the solvency of SMEs. This study is important because SMEs, despite their contributions to the South African economy, have not been given due attention as research on corporate finance has been biased towards large firms. The results indicated that SMEs have a difficulty accessing debt finance and that SMEs that use debt are not insolvent. Lastly, the study recommended that small manufacturing firms, commercial banks and the South African government take certain measures. These measures are expected to improve the accessibility to debt and reduce the cost of debt to SMEs.

Key words: Debt, insolvency, SMEs.

INTRODUCTION

The failure rate of SMEs in South Africa is very high. About 75% of SMEs become insolvent within the first five years of operation. One of the primary reasons for the high failure rate of SMEs is the high cost of debt finance occasioned by the high interest rate. According to Coleman and Cohn (2001) debt is one of the variables that can cause the insolvency of SMEs. Most of the empirical studies such as Coleman and Cohn (2001) and Eriotis et al. (2002) regarding the impact of debt on the solvency of firms have focused primarily on large firms in developed countries. Few studies, such as Tze-Wei Fu et al. (2002) have been conducted on smaller firms in developing countries or emerging markets such as South Africa. Rajan and Zingales (1995) however, argue that studies done in developed countries, alone, cannot be completely used to substantiate theories on corporate finance. Studies carried out in developing countries are also very important and may reach different conclusions from those carried out in developed countries. This is because the financial systems of developed countries are relatively more efficient than those of developing countries. The reason for this is that most developed countries, unlike developing countries, have capital markets which have been in existence for a long time and are, therefore, well developed. Furthermore, interest rates are generally much lower in developed countries compared to developing countries. Therefore, without testing for the robustness of these findings outside the environment in which they were uncovered, it is hard to determine whether these empirical regularities are merely spurious correlations or whether they support one theory or the other.

Similarly, SMEs despite their importance in an economy have not received the attention they deserve. According to Ntsika (2002) SMEs in South Africa contribute 56% of private sector employment and 36% of the gross domestic product. Barbosa and Moraes (2004) suggest that one of the reasons why SMEs have not been thoroughly studied is that they have always posted

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methodological difficulties in research. SMEs are not obliged to prepare or publish annual financial statements that can be used to analyse their performance. Conversely, large firms are usually compelled by law to publish annual financial statements. In addition, data on the performance of large firms (especially listed firms) can easily be obtained on the stock exchanges or from credit rating agencies, although this is not the case with small firms. Such a lack of easily available data makes small firms difficult to study. Rajan and Zingales (1995) indicate that although the study of the capital structures of listed and large firms may be of the greatest importance to the financial community, the interests of academics are broader.

Academics are interested in studying the whole universe of firms and not just large firms. Furthermore, there is no certainty that research on SMEs will reach the same conclusions as those on large firms, in view of the major differences between the two types of business organisations. A study by Schoombee (1998) reveals that SMEs are relatively riskier and more likely to fail than large firms. SMEs have lower access to capital markets and therefore pay higher costs for capital than large firms. Consequently, corporate finance theories which apply to large firms may not necessarily hold for SMEs. The primary objectives of this study are twofold: The first objective is to investigate if SMEs in South Africa have access to debt finance. The second objective of the study is to investigate the impact of the usage of debt finance on the solvency of SMEs.

THEORETICAL FRAMEWORK

Modigliani and Miller (1958) argue that the capital structure is irrelevant to the value of the firm in a perfect, frictionless world without taxes. The capital structure is the mix of debt and equity financing which a firm uses to finance its operations. However, the perfect world without taxes is unrealistic and this led to the revision of Modigliani and Miller's 1958 argument in 1963 with the introduction of taxes. Modigliani and Miller (1963) argue that interest payments on debt are tax-deductible whereas dividend payments on equity do not enjoy such tax advantages. Therefore, in a world of tax-deductible interest payments, firms can use debt to lower their costs of capital and maximise their profitability.

The tax advantage of debt makes it cheaper than equity. The mix of cheap debt with relatively expensive equity reduces a firm's cost of capital, which is the cut-off rate for investment acceptance decisions. This is known as the leverage effect of debt, and refers to the use of debt capital to minimise a firm's cost of capital and maximise its profitability. Leverage (financial leverage as distinct from operational leverage) is described as the level of debt a firm uses in its capital structure. Leverage creates a return on equity that is higher than if the business had no debt. However, leverage also introduces

an element of financial risk to the firm. Financial risk is described as the risk placed on ordinary shareholders of a firm as a result of the use of debt. Financial risk stems from the obligation to make interest and principal payments on debt irrespective of the financial performance of the firm (Brealey et al., 1995). Modigliani and Miller (1963) suggest that debt can be used to improve the profitability of firms. However, the use of debt can also increase the financial risk of a firm. This suggests that debt can lead to the insolvency of firms.

ACCESS TO DEBT FINANCE BY SMEs IN SOUTH AFRICA

Leverage (debt) is particularly important to SMEs in South Africa as other sources of funds are relatively limited. Most small firms suffer from inadequate capitalisation as they cannot participate in the capital markets. Therefore, access to debt is of primary importance to SMEs in order for them to contribute significantly to the South African economy (World Bank, 2000).

However, despite the importance of the small business sector, in South Africa, access to finance is a frequently cited problem. Sources of capital are more limited for SMEs compared to large firms. Therefore, unlike large, particularly publicly-listed firms, SMEs do not have the option of issuing shares or debentures in the capital market. Even if they are allowed to participate in the capital market, the high transaction costs associated with publicly issued debt and equity will be too expensive for them. Owing to their inability to access the public debt and equity markets, SMEs tend to be heavily reliant on commercial banks as a source of debt financing (Berry et al., 2002).

Research by Berry et al. (2002), documents the reliance of SMEs on bank debt as a source of financing. These researchers, however, point out that access to bank debt is, paradoxically, a frequently cited challenge for SMEs. SMEs are often relatively new and lack a consistent track record of profitability that would demonstrate the capability to repay a loan. In addition, many SMEs lack assets that could be used as collateral. SMEs are also more prone to financial distress and failure. Commercial banks, because of these factors, consider lending to SMEs a high risk. Therefore, commercial banks often deny loans or offer loans to SMEs at higher rates of interest to accommodate the perceived high credit risk of SMEs (Coleman and Cohn, 2001).

The inaccessibility of debt finance to SMEs can further be attributed to information asymmetry. Information asymmetry arises when one party to a transaction has better information than the other. SMEs may have more information about their future prospects than the banks. Since banks do not have the necessary information, even small firms with profitable investment opportunities are turned down when requesting credit facilities. Banks, therefore, introduce restrictive covenants and also collect

collateral from small firms to mitigate this problem (Bose and Cotheren, 1997).

Foxcroft et al. (2002) agree with the above point of view. They furthermore stipulate that an important dimension of relationship building is duration, since the longer the borrower has been servicing its loan, the more likely the business is viable and its owner trustworthy. Conditional on the past experience with the borrower, the lender expects the loan to be less risky, and this should reduce the expected cost of lending and increase the willingness to provide funds. An SME with close ties to its bank should, therefore, have greater accessibility to funds relative to a firm without such ties.

Berry et al. (2002), however argue that in contrast to this scenario, recent evidence suggests that banks have increased their lending to small firms since 1996. The big four commercial banks in South Africa (ABSA, Standard Bank, Nedcor and First National Bank) currently have small firm units and products, which are exclusively, targeted at small firms. Therefore, the accessibility of small firms to debt capital from commercial banks might have improved. However, it is difficult to confirm this, because the major banks do not disclose statistics about lending to small firms in their books.

In addition, The World Bank (2000) and Falkena et al. (2002) find that the majority of SMEs in South Africa are not severely, constrained by a lack of access to debt. Rather, when access to debt is an issue, it is related to size, age and the race of the owner. Furthermore, the constraint of access to debt becomes less binding as a firm grows older and larger. Conclusively, it seems that the issue of accessibility of debt capital to small firms still remains highly debatable. Studies by Driver et al. (2001) and Rogerson (2000) stipulate that SMEs in South Africa are challenged by access to debt capital. Other studies such as Berry et al (2002) and the World Bank (2000) find that access of debt finance to SMEs in South Africa, is not a constraint.

DEBT AND INSOLVENCY OF SMES IN SOUTH AFRICA

SMEs may become technically and possibly legally insolvent as a result of the usage of debt. Brigham and Houston (1999) describe technical insolvency as the situation where a firm cannot meet its current obligations as they fall due (that is, the firm's current assets are lower than its current liabilities) even though its total assets may exceed its total liabilities. Legal insolvency occurs when a firm's total liabilities exceed a fair valuation of its total assets. This implies that the net worth of the firm is negative. Coleman and Cohn (2001) in a study on the use of leverage by small firms in the United States of America, point out that SMEs, because of their tendency to rely on debt capital, are also particularly susceptible to the problems of insolvency.

Prior research on the impact of debt on the insolvency of firms in South Africa has focused mainly on large firms. Court and Radloff (1994) found that debt is one of the significant economic variables that can lead to the insolvency of large firms quoted on the Johannesburg Stock Exchange.

Kidane (2004) finds that in South Africa factors that can cause the insolvency of firms, apart from bad management, changes in technology and economic recession, is the excessive use of debt finance. Interest rates are relatively, high in South Africa compared to developed countries. Thus, firms that are highly levered might be unable to meet loan commitments according to the contractual agreements they have with their banks. This could lead to their insolvency. Court and Radloff (1994) also agree that the use of debt is one of the significant economic variables that can lead to the insolvency of firms in South Africa.

The weak financial structure of firms as evidenced by their high and rising debt-equity ratio has been found to be their primary source of insolvency. Many firms cannot sustain this high debt ratio and, subsequently become insolvent. A high debt ratio, in itself, does not make a firm insolvent as long as the firm is earning enough to cover interest and principal payments. However, the more leveraged a firm is, the more vulnerable it is to bankruptcy. It is, therefore, the flow of earnings and thus the ability of the firm to make interest and principal payments that will determine whether the firm will, actually, become insolvent or not (Kim and Lee, 2002).

Traditionally, debt finance has been viewed as less expensive than equity. It furthermore has been used both to decrease the average cost of capital and enhance shareholders returns. However, there is a negative side to debt, since interest payments must be made regardless of market conditions. This vulnerability is an important factor that firms must consider when making capital structure decisions. In addition, there is a very strong economic and statistical link between macro-economic variables and a firm's ability to meet debt obligations. The macro-economic environment implies the level of aggregate demand, the level of interest rates, and the level of inflation. A positive macro-economic environment results in a rise in aggregate demand and positively impacts on the ability of a firm to meet debt obligations. The ability to service debt becomes problematic when the macro-economic environment deteriorates; resulting in the insolvency of firms (Glen, 2004).

Rwelamila et al. (2004) affirm that, during the early stages of starting a firm, many owners commit themselves to the use of debt, which might be one of the sources of finance available to them. The use of debt can be disastrous, as high interest rates and unfavourable repayment schedules are often overlooked due to the pressure of financing the firm. The annual interest rate on debt finance for SMEs can be as high as 17% in South

Africa. Consequently, profit can only meet interest payments and the actual amount borrowed is paid off very slowly, leading to further interest charges. In a continuing cycle, the firm will soon reach a liquidity crisis and, subsequently insolvency. However, no empirical study has been conducted on whether debt finance leads to the insolvency of SMEs in South Africa.

Against this background, the study investigates whether SMEs in an emerging economy such as South Africa can use debt and still remain solvent in this era of high interest rates. Furthermore, SMEs often pay interest premiums and a host of non-interest fees such as application and other transaction fees when borrowing from commercial banks. The cause of this is that SMEs are considered a high credit risk compared to large firms. This high cost of funds because of increased risk increases the costs of debt for small firms. Consequently, the use of debt could lead to the technical and legal insolvency of SMEs. Consequently, it is hypothesised that:

H_1- SMEs have difficulties accessing debt capital from commercial banks.
H_2- The use of debt finance by SMEs leads to insolvency.

According to the Government Gazette of the Republic Of South Africa (2003) SMEs in the manufacturing sector can be defined as follows:

- Total full paid employees: Less than 50.
- Total annual turnover: Less than thirteen million rand (R13.00 m).
- Total gross asset value: Less than five million rand (R5.00 m).

Furthermore, debt capital is limited to debt obtained by SMEs from commercial banks. Coleman and Cohn (2001) reveal that commercial banks are the most significant source of debt for SMEs, channeling more than three quarters of their requests.

RESEARCH METHODOLOGY

The study covered SMEs in the Buffalo City Municipality of the Eastern Cape Province of South Africa. The Buffalo City Municipality consists of East London (including Mdantsane), King William's Town and Bhisho. The private sector economy of the municipality is dominated by manufacturing and agriculture. Manufacturing provides approximately 20% of formal employment in the area. The automotive industry, food processing, textiles and clothing are the major manufacturing areas in the municipality (Buffalo City Municipality, 2008). The study covered SMEs in the manufacturing sector. Manufacturing activity is, broadly, defined to include the manufacturing of the following products, namely; food products, beverages, wearing apparels, dressing and dyeing of fur, leather products, footwear, wood and wood products, paper and paper products, plastic products, non-metallic mineral products, basic metals, fabricated metal products, machinery and equipment, electrical machinery and apparatus, radio, television and communication equipment and furniture (Statistics South Africa, 2008).

Wheather and Cook (2000) describe the term survey population as the list of population elements from which the sample will be drawn. In practice, it is difficult to find complete lists or records of all of the elements in the survey population. This results in a sample drawn from lists which do not necessarily contain all of the elements. The survey population of two hundred and twenty six SMEs was obtained from the Small Enterprise Development Agency (SEDA) East London Office. Simple random sampling was used to choose pick one hundred and seventy six SMEs which represents 78% of the population. This is consistent with previous similar empirical studies. Data for the research study was gathered through self-administered questionnaires, which involved a direct and face-to-face meeting between the researcher and the respondent. One hundred and fifty two respondents completed the questionnaires. Reliability is concerned with consistency of measures. The level of an instrument's reliability is dependent on its ability to produce the same result when used repeatedly (Babbie and Monton, 2001). Reliability was ensured by pre-testing the research instrument in the survey development stage through a pilot study, by using a panel of experts to review the questionnaire for question phrasing and sequencing. Validity refers to whether an instrument actually measures what it is supposed to measure given the context in which it is applied (Babbie and Monton, 2001). Validity was ensured by using the Altman Z score (Multiple Discriminant Analysis) which is universally recognized as an insolvency predictor.

Altman (1983) introduced the Multiple Discriminant Analysis (MDA) to develop a predictive model for insolvency of firms with a high degree of accuracy. This technique, based on regression analysis, establishes coefficients for the ratios that minimise misclassification. A major reason for the high rate of financial distress of firms is attributed to the effect of heavy debt burdens. Using a sample of 66 manufacturing companies (33 failed and 33 successful), Altman's regression model achieved an accuracy of 95%. Altman argues that ratios, alone, cannot provide the complete story, and can be misleading when viewed in isolation. He therefore combined several ratios with statistical techniques to arrive at a single numeric score for the financial health of companies called the Z score. The Altman regression model that predicts the Z score for SMEs in the manufacturing sector is explained by the equation:

$$Z = 0.717(X1) + 0.847(X2) + 3.107(X3) + 0.420(X4) + 0.998(X5) \quad (1)$$

Where:

$$X1 = \frac{\text{Working capital}}{\text{Total assets}}$$

$$X2 = \frac{\text{Retained earnings}}{\text{Total assets}}$$

$$X3 = \frac{\text{Earnings before interest and taxes}}{\text{Total assets}}$$

$$X4 = \frac{\text{Book value of equity}}{\text{Total assets}}$$

$$X5 = \frac{\text{Sales}}{\text{Total assets}}$$

Components of the equation

- X1 represents the ratio of working capital to total assets. This is

the Z score which is considered to be a reasonable predictor of the increasing financial problem of a firm. A firm that experiences repeated losses usually suffers a reduction in working capital relative to its total assets;

- X2 represents the ratio of retained earnings to total assets. This is a Z score component that provides information on the extent to which a firm has been able to reinvest its earnings in itself;

- X3 represents the ratio of earnings before interest and taxes to total assets. The ratio adjusts for tax factors and, also, makes adjustments for leveraging due to borrowings. These adjustments allow more effective measurements of a firm's utilization of assets;

- X4 represents the ratio of book value of equity to total assets. This ratio provides an indicator of how much a firm's assets can decline in value before debt exceeds assets; and

- X5 represents the ratio of sales to total assets. This ratio measures the ability of a firm's assets to generate sales.

Interpretation of the Z scores

Altman (1983) stipulates that the analytical range of the Z score for the prediction of insolvency of SMEs in the manufacturing sector is as follows:

- Less than 1.23 (high probability of insolvency).
- 1.23 to 2.90 (gray zone where insolvency is difficult to predict).
- Greater than 2.90 (low probability of insolvency).

This implies that firms in the sample with Z scores of less than 1.23 are regarded as insolvent. Firms with Z scores of between 1.23 and 2.90 are in the gray zone where insolvency is difficult to predict. Firms with Z scores of above 2.90 are solvent.

In addition to the Z score, liquidity ratios such as current ratio and quick ratio as well as the times interest earned ratio (solvency ratio) and the net worth were used to measure the solvency of SMEs in the sample. The current ratio is the ratio of all current assets to all current liabilities. The current ratio is the most commonly used measure of technical insolvency. The norm is a 2:1 relationship and implies that current assets should double current liabilities (Brigham and Houston, 1999). The quick or acid test ratio is calculated by deducting inventories from current assets, and dividing the remainder by current liabilities. The norm is a 1:1 relationship and implies that current assets, minus inventories, must be equal to current liabilities (Gitman, 2003). The times interest earned ratio is a measure of the ability of a firm to pay back interest on debt. This ratio represents how many times net income generated by the firm, without considering interest and taxes cover the total interest charge. A firm is financially distressed whenever its earnings before interest and taxes are less than its interest expense (Gitman, 2003). The net worth is the difference between the total assets and the total liabilities of a firm. The net worth of a firm is positive if its total assets are greater than its total liabilities. It is negative if the total assets are lower than the total liabilities. The net worth is used to measure the legal insolvency of a firm (Brigham and Houston, 1999).

RESULTS AND CONCLUSION

Demographic information shows that 31% of the res-pondents are operating in food processing. 18% in metal fabrication, 13% are in clothing manufacturing. Other products manufactured include wood 11%, plastic, 9%, furniture 7%, leather, 7% and paper products 4%.86% of the respondents are male, and 14% are female. 48% of the

respondents are within the age bracket of 31 - 40 whilst 38% of the respondents are in the 41 - 50 age brackets. 5% of the respondents are in the 21-30 age bracket, 5% in the 51 - 60 age bracket and 4% in the 60 and above age bracket. 33% of the respondents have been in operation for between 1 and 5 years, 26% have been in operation for 6 - 10 years, 30% have been in operation for 11 - 15 years, 7% in operation for between 16 - 20 years, and 4%.

Access to debt finance

Ninety-four percent of the respondents, applied for credit facilities from commercial banks. Six percent of the respondents never applied to commercial banks for credit indicating that there is a high demand for credit by SMEs from commercial banks. 32% applied for overdrafts, 30% applied for credit cards, 27% applied for long-term loans, 7% for installment sale credit, 3% for leasing an 1% for factoring. 61% of the respondents had their applications rejected, 39% of the applicants were successful. This implies that a majority of the respondents that applied for credit were denied by the commercial banks. This result indicates that SMEs have difficulty in accessing debt capital from commercial banks supporting the first hypothesis.

Debt and solvency of SMEs

Respondents that use debt in their capital structures were asked about their perception relating to the ability to meet debt obligations. 43% agreed that they have difficulties meeting debt obligations (principal and interest payments on debt). 57% of the respondents disagreed that they have difficulties meeting debt obligations. The results suggest that most SMEs that use debt finance are not insolvent.

The ability of a firm to meet its debt obligations can be measured by the current ratio, the quick ratio and the times interest earned ratio as depicted by Table 1. These ratios were calculated from the financial statements of SMEs. The current ratio and the quick ratio of leveraged SMEs were 1.56:1 and 0.98:1 respectively. The times interest earned ratio of leveraged firms was 1.83. The current ratio and the quick ratio of leveraged firms are lower than the norm of 2.1 and 1.1 respectively. The times interest earned ratio of 1.83 implies that the net incomes of the leveraged respondents, provides a minimal cover for their interest expenses. The results of these ratios indicate that most of the respondents can meet debt obligations.

The data collected from the leveraged respondents was subjected to further statistical tests using the MDA. The Altman Z scores (refer to Table 2) show that 8% of the leveraged respondents are insolvent, 31% are in the gray zone where insolvency is difficult to predict and 61% are

Table 1. Analysis of quantitative data of the respondents.

Performance measure Profitability ratios	Ratios calculated from data collected from respondents using debt (leveraged SMEs)	Ratios calculated for respondents not using debt (unleveraged SMEs)
Return on assets	11.38%	12.9%
Return on equity	3.99%	6.11%
Liquidity ratios		
Current ratio	1.56:1	1.73:1
Quick ratio	0.98:1	0.85:1
Solvency ratio		
Times interest earned ratio	1.83	-
Debt ratios		
Debt to assets ratio	51.68%	-
Debt to equity ratio	1.31 times	-
Total assets and liabilities		
Total assets	R1,775,097	
Total liabilities	R1,055,741	

Source: Data analysis for the study.

Table 2. Altman Z scores of the leveraged respondents.

Altman Z score	Definition	% of respondents
Less than 1.23	Insolvent	8%
1.23 to 2.90	Gray zone	31%
Greater than 2.90	Solvent	61%

Source: Data analysis for the study.

solvent. In addition, the study used ratios to measure if the leveraged firms are technically and legally solvent. Technical insolvency is described as a situation where a firm's current assets are lower than its liabilities. Legal insolvency is described as a situation where a firm's total assets are lower than its total liabilities. The results as depicted by Table 1 show that the average current ratio of leveraged SMEs is 1.56:1 and the average quick ratio is 0.98:1. The results indicate that although the current ratios are weak, the firms on the average can still meet debt obligations. This furthermore implies that the respondents are not technically insolvent. Table 1 furthermore depicts the average total assets of the leveraged respondents as R1,775,097 and their average total liabilities as one R1,055,741. The respondents' average total assets are greater than their average total liabilities. This implies that the respondents are not legally insolvent.

In conclusion, the current assets of the respondents are greater than their current liabilities. This implies that the respondents on the average are not technically insolvent. Furthermore, the total assets of the respondents are greater than their total liabilities. This implies that the respondents on the average are not legally insolvent. In addition, the Altman Z scores of the respondents show

that most of the leveraged respondents are not insolvent. Therefore, the results do not support the second secondary hypothesis which states that the use of debt finance by SMEs leads to insolvency.

MANAGERIAL IMPLICATIONS

SMEs need to keep detailed financial records: This survey indicates that not all SMEs prepare annual financial statements or keep books of account. Therefore, SMEs are not always able to present full accounting records and other documentation called for by the banks, thereby making the appraisal of their applications difficult. It is recommended that SMEs keep detailed accounting records, and audit their financial statements on an annual basis. This could be done through education and training of owners of SMEs especially business-related education, by attending short courses and seminars. The South African government should also intensify efforts to assist small firms with education and training. This is why the formation of the Small Enterprises Development Agency (SEDA), in 2005 is a step in the right direction.

The cost of debt to SMEs is too high. This is attributed to the high interest rate of about 15% prevailing in South

Africa. There is the need o reduce the interest rates to reduce the cost of debt to SMEs. This will enable SMEs to use debt to maximize their profitability. Against this background, it is recommended that the government makes an effort to reduce the interest rates. This can be done by reducing the Repo rate. The Repo rate has a direct impact on the financing costs of commercial banks, and also determines the minimum interest rates charged by commercial banks. The reduction of the Repo rate will reduce the cost of funds to small firms and increase their profitability. Most SMEs depend on debt finance because they do not have access to adequate equity. Efforts to increase the supply of equity to SMEs should lead to a decrease in their demand for debt. It is recommended that SMEs source equity from the Alt X Exchange. However listing requirements on this exchange are too stringent and most SMEs may be unable to meet the requirements.

Also, commercial banks in South Africa do not provide a breakdown of their loans and advances by sectors. This implies that it is statistically difficult to establish the percentage of loans and advances that are allocated, by commercial banks, to SMEs in South Africa. This study recommends that the monetary authorities in South Africa mandate the commercial banks to provide a breakdown of their loans and advances by sector so that it will be easy to determine the amount of funds which are allocated to the small business sector. Furthermore SMEs do not send annual financial records on their performance to any of the government authorities such as the Small Business Development Authority or Statistics South Africa. This makes it difficult to conduct academic exercises on small firms because there is no general pool where detailed information can be obtained. It is recommended that SMEs should be mandated by the government to send annual financial records on their performance to government agencies. Commercial banks also need to create awareness programmes on the requirements for extending credit facility to SMEs.

Empirical studies on the accessibility of debt to small firms reveal that the South African banking sector is extremely concentrated with the four large banks accounting for sizeable percentages of deposit taking and lending. These banks have primarily focused on lending to large firms. Efforts to relax the entry requirements into the banking sector and increase the number of lenders suggest an increase in the availability of credit to small firms. It is, therefore, recommended that the proposals before the South African Parliament, on second and third tier banking (which is expected to increase the number of banks) be approved as these expected entities are to deal, primarily, with small and micro firms. Second-tier banks are savings and loans institutions, while third-tier banks are co-operative banks.

LIMITATIONS OF THE STUDY

This study covered only SMEs in the manufacturing firms in the Buffalo City Municipality of the Eastern Cape Province of South Africa. Gumede (2002) points out that the manufacturing sector is the most important sector of the South African economy. Furthermore, debt capital is limited to debt obtained by small manufacturing firms from commercial banks. Coleman and Cohn (2001) reveal that commercial banks are the most significant source of debt for small firms, channeling more than fifty percent of their requests

AREAS FOR FURTHER RESEARCH

This research work suggests lines of enquiry for further research. First, further research could determine if the findings of this research are consistent across different industries. There is the need to duplicate the research in other industries to confirm if the results of this research can be generalised across industries.

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