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OPERATIONAL WEALTH FINANCING OF LITTLE AND MEDIUM-SIZED ENTERPRISES

BORATE SAGAR SHANKAR
Head of Dept. of Commerce
College of Computer Sciences,
Wakad, Pune-57 **(MS) INDIA**

ABSTRACT

This paper investigates the come up to of little- to medium-sized Mauritian manufacturing firms to operational wealth finance using a survey-based approach and case studies. Financing has been cited as one of the most common problems faced by SMEs and is often viewed as one of their main barriers to growth. Using parametric and non-parametric techniques, the important variables that affect the demand for financing are examined. Interestingly, it is observed that the sample firms adopted more informal sources of financing and net operational to meet their financing requirements. The financing preferences of the firms were predominantly short-term and there was definite proof that they were reluctant to move down the pecking order for fear of losing control of their businesses. The research findings provided some new proof in support of the different approaches to financing operational wealth. These SMEs used more informal sources such as shareholder loans and bootstrap finance. These results indirectly suggest that firms experience momentous information costs that prevent them from gaining access to the traditional sources of financing. The findings of the study will be useful to the financial institutions that fund SMEs and to policy makers.

Keywords: *operational wealth finance, financing preferences, Pecking order, casual sources*

INTRODUCTION

This paper investigates the operational wealth finance of little to medium sized Mauritian manufacturing firms. Finance has been cited as one of the main barriers to SMEs' growth, and many governments have attempted partial solutions through the creation of specific financing schemes. There are various traditional sources of financing for SMEs ranging from bank loans, bank overdrafts, own funds/savings, loans from family or friends, and equity funding. However, non-traditional sources of finance also exist that entrepreneurs can use in the financing of their businesses; these have been described by many researchers as bootstrapping finance.

Operational wealth is a significant and important issue during financial decision making because it is a part of the investment in total assets that requires an appropriate financing investment. Generally, operational wealth is financed by a combination of long-term and short-term funds. This portion is the net WC; that is, the excess of the current assets over the current liabilities. On the other hand, the short-term sources of WCF consist of trade credit, short-term loans, bank overdrafts, tax provisions and other current liabilities that can be used to finance temporary WC needs. Sometimes, a WC deficit exists if the current liabilities exceed the current assets. In such a situation, short-term funds are used to also finance part of the non-current assets and the firm is said to be adopting an aggressive WC policy.

SMEs are the key drivers of the Mauritian economy through their important contribution to GDP growth and socio-economic development. Because of their significance and their proven resilience in responding to fast changing conditions, even during the global economic crisis, SMEs have now become even more important in advancing the government's efforts to overcome socio-economic disparities. The objective of this study is to examine the operational wealth financing preferences of little- to medium-sized manufacturing firms operating in diverse industry groups. A second objective of this study is to identify the main factors influencing the demand for WCF from the sample firms and to highlight the use of informal sources of financing.

Literature Review:

In many countries, observed studies have indicated that little business managers experience problems in raising wealth for the development of their businesses. Different studies have frequently referred to the concept of a financial gap to explain why many little businesses face this type of difficulty. Access to finance has been identified as a key feature for SMEs to succeed in their drive to build productive capacity, to compete, to create jobs and to contribute to poverty alleviation in developing countries. Operational wealth structure refers to the elements of WC and it shows which of the possible components is responsible for investment in WC. WC can be regarded as the lifeblood of the business and its effective provision can do much to ensure the success of the business, while its inefficient management or neglect can lead to the downfall of the enterprise.

Bootstrap Finance

A business itself has the capacity to generate wealth. This type of financing, called bootstrap financing, is available to virtually every little business and includes a combination of social and economic transactions; for example, buying low-cost equipment and having family members help during peak periods. Bootstrap financing also encompasses factoring, leasing, the use of credit cards and the frugal management of the business.

Pecking Order Assumption (POA)

This hierarchical ranking is due to the presumed fact that the relationship between the financier and the manager is characterized by information asymmetry. Several empirical studies have supported Myers' reasoning. If debt financing becomes necessary, the managers are assumed to favor short-term debt because this source does not tend to involve any demand for collateral security.

According to Myers, explain business managers' financial preferences using a pecking order approach. And business managers prefer internal to external financing and debts to external equity. In summary, the 'POH' states that businesses adhere to a hierarchy of financing sources and prefer internal financing when available; if external financing is required, debt is preferred over equity. Consistent with this reasoning, the owner manager's desire to maintain control and independence are enough to support the explanation of his/her financial preferences. Owners might perceive that any external providers of funds can interfere in the management of the business.

Methodology

The data for this study were collected as part of a comprehensive survey2 on the financial and WCM practices of little- to medium-sized Mauritian manufacturing firms operating in eight diverse industry groups3. The study was confined to the manufacturing sector (an important sector of the economy in terms of job creation and contribution to economic growth) where WC is more significant. The sample was drawn from the directory of SMEDA4.

A total of 160 survey forms were collected out of a sample of 560 firms, representing 20% of the population (firms employing up to 50 employees), which satisfies the sampling criteria. A stratified sampling was used so that each of the eight main industry groups is represented. Four questionnaires had to be excluded because they were not properly filled in and many sections were left unanswered, giving a total of 188 usable responses and representing an effective response rate of 33.57%. It must be noted that the Mauritian business community is not used to this type of survey. Despite their non-familiarity with survey instruments, this response rate was possible through the development of a network with the SME Association and other support institutions and the use of multiple channels to collect the data.

This paper focuses on the financing variables and examines the financing preferences of the firms that are requesting WCF. In an attempt to measure the severity of the financing problem, the survey instrument included a number of questions to capture the variables of interest.

Data Analysis and Results:

The survey instrument contains a number of variables to test for significant differences based on the firms' characteristics and the owner managers' profile. The majority of the questionnaires were completed by the owner manager of the firm or his/her representatives, which in most of the cases were close family members that had been appointed as director. The presence of family members increases confidence in the completeness and reliability of the information provided.

Family Members	Percent	Main Role	Percent	Legal Entity	Percent
No one else	25.5	Overall Responsibility	49.6	Sole proprietorship	36.2
Close Family	40.4	Purchasing and Production	2.8	Partnership	8.5
Other Family Member	23.4	Administrative and Finance	3.5	Private Limited Co.	54.6
Non Family Member	10.6	Managing Director	44.0	Society	0.7
Total (n =188)	100.0		100.0		100.0

Family members involved, main role and legal entity of owner manager

Financial Bootstrapping Techniques Measures to:

Minimize operational wealth requirements	Meet the need for wealth
1. Directors also work at operational level 2. Family members engaged as accountants 3. Family members help during peak periods 4. Hire personnel for shorter periods – link to customer order 5. Long operational hours and salary below market rate	1. Business start up in the family garage 2. Wife took employment to supplement wealth 3. Prior experience as an intangible assets 4. Low investment in office furniture and directors do not fancy luxury offices 5. Shareholders loan

Conclusion and Discussions:

Overall, the firms report different degrees of difficulty in obtaining financing, more particularly to meet their WC requirements. The sample firms meet their requirements differently based on their size, their stage in the business life cycle and their trade credit variables. Most important and consistent with other studies, it is the littleest firms that reported the greatest difficulties in obtaining financing and that operated on less favourable credit terms. The trade credit variables have an effect on the firms that are financially constrained.

Furthermore, the research findings lend limited support to the literature-driven hypothesis that the older firms tend to have a large fixed asset base that could be used as security to support their demand for financing. We also observed that the firms with more family involvement tend to use equity as a form of financing and have a lower preference for committing through borrowing. A summary of the 12 mini-cases revealed that the firms at different stages of the life cycle have different needs for operational wealth and that the firms operating in the food industry make less use of trade credit.

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