

# Evaluating the Sources of Financing Working Capital of Small Businesses in the Tarkwa Nsuaem Municipality

Ernest Frempong<sup>1</sup>, Albert Boata<sup>2</sup>

<sup>1</sup>Assistant Internal Auditor, University of Mines and Technology, (UMaT) Tarkwa, Ghana

<sup>2</sup>Senior Accountant, University of Mines and Technology, (UMaT) Tarkwa, Ghana

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## ABSTRACT

The role of small and medium enterprises in the development of the economies of third-world countries is by far indispensable. However, the ability of these enterprises to raise their working capital to perform these roles remains laborious. This paper evaluated sources of financing working capital, assessed the accessibility and utilization of traditional financing options, examined the role and significance of alternative financing methods and proposed recommendations to SMEs in the Tarkwa Nsuaem Municipality of the Western Region of Ghana. The study considered 120 (53.3%) out of 225 SMEs in the Municipality. It adopted a quasi-experimental research design and obtained data using a cross-sectional survey. Descriptive statistics was used to evaluate the components of working capital. The study showed that SMEs operators preferred the use of personal funding for their businesses to the use of bank loans. Again, the firms appear to be liquidity conscious and thus, refrained from financing long-term projects with short-term funds. A key recommendation of the paper is that SMEs should make use of entrepreneurial programs offered by the NBSSI and NGOs since these come with education and training.

**Keywords:** SMEs, financing, businesses, capital

## INTRODUCTION

The paper evaluated the sources of financing of working capital among SMEs in the Tarkwa Nsuaem Municipality of the Western Region of Ghana. Small and Medium-Sized Enterprises (SMEs) constitute about 60 percent of the private sector of the Ghanaian economy. They therefore contribute significantly to the economic development and growth by providing employment opportunities for the vast majority of the workforce and increasing the nation's access to the world market." According to Abor and Quartey (2010) as stated in Orobia, Padachi, and Munene, 2016, "small-scale businesses are seen as the engines that drive economies across nations, through their contribution in terms of job creation and poverty reduction. However, despite their impact, such businesses are generally characterized by lack of funding, dominated by women, and low productivity levels.

In the light of the above, the objectives of carrying out the research are:

1. To identify the various sources of financing available for working capital in small businesses within the Tarkwa Nsuaem Municipality.
2. To assess the accessibility and utilization of traditional financing options such as bank loans and overdraft facilities by small businesses in the Tarkwa Nsuaem Municipality.

3. To examine the role and significance of alternative financing methods including trade credit and supplier financing in meeting the working capital needs of small businesses in the Tarkwa Nsuaem Municipality.
4. To propose recommendations to enhance the availability and effectiveness of financing options for working capital, thereby supporting the growth and sustainability of small businesses in the Tarkwa Nsuaem Municipality.

## **METHODS**

The study adopted a quasi-experimental design. The target population was owners of small businesses employing 9 or fewer employees in Tarkwa Nsuaem Municipality in the Western Region. Tarkwa Nsuaem was chosen because it is a commercial heartland of the Western region where most business activities take place. Tarkwa Nsuaem has five major commercial centers and each center consists of at least forty-five SME's. Out of forty-five SMEs in each commercial center, twenty-four SME's, were randomly selected. In so doing one hundred and twenty (120) small business owners producing or selling general goods like, sachet water, clothing, electrical and plumbing materials were selected to serve as the sample population. Simple random and purposive sampling techniques were used simultaneously to identify and select all the owners of small businesses in Tarkwa. The purposive sampling technique ensured that only owners of small businesses were selected. The simple random technique ensured that all the owners of small businesses in Tarkwa had equal chances of being selected for the research.

In the absence of official data on the number of small businesses within the area of study, a questionnaire was used to collect data. The primary data was collected using self-administered structured and unstructured questionnaires. The researchers circulated the questionnaire to the sampled respondents on the first visit and time was given for its collection.

## **LITERATURE REVIEW**

### **Conceptual Review**

The industrial census conducted by the Ghana Statistical Services (GSS) in 1987 considered “micro and small-scale enterprises as those employing up to 9 employees, medium-scale enterprises as those employing between 10 and 29 workers, and large-scale enterprises as those employing 30 or more employees”.

The definition of Small and Medium Scale Enterprises (SMEs) varies from country to country and from one institution to another. The classification of these enterprises can be based on the firm's assets, number of employees, or annual sales. “Under the Venture Capital Trust Fund Act 2004 (Act 680), a small and medium scale enterprise is defined as an industry, project undertaking or economic activity whose total asset base, excluding land and building does not exceed the cedi equivalent of US\$ 1 Million in value”. The National Board for Small Scale Industries (NBSSI) applies both the fixed assets and the number of employee criteria. It defines small and medium-scale enterprises as those with not more than 29 employees, and has plant and machinery (excluding land, building and vehicles) not exceeding 96,000 Ghana cedis.

“SMEs play an important role in economic development. In the contemporary world, they are seen not just as drivers of entrepreneurship, avenues of employment, and enhancers of social and political stability but also as sources of innovative and competitive power (Bhattacharya and Londhe, 2014). Finance, according to them forms the most critical input of a business entity irrespective of its size”. It is obvious that all firms need financing for growth and survival, and source finance internally (e.g. generated cash flows or owned funds) or externally (e.g. loans, equity infusions, government grants and subsidies). The activities of this

sector can be classified as production (crop and animal farming, food processing etc), trade (e.g. shop keeping) and service provision such as barbering.

Small businesses are thus integral to the economic development of local communities, contributing significantly to employment and income generation. However, securing adequate financing for working capital needs poses a critical challenge for small businesses. Working capital is essential for the day-to-day operations of small businesses, covering expenses such as salaries, inventory, and overhead costs, which necessitates a thorough examination of financing sources. This article explores various sources of financing working capital for small businesses and evaluates their effectiveness.

### 1. Traditional Banking Institutions

Conventional banking institutions, such as commercial banks, serve as primary sources of working capital financing for small businesses. They offer tailored financial products including overdraft facilities, lines of credit, and short-term loans. However, accessing financing from these traditional banks proves challenging due to stringent lending criteria, high collateral requirements, and bureaucratic tendencies.

### 2. Microfinance Institutions

Microfinance institutions (MFIs) have emerged as vital players in providing financial services to underserved segments, including small businesses. Offering microloans and flexible financial products, MFIs cater to working capital needs with less stringent criteria and collateral requirements compared to traditional banks.

### 3. Informal Sources of Financing

Small businesses also often resort to informal financing sources alongside formal financial institutions. These include contributions from family and friends, trade credit from suppliers, and personal savings of business owners. While informal sources offer quick accessibility, they may lack professionalism and reliability compared to formal institutions.

### 4. Government Support Programs

Government initiatives aimed at fostering entrepreneurship and small business development serve as alternative sources of working capital. These programs offer grants, subsidies, and low-interest loans to small and medium-sized enterprises (SMEs). However, accessing such support often involves navigating bureaucratic hurdles and meeting specific eligibility criteria.

Each financing source for working capital for small businesses presents advantages and limitations. While traditional banking institutions offer stability and professionalism, they may be inaccessible due to stringent requirements. MFIs provide greater accessibility but may come with higher interest rates. Informal sources offer flexibility but lack reliability, while government support programs offer financial assistance with bureaucratic challenges.

## Theoretical Review

### *Theories of Working Capital*

Three theories that underpin this study are the Myers' Pecking Order theory, and the aggressive and the conservative working capital approaches.

### *The Pecking Order Theory*

This theory was propounded by Myers (1984) who opined that firms prefer internal to external finance and fund their projects in a hierarchical style by first using internally generated funds (internal equity), followed by debt, and lastly external equity. SMEs do not normally have the option to issue equity owing to their size and limited resources. This makes internal finance more attractive to them than external. Similarly, they face serious challenges in securing finance from banks and allied financial institutions and this also justifies their reliance on internal sources to finance working capital. Thus, Myer's pecking order theory is relevant to this study since the sources of financing the working capital of SMEs are also evaluated by the study.

### *Aggressive Working Capital Approach*

The aggressive approach predicts that a firm that makes use of more short-term sources of finance than long-term sources will incur a minimal cost but will be exposed to high perceived risk. Liquidity problems could also ensue if there is an interruption in the flow of funds from short-term sources. In line with this, Pais and Gama (2015) argued that "with high levels of non-current assets and little investment in current assets, particularly with low cash balance and low level of inventory, firms generate more profits". This, however, presents a high risk of the possibility of insufficient funds for daily operations and paying short-term debts (Van-Horne and Wachowicz, 2008) as stated in Pais and Gama (2015). With the aggressive approach, "firms can reduce their financing costs or make more funds available for long-term investments by minimizing the investments in current assets (Nobanee and Abraham, 2015)".

### *Conservative Working Capital Approach*

This approach predicts that a firm will hold a large amount of non-fixed assets relative to total assets and this will generate lower profits and result in lower perceived risk (Nobanee and Abraham, 2015). With the conservative approach, firms finance their permanent assets and meet all seasonal demands with permanent capital. This reduces the risk of insolvency as the lives of both assets and liabilities are closely matched. However, funds may be invested in such investment which fetches small returns to build up liquidity. "Most small and medium enterprises do not have long-term assets such as buildings or vehicles and, consequently, the percentage of current assets over total assets is quite large (Garcia-Teruel and Martinez-Solano, 2007) as in Pais and Gama (2015)".

### **Empirical Review**

According to Bhattacharya and Londhe (2014), finance forms the most critical input for a business enterprise whether large or small. They assert that all firms require financing to grow and survive and sources of this finance could be external (e.g. loans, equity infusions, subsidies and government grants) or internal (e.g. generated cash flows or owned funds). Many firms are self-financed in the beginning. Once the firms reach a certain degree of maturity in the development of their product line and customer base, external finance becomes available. The flow of institutional finance is linked with the creditworthiness of the enterprise. Micro and small enterprises, due to their small size and low capital base, generally find it difficult to satisfy the conditions laid down by the banks, particularly, in establishing the viability of the project, meeting collateral requirements and making timely repayment of loans. Hence, they do not find a place among the preferred clients of the banks. Some researchers, business executives and managers of small and medium enterprises have attributed the failure of small and medium enterprises in Ghana and Africa to owner/managers inability to access credit (Adegbite, 1997) as stated in Fening and Park, (2008).

Most firms invest a significant amount of their resources in capital. This is especially true of smaller organizations (Deloof, 2003) as cited by Tran et al. (2017). Naturally, small businesses have limited access

to long-term markets. They tend to depend on their capital, loans from friends and relatives of their owners, short-term bank credit, and trade credit to finance the working capital required for day-to-day business operations (Tran et al., 2017). Therefore, most assets of small and medium-sized enterprises are in the form of current and current liabilities as their main sources of external finance (Garcia-Teruel and Solano, 2007) as documented in Pais and Gama (2015)".

Nobanee and Abraham (2015) opined that small firms are generally undercapitalized and hence dependent on owner-financing, trade credit and short-term bank loans. Further, the sizes of these firms make them more vulnerable to working capital fluctuations (Orobia, Padachi, & Munene, 2016) as noted in Nobanee and Abraham, (2015). Rafuse (1996) has pointed out that the insufficiency of working capital is the major reason for the failure of small businesses in developed as well as developing countries.

"Small firms are generally undercapitalized and hence dependent on owner-financing, trade credit and short-term bank loans (Nobanee & Abraham, 2015)". Access to finance is crucial for the profitability and sustainable growth of SMEs since it promotes the growth of existing businesses and facilitates the creation of new ones (Abdulsaleh & Worthington, 2013). However, sourcing finance has been problematic for SMEs owing to their sizes (Wilson & Summers, 2002), and lack of collateral (Xuegong & Xueyan, 2011). These compel banks to be selective in providing finance to them.

Xuegong and Xueyan (2011) used data collected from 151 Small and Medium Enterprises and 10 financial institutions through a survey conducted by local partners in three locations in China to study SMEs' access to finance. Their survey showed that there was selectivity among financial institutions in attending to the financial needs of SMEs. The financial institutions preferred larger, fast-growing and older SMEs in certain types of business. It also revealed that the institutions had more trust for older, experienced, and wealthier SME owners than others. Availability of collateral, business capability and strong innovation potential were other factors they considered in granting loans to SMEs. Their major finding was that banks are still the main sources of finance for SMEs despite the challenges SMEs face in working with them. In line with the findings of Xuegong and Xueyan (2011), Nguyen, Gan, and Hu (2015) found that gender, attributes of the owner, and level of education are the significant determinants of SMEs' access to credit followed by their relationship with customers and banks. They exploited primary data collected from a survey of 700 SMEs in 2013 and assessed the accessibility of credit to SMEs in Vietnam, identified the influential factors of their credit accessibility, and the interest paid on the loans they contracted. They employed logistic regression in determining the ability of SMEs to access credit and OLS to measure interest charged on the largest loans contracted by the SMEs. Regarding interest rates charged on loans, attributes of the owner were found to be statistically insignificant. They also found that money lending was the most expensive source of financing the operations of SMEs followed by loans from banks and microfinance institutions.

Wilson and Summers (2002) on the other hand, found "that it is demand and product characteristics that influenced the terms of credit which by logical extension determine the availability of credit to SMEs". They studied factors that affected lending to small business organisations. Their sample included firms with an employee base of 10. They further showed evidence that the size of a firm directly influences the choice of credit extension by setting limits on the likelihood of economies of scale. The firm size according to their findings also has an indirect influence on its access to finance and bargaining power (suppliers).

Similarly, Jie and Xiao (2002) "tested the ownership discrimination hypothesis, which indicates that the difficulty of SMEs in accessing finance results from the state-owned banking sector's discrimination against the private sector". On the contrary, the outcome of their survey did not support this argument. They used data obtained from a visiting-based survey on the financing structure and life cycle of SMEs in China and found that the life cycle of an SME was closely associated with its ability to access finance. On the contrary, a study by Xiankun (2009) (Petersen & Rajan, 1994) pointed to "factors other than the discriminatory and selective lending criteria of banks which inhibit SMEs' access to finance". The study carried out in

Dongping County, Shangdong province of China revealed that “major obstacles to access to finance by SMEs were poor track record of credibility, lack of collateral (most of the SMEs worked with hired equipment and property), unreliable SME financial information resulting from inappropriate book keeping, and high cost of loans from banks particularly where guarantees, insurance, and asset assessment were involved”.

Ikem, Chidi, and Titus (2012) also found that “SMEs’ access to finance largely depended on the reliability of accounting information they generated which was determined by the accounting practices they adopted. They examined the degree to which the financial difficulties of SMEs in Nigeria could be mitigated by accounting information using data collected from a sample of SMEs. They analysed a group logit model with the aid of an OLS technique for results”. As regards the influences of credit accessibility of SMEs, Petersen and Rajan (1994) had an empirical examination of how the cost and availability of credit to a firm are influenced by the relationship that exists between the firm and its creditors. They analysed data collected in a survey of SMEs with a response rate of 70 to 80 percent from 1988 to 1989. They found that the relationship had little effect on the price of credit. They, however, found such relationships to be more valuable in terms of volumes of credit that flow from the creditor to the firm.

Yong, Xiaoxia, Zhijun, and Tianqiang (2004) surveyed Wenzhou, Zhejiang Province of China, a city famous for its booming private sector. Their findings indicated that banks are increasingly displacing informal financing as the major channel of SME financing. They found that 78.9% of SMEs are now contracting bank loans whilst 68.6% and 45.7% of them still depended heavily on relatives and internal reserves respectively”.

Using a sample of firms selected from the 1988 Yearbook of the Metal and Engineering Industry (MTIA) of Australia, Holmes and Kent (1991) reassessed the concept of ‘finance gap’ that explains the differences in capital structure of large and small firms and offered an alternative explanation using the Pecking Order framework. Their results were in line with the view that the pecking order influences the capital structure of a firm and that variations between large and small firms could be related to the fact that small firms operate within a ‘constrained’ pecking order.

A study by Amoako-Tuffour and Ansah-Adu (2017) in Ghana revealed that stringent requirements and a lack of collateral often hinder small businesses’ access to formal financing, leading many to resort to informal sources like savings and trade credit.

Similarly, Gyasi et al. (2020) explored small businesses’ financing preferences in Ghana, highlighting a preference for informal sources due to their accessibility and flexibility. However, the study also underscored the limited availability of formal financing options tailored to the specific needs of small businesses. This therefore calls for the need for small businesses to diversify their funding sources.

### **Diversity of Financing Sources for Small Businesses**

Small business enterprises in Ghana encounter diverse hurdles when seeking financing to meet their working capital demands. Nevertheless, the presence of a wide array of financing channels presents opportunities for these businesses to secure the necessary capital for their operations. This literature review scrutinizes the spectrum of financing options accessible to small business enterprises, encompassing both formal and informal avenues.

#### **1. Conventional Banking Institutions**

Traditional banking establishments, such as commercial banks, persist as fundamental sources of financing for small enterprises globally (Berger & Udell, 1998). These entities offer an array of financial instruments

tailored to cater to the working capital requisites of small businesses, comprising lines of credit, term loans, and overdraft facilities. Nonetheless, small businesses often encounter hurdles in accessing bank financing due to stringent lending criteria, elevated collateral prerequisites, and protracted approval processes (Amoako-Tuffour & Ansah-Adu, 2017).

## 2. Microfinance Institutions

Microfinance institutions (MFIs) have emerged as pivotal entities in providing financial services to underserved segments of the populace, including small businesses (Karlan & Morduch, 2010). MFIs extend microloans and other financial products designed explicitly to address the working capital needs of small business enterprises. Unlike traditional banks, MFIs typically maintain more flexible lending criteria and may necessitate lesser collateral, rendering them accessible to a broader spectrum of small businesses (Coleman & Robb, 2009).

## 3. Informal Financing Channels

In addition to formal financial institutions, small business enterprises frequently resort to informal sources of financing to fulfill their working capital requirements. These avenues may comprise contributions from family and acquaintances, trade credit from suppliers, and personal savings of the business owner (Gyasi et al., 2020). While informal financing channels offer expeditious and accessible means of procuring capital, they may lack the professionalism and dependability associated with formal financial institutions.

## 4. Governmental Support Initiatives

Governmental endeavors and support programs geared towards fostering entrepreneurship and facilitating small business development can also serve as sources of working capital financing for small business enterprises (Amoako-Tuffour & Ansah-Adu, 2017). These initiatives may encompass grants, subsidies, and low-interest loans specifically targeted at small and medium-sized enterprises (SMEs). However, accessing governmental support programs often entails navigating bureaucratic procedures and fulfilling specific eligibility criteria, posing challenges for small enterprises.

Small business enterprises possess access to a myriad of financing channels for fulfilling their working capital requisites. Nonetheless, each avenue harbors its merits and demerits, compelling small business proprietors to meticulously assess their options based on their circumstances and financing necessities. By comprehending the diversity of financing avenues available, small enterprises can make informed decisions to effectively manage their working capital and foster their growth and sustainability.

## FINDINGS DISCUSSION

Results from the study revealed that there are 6 categories of small businesses that are operated in the capacities of Trading, Hairdressing & Barbering, Dressmaking, Electrical services, Printing & Photocopying centers and Transport & Mechanical services.

Table 1: Categories of Operators

SN	Categories of Operators	Frequency	Percentage (%)
1	Trading	41	34.17
2	Hairdressing & Barbering	15	12.5
3	Dress Making	12	10
4	Electrical services	20	16.67

5	Printing & Photocopying services	19	15.83
6	Transport & Mechanical services	13	10.83
	<b>Total</b>	<b>120</b>	<b>100</b>

Source: Field data 2024

The results show that some entrepreneurs jointly establish and manage their enterprises. However, most of the entrepreneurs were sole proprietors as depicted in Table 2. The sole proprietors constituted the bulk of operators with a frequency of 89 (74.17%) out of the 120 entrepreneurs.

Table 2: Nature of Business

Nature of Business	Frequency	Percentage (%)
Sole Proprietorships	89	74.17
Partnerships	18	15
Cooperatives	13	10.83
<b>Total</b>	<b>120</b>	<b>100</b>

Source: Field data 2024

### Sources of Financing Working Capital Required by Small-Scale Businesses in Tarkwa Nsuaem

The research findings show that 80 (66.67%) entrepreneurs self-financed the setup of “their businesses. The rest of the respondents borrowed money from the bank and friends and also purchased their goods on credit to actualise their business plans (see Table 3)”. This could be attributed to the banks’ apathy for granting loans to start-ups owing to their susceptibility to failure. This contrasts the finding in Yong, Xiaoxia et al. (2004) where 78.9% of SMEs in the Wenzhou, Zhejiang Province of China depended heavily on bank loans for setting up and running their operations. The finding, however, is in line with the Myers (1984) pecking order hypothesis which indicates that firms prefer internal to external finance and fund their projects in a hierarchical style by first using internally generated funds (internal equity), followed by debt, and lastly external equity.

Table 3: Sources of Investment Fund

Source	Frequency	Percentage (%)
Self-financing	80	66.67
Borrowed from the Banks	26	21.67
Purchasing on credit	9	7.50
Borrowed from friends	5	4.17
<b>Total</b>	<b>120</b>	<b>100</b>

Source: Field data 2024

Overall, small businesses in the Tarkwa Nsuaem Municipality could generally rely on the following financing options for their businesses.

Short-term sources: short-term financing is loans that are to be repaid within a year from the time they are borrowed. Banks, cooperatives, microfinance, rural banks, savings & loans and susu companies are some of the institutions that offer these loans. Bank overdraft is one such source of business finance for small



businesses in Tarkwa Nsueam.

**Long-term loans:** long-term financing represents the amount of money that is given to an individual or a company on agreement it will be repaid in a period exceeding 12 months and at predetermined interest rates. Long-term loans are usually secured against certain assets and are offered by commercial banks, the government and financial institutions. This type of loan provides long-term working capital for Tarkwa Nsueam businesses.

**Trade Credit:** this credit service offered by suppliers allows businesses to get goods and pay for them later. This is a source of working capital that may be acquired from all suppliers depending on the business arrangements, the type of business conducted and the worth of the credit to be offered.

## CONCLUSION

The purposes of the study were to evaluate sources of financing working capital, assess the accessibility and utilization of traditional financing options, examine the role and significance of alternative financing methods and propose recommendations to small-scale businesses in the Tarkwa Nsueam Municipality. The study covered 120 out of 225 operators of small-scale businesses in the Municipality. Most of the SME entrepreneurs in the Municipality strictly observe the pecking order theory of capital structure as they prefer personal funding of their businesses to bank funding due to stringent lending criteria and high collateral requirements.

The SME operators have been cautious of liquidity problems that engulf small-scale businesses and thus do not use short-term funds to finance long-term investments. They, however, have the challenge of meeting supplier deadlines frequently and have to negotiate with creditors to extend credit periods. This could affect the quantity of supplies received and invariably affect their ability to meet the demands of customers.

## RECOMMENDATIONS

It is commendable that business start-ups are funded with personal resources. It would however be better for SME entrepreneurs to also make good use of government entrepreneurial schemes such as those offered by the NBSSI and those of non-governmental organisations (NGOs) since these schemes come with education and training.

Where there is the need for entrepreneurs to buy supplies on credit, they should negotiate for longer payment periods at the outset of the transaction to avoid supplier apathy emanating from the entrepreneurs' failure to meet payment deadlines.

It is further recommended that a similitude of this study be undertaken among SMEs in a wider locality such as a region or nation as a test for consistency of the findings.

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